

# 2017 ON KOREA

VOLUME 10

Approaching North Korea

Emerging Issues in South  
Korean Foreign Relations

Understanding the South  
Korean Economy



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Located in Washington D.C., the Korea Economic Institute of America (KEI) is the nation's oldest nonprofit policy outreach and educational organization focused on promoting economic, political, and security relations between the U.S. and Republic of Korea. KEI aims to broaden and deepen understanding among American policy leaders, opinion makers, and the public about developments in Korea and the value of the U.S.-Korea relationship. Since its founding in 1982, the Institute has organized programs across North America and published research on a diverse range of issues, including U.S.-Korea trade and investments, the North Korea nuclear program, alliance issues, the role of Korean Americans in U.S. politics, and China's growing role in the Asia-Pacific region. Through its publications, outreach programs, social media outlets, and website, KEI provides access to in-depth and current analyses about the two Koreas and issues impacting U.S.-South Korea relations.

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- Publishing three celebrated annual volumes—*On Korea*, *Joint U.S.-Korea Academic Studies*, and *Korea's Economy*—used by experts, leaders, and universities worldwide.
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*KEI is contractually affiliated with the Korea Institute for International Economic Policy (KIEP), a public policy research institute located in Seoul and funded by the government of the Republic of Korea.*

## PREFACE

The Korea Economic Institute of America (KEI) is pleased to issue the tenth volume of *On Korea*, compiling the KEI Academic Papers released over the past year.

International developments ~~over the past year~~ have presented a number of challenges for Korea, but perhaps none is more alarming than the unprecedented increase in North Korean provocations. North Korea's ~~recent~~ nuclear tests and missile launches have sparked a debate on the effectiveness of punitive measures against the Kim regime in the last decade. The first section contributes to this conversation. The deterioration of the North Korean problem exacerbates an increasingly complex global political and economic landscape to which Korea must adapt. In this light, the second section identifies new areas of cooperation and potential fault lines for competition in Korea's foreign relations. To conclude the volume, the final section examines pressing issues in the Korean economy, with separate chapters to examine the influence of key domestic and externally driven factors.

KEI Academic Papers are commissioned following a call for proposals to academic and policy communities in the United States, South Korea, and around the globe. The objective is to provide opportunities for recognized specialists and new voices to present fresh research and innovative works on Korea. Moreover, these papers provide great examples of the breadth and depth of issues centered on Korea and those that affect the U.S.-Korea alliance. These papers are original pieces written exclusively for this volume. The authors also presented their findings before a Washington, D.C. policy audience. KEI prepares each paper for publication and distributes it to more than 5,000 recipients in governments, the private sector, policy institutes, and educational communities around the world.

For over 36 years, KEI has been dedicated to promoting objective and informative analyses and highlighting interesting policy research on Korea. We hope you agree this *On Korea* volume is a positive example of that calling.

The Honorable Donald Manzullo



President and CEO  
Korea Economic Institute of America  
January 2017

APPROACHING NORTH KOREA



## NORTH KOREA POLICY: RECOMMENDATIONS FOR THE TRUMP ADMINISTRATION

David Straub

### ABSTRACT

Among the most important issues that will confront the new Trump administration is how to deal with North Korea. Before Mr. Trump leaves office, North Korea may achieve the capability of attacking the United States with nuclear weapons, a situation previous U.S. leaders have deemed unacceptable. President Trump's policy needs to be based on a solid understanding of the complex and dangerous nature of the North Korea problem and the history of American involvement on the Korean Peninsula. To that end, the paper provides an unvarnished and unbiased assessment of American interests on the peninsula, past U.S. policy toward North Korea, and the current situation. It takes a fresh look at the critically important question of why North Korea's leaders seek to be able to credibly threaten the United States with a nuclear attack. The paper also critically analyzes many of most debated aspects of North Korea policy—the military option, regime collapse, unification, sanctions, negotiations, nuclear freeze, military exercises, peace treaty, and human rights and humanitarian aid—and explains in specific terms why none is a panacea. Finally, the paper offers and explains realistic strategic and diplomatic policy recommendations for the new U.S. administration. It concludes that, despite the challenges, the United States can defend its interests on the Korean Peninsula with a clear-eyed policy, increased resources, and political will.

**Key words:** *North Korea, United States, Trump administration, policy recommendations, leadership intentions*

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David Straub is a former Senior U.S. Foreign Service Officer who participated in the Six Party Talks and New York channel dialogue with North Korea.

## INTRODUCTION

Among the top problems facing the new Trump administration will be how to deal with North Korea, as the president-elect himself has indicated.<sup>1</sup> Since 1989, four successive presidents proved unable to stop Pyongyang from developing nuclear weapons and the means to deliver them. Under Kim Jong-un since 2011, North Korea has accelerated those programs. Experts fear it may achieve the capability to attack the United States with nuclear weapons during Mr. Trump's term in office, a situation many U.S. leaders have declared "unacceptable."<sup>2</sup>

As a candidate, Mr. Trump's statements about North Korea were few and inconsistent.<sup>3</sup> His positions were at odds with those of his predecessors from both parties, although he has since modified or retracted some. As president, Mr. Trump will need to make decisions about many urgent issues, but he should give priority to North Korea. At best, it will take President Trump months to put his North Korea team in place and flesh out his policy. In the meantime, Pyongyang may engage in dangerous provocations. Political turmoil in South Korea adds to the urgency.

Wise men groups, institutions, and individuals in the United States and throughout the world have recently published many North Korea policy studies and recommendations in anticipation of a new U.S. administration. Collective private-sector efforts tend to paper over differences among members, resulting in recommendations that are vague or internally inconsistent.<sup>4</sup> Those by institutions and individuals may reflect idiosyncratic understandings of the problem, and the way they valorize U.S. interests may differ from most Americans.<sup>5</sup>

This paper seeks to provide an unbiased and unvarnished assessment of the North Korea problem and realistic recommendations for a U.S. policy response, especially its diplomatic approach. The essential message is that the United States has the means to defend its interests, including those of its allies, if it adopts a policy based on a clear-eyed understanding of North Korean aims and summons the political will to implement it.

This study begins with a review of U.S. interests on the Korean Peninsula and the basic policy Washington has pursued since the Korean War. It then briefly assesses the current situation before focusing in detail on the critically important question of Pyongyang's strategic aims. It concludes with a discussion of policy elements and tools and some recommendations for the Trump administration.

## U.S. INTERESTS AND POLICY TOWARD NORTH KOREA

Since the Korean War, all American presidents have pursued the same basic policy toward the Korean Peninsula. The first priority for American presidents has been protecting, nurturing, and promoting South Korea. During the Cold War, U.S. leaders regarded it as essential to check communist expansion, and the deaths of nearly 34,000 Americans in the Korean War made it politically unacceptable at home to again risk the loss of South Korea. This led to the signing of a security treaty with the ROK in 1953, the stationing of American military forces in South Korea to this day, and large-scale support for South Korea in earlier decades. Thanks to South Korea's later economic success and democratization, Americans came to regard it as a model of the benefits of U.S. security policy for both the United States and its foreign partners.

The second U.S. priority has been avoiding another Korean War. It resulted in an enormous number of South Korean casualties, the destruction of Seoul, and outright conflict with the PRC. It also risked nuclear war with the Soviet Union. Yet strategically little more was achieved than a return to the *status quo ante*. Thus, President Nixon told Chou Enlai in 1972 that the Korean Peninsula "must never ... again" be "the scene of a conflict" between the United States and the PRC.<sup>6</sup>

For the past three decades, the United States has had a third priority: preventing North Korea from developing nuclear weapons. North Korea's possession of nuclear weapons, much less international acceptance of it, involves risks that threaten vital American interests. These include (1) undermining the global nuclear nonproliferation regime, a core element of U.S. security policy since the Truman administration; (2) North Korea's nuclear proliferation to other regimes or terrorists; (3) emboldening Pyongyang to the extent that it believes it can use conventional means to attack South Korea with impunity; (4) causing South Korea and Japan to question U.S. credibility, risking their development of nuclear weapons and the unraveling of the U.S. position in East Asia; and (5) becoming subject to North Korean blackmail or even nuclear attack on South Korea, Japan, and the United States itself.

After North Korea's nuclear activities became a concern, all U.S. leaders from President George H.W. Bush through President Obama used a combination of sticks and carrots to induce Pyongyang to stop and, now, roll back its nuclear weapons and long-range missile capabilities. The carrots are the establishment

of diplomatic relations; sanctions easing; economic, energy, and humanitarian aid; and the signing of a peace treaty. The sticks are the threat of ever-increasing diplomatic, economic, and financial sanctions, and—for the worst case—keeping open the option of militarily destroying its nuclear and missile capabilities.

### ***Tensions Among U.S. Strategic Priorities***

Tension between the top two U.S. priorities of protecting South Korea while avoiding war resulted in the United States consistently dissuading South Korea from retaliating militarily against North Korean attacks. This created a moral hazard that continued until 2010, when North Korea sank a ROK naval vessel and later engaged in an artillery attack on South Korean territory. Pressed by the ROK, United States agreed that South Korea could retaliate proportionately against future North Korea military attacks, but U.S. officials remain anxious this could lead to a retaliatory cycle and possibly another war.<sup>7</sup>

Tension also exists between the United States' top two priorities of protecting South Korea and avoiding another war on the Korean Peninsula, on the one hand, and, on the other, of ending North Korea's nuclear program. Although American presidents have sometimes referred to a military option against North Korea's nuclear program, they never seriously contemplated it due to the risk of another war.

### ***North Korea Policy Under the Obama Administration***

In 2009, newly inaugurated President Obama told North Korea he wished to negotiate an end to the nuclear program and resolve other issues of concern to both countries.<sup>8</sup> Just four months later, North Korea detonated a nuclear device that, unlike its first test in 2006, was fully successful. Nevertheless, the Obama administration soon began talks with Pyongyang that resulted in the “Leap Day deal” of 2012—U.S. food aid in exchange for a freeze on North Korean nuclear and long-range missile tests. North Korea launched a rocket into space six weeks later, sinking the deal and destroying what little hope for negotiations had remained in Washington. Especially since the imposition of UN sanctions after Pyongyang's nuclear and missile tests in 2009, the regime has repeatedly made it clear it has no intention of negotiating away its nuclear and missile capabilities.

After the Leap Day deal failure, the Obama administration held firm that it would negotiate but only if Pyongyang genuinely put its nuclear program on the table. As North Korea instead accelerated its testing of nuclear devices and missiles, the Obama administration led the international community in greatly increasing sanctions on Pyongyang. Prodded by Congress, the administration moved in 2016

to apply secondary sanctions on Chinese and other companies trading with North Korea. It also sharpened the focus on North Korea's human rights situation and designated leader Kim Jong-un personally responsible for it. Increasingly, U.S. and South Korean leaders publicly questioned the legitimacy of the North Korean regime, and U.S. and ROK statements and military exercises signaled to North Korea's top leaders that they could be destroyed if they threatened the other side.

At its outset, the Obama administration calculated that increasing pressure on Pyongyang while continuing to hold out the possibility of a negotiated denuclearization would slow down, if not soon stop, North Korea's nuclear and missile programs. Like the George W. Bush administration, the Obama administration sought to persuade the PRC to put much more pressure on Pyongyang to denuclearize. Far from slowing down the nuclear and missile programs, however, the new Kim Jong-un regime accelerated them. The two North Korean nuclear tests in 2016 alone have underlined that the longstanding U.S. approach will likely not work before Pyongyang achieves the capability of credibly threatening the United States with a nuclear strike. The Obama administration spent its final year trying to make its policy catch up with this new realization.

Nevertheless, it is not correct to argue, as many critics do, that the Obama administration pursued a policy of “strategic patience” that, in practice, meant “doing nothing.” Notably, the North Koreans strongly disagree with such critics. On November 21, 2016, their foreign ministry issued a long list of Obama administration measures during the past five years intended to force Kim Jong-un to give up nuclear weapons. It called them “...indeed unprecedented in its pace and intensity.”<sup>9</sup> That the Obama administration was not successful does not mean it was not fully seized of the problem or that it did not work hard to resolve it; it means that the North Korea problem is much harder than most critics appreciate.<sup>10</sup>

## THE NORTH KOREA PROBLEM TODAY

The North Korea problem has never been more serious. Pyongyang aims to credibly threaten not only South Korea and Japan but also the United States itself with a nuclear attack. North Korea claims it already has such a capability; experts doubt this but believe it will eventually be achieved, possibly during the Trump administration. Meanwhile, Pyongyang has not shied away from public threats to use nuclear weapons against the United States. North Korea may eventually have a nuclear arsenal on the scale of those of India and Pakistan, and its deployment of mobile missiles, tactical nuclear weapons, and nuclear-capable submarines could significantly increase the risk of war, including through accidental misuse.<sup>11</sup>

There is little reason for optimism that Kim Jong-un will, on his own, choose a better course. Initial international hopes that he might be a reformer evaporated years ago. While debate continues about the extent to which Kim has consolidated his position,<sup>12</sup> he has already been in power for five years. Efforts to put him under greater pressure to give up nuclear weapons have been weakened by the PRC's reluctance to support sanctions it fears might threaten his regime and risk instability along the two countries' 880-mile border. In recent years, North Korea's economy has grown slightly despite increased sanctions, and North Korean leaders appear increasingly confident they can manage the international consequences of their nuclear policy.

The U.S. position in Northeast Asia has been weakened over the past two decades by the widespread perception that the United States is declining while China is rising. The increasing strategic competitiveness of China and Russia with the United States has limited their cooperation with Washington on North Korea policy. China has come to share with North Korea the objective of ending the U.S.-ROK and U.S.-Japan alliances (although the goal is far more important and urgent for Pyongyang).<sup>13</sup> Only Japan remains strongly supportive of the U.S.-ROK alliance and U.S. policy toward North Korea, but its conservative administration is on poor terms not only with the PRC but also with South Korea.

Perhaps most important, South Koreans have long been severely polarized over North Korea, and the country is currently in political turmoil over a domestic scandal involving President Park Geun-hye, a conservative and North Korea policy "hawk." Even if she is not forced to step down before her term ends in February 2018, her authority has already been greatly diminished. If a progressive replaces her, South Korea will likely adopt an updated version of the sunshine policy of appeasing North Korea, including deemphasizing the use of sanctions.

## NORTH KOREA'S STRATEGIC AIMS

North Korea's nuclear threat is a product of its capabilities and intentions. Unfortunately, reliable intelligence about North Korean leadership intentions appears to remain unavailable, even to the U.S. government. Past U.S. leaders had hoped that Pyongyang's nuclear goals were limited to defensive purposes, such as military deterrence, as Pyongyang itself claims, and that it might be willing to negotiate away its nuclear programs for security assurances and aid. The failure of negotiations based on these assumptions has left unanswered whether Pyongyang was ever willing to end its nuclear programs or whether it engaged in a prolonged

and elaborate deception. In any event, its behavior over the past decade has resulted in an international consensus that it does not intend to give up nuclear weapons in the foreseeable future.

It is essential to understand North Korea's strategic goals and how nuclear weapons fit into these so that a suitable policy response can be formulated.<sup>14</sup> Like other countries possessing or pursuing a nuclear weapons capability, North Korea presumably has many reasons for doing so. These include defensive goals such as deterring military threats and other pressures—not only from the United States and South Korea but also from the PRC, Russia, and Japan—and bolstering domestic, especially military, support for the regime.

Although it is unlikely that North Korea's leaders, who have not acted suicidally, intend to attack the United States or its allies with nuclear weapons, their strategic aims have always included an offensive element: the unification of the Korean Peninsula on their terms. This is evidenced by North Korea's invasion of the South in 1950 and its contemplating doing so again in 1975 as South Vietnam fell; its continued military attacks and terrorism against South Korea; its rejection of ROK legitimacy; and its efforts to subvert South Korea through propaganda, threats, espionage, sabotage, and cyber-attacks.

North Korea's leaders have sought reunification on their terms because they regard the status quo as unsustainable and a negotiated reunification as unacceptable. They fear that South Korea will continue to outpace them and that their own people will rise up once they understand how successful South Korea is. Pyongyang's leaders cannot negotiate reunification because they know that would entail democratization of the North as well. In such a case, they could not rely on any guarantee of their personal immunity from prosecution, because they fear that demands for their punishment by their own former citizens would prove to be irresistible. North Korea's leaders therefore regard South Korea as the top long-term threat to their security, a threat that must be countered and, as soon as possible, eliminated.

To North Korea's leaders, the U.S. alliance is the South's mainstay. The United States has deterred North Korea militarily and provided South Korea vital diplomatic, economic, and technological support, while inducing the international community to deny the same to Pyongyang. To North Korea's leaders, who both identify with their regime and fear what would happen to themselves if it fails, the impulse to attribute most of South Korea's security and success to U.S. support is powerful.

North Korea's leaders have thus consistently sought to end the U.S.-ROK alliance, but to their consternation it has only grown stronger. Now they hope that the credible threat of being able to attack the United States with nuclear weapons will finally force Washington into negotiations aimed at undermining the alliance. Pyongyang's stated demands include acceptance of North Korea as a legitimate nuclear weapons state, removal of the U.S. nuclear umbrella over the ROK and Japan, an end to U.S.-ROK military exercises, the withdrawal of U.S. forces from the South, and a (bilateral) peace treaty with the United States (on North Korea's terms).<sup>15</sup> If *any* of these demands were accepted under the current circumstances, it would eviscerate the alliance.

To succeed, North Korean leaders feel they must make U.S. leaders believe they have the capability of attacking the United States with nuclear weapons. Thus, for some time now, they have been claiming they already have such a capability, even though most experts are doubtful. They must also convince American policymakers that even increased sanctions cannot dissuade the North but will only make it more determined.

In the meantime, however, members of the North Korean elite must suffer from profound psychological stress, because they cannot be certain their strategy will work in time and because the various risks require contradictory responses. For example, the need to intimidate the United States entails accelerating the nuclear and missile programs. But doing so results in increased international sanctions and greater efforts by the international community to propagandize the North Korea populace. In the worst case, they fear the United States might use military force to destroy North Korea's nuclear and missile programs. With North Korean leaders in such a difficult situation, it is not possible to predict with confidence what their near-term steps will likely be, for example, whether they will accelerate the nuclear and missile programs, engage in more attacks on South Korea, or revert to one of their occasional "charm offensives," perhaps directed this time at the new U.S. administration or a new South Korean government.

This theory of North Korean leadership intentions cannot be proven but it economically explains Pyongyang's behavior and has a great deal of historical evidence to support it. To those who would argue that North Korean leaders would have to be delusional to believe they might someday end the U.S.-ROK alliance, much less subvert the ROK, the author agrees they are very unlikely to achieve these aims. But North Korea's leaders see no better option, and as they have long pointed out to Americans, the United States has accustomed itself to India and Pakistan having nuclear weapons. North Koreans also rely on China's strategic mistrust of the United States to limit U.S.-PRC cooperation against them.

## NORTH KOREA POLICY ELEMENTS AND TOOLS

The complexity of the North Korea problem requires that U.S. policy makers have a clear understanding of the advantages and risks of various possible policy elements and the tools with which to achieve them. This section discusses some of the more important of these as the basis for the policy recommendations for the Trump administration that will be laid out in the concluding section.

### ***Military Option***

As noted above, American leaders never seriously planned to attack North Korea's nuclear and missile facilities for fear that Pyongyang would destroy Seoul. American planners also could never be certain they knew where all North Korea's facilities were located. Even if they did, Pyongyang would likely rebuild destroyed facilities, perhaps quicker than before. Much of the international community, including many South Koreans, would condemn the United States for reckless behavior, and China's reaction would be highly negative, entailing all but certain costs for the United States in its pursuit of a broad "positive" agenda with Beijing.

As North Korea has accelerated its nuclear and missile development, there has been a surge in speculation, especially in South Korea, that the United States might yet resort to military force. The argument is that North Korea's nuclear and missile programs have been too limited and primitive to constitute a serious threat to U.S. allies, much less the United States itself. But as North Korea approaches having the capability of threatening U.S. territory with nuclear attack, the top U.S. priority regarding the Korean Peninsula may change from protecting South Korea to protecting the United States itself. The lack of real-time insight into Pyongyang's intentions means that if North Korea develops the capability of attacking the United States with nuclear weapons, American leaders must assume they might actually do so.

The alternative argument in South Korea is that the United States will not be prepared to sacrifice San Francisco for Seoul, and so may enter into negotiations with Pyongyang that put the ROK in strategic peril. This has led some South Koreans to call for their country to develop its own nuclear weapons, or at least press Washington to reintroduce U.S. tactical nuclear weapons into South Korea.<sup>16</sup>

### ***Regime Collapse***

North Korea's regime stability has long been an issue of debate. Some accuse the United States of having foolishly waited for a collapse of the North Korean regime rather than negotiate with Pyongyang. Others argue that the regime has

long been on its last legs and that the United States should work for its collapse, as the only way to resolve the problems it presents.

The situation is more complex and fraught with risk than the advocates of either position appreciate. A regime such as Pyongyang is strong but brittle; someday it will suffer a dramatic disjuncture. Unfortunately, there is no way to estimate when that might occur, what form it might take, whether the situation would soon stabilize or result in even more instability, and whether the result would be better or worse. U.S. policy makers cannot count on change occurring before Pyongyang gains a nuclear capability against the United States homeland. Intensified U.S. pressures would somewhat increase the likelihood of change within North Korea occurring sooner, but other risks and uncertainties would remain.

### **Unification**

Soon after President Obama's inauguration, he and ROK President Lee Myung-bak proclaimed Korea's peaceful reunification to be a major goal of the alliance.<sup>17</sup> The United States has always supported Korea's reunification as a free and democratic state, but there has never been an occasion after President Truman's dismissal of General MacArthur in 1951 when U.S. leaders believed it might be achieved without incurring an unacceptable degree of risk to their higher priority of protecting South Korea.

Even in the best case—a peaceful collapse of the North Korean regime and initial cooperation by most North Koreans with a unification *process*—there is no guarantee that the *end state* of unification can be maintained. Moreover, the likelihood of a best-case scenario is low. Strong support from the South Korean establishment and people would be a necessary but not sufficient condition to make a success of a reunified Korea, but most South Koreans today are wary of reunification and unwilling to make sacrifices for it. If, in a reunified Korea, North Koreans came to feel that South Koreans did not respect them and were not prepared to help them, the result could be disastrous.

### **Sanctions**

All U.S. administrations since 1950 have made sanctions a major part of their response to North Korean misbehavior. The Obama administration significantly increased sanctions as North Korea accelerated its nuclear and missile programs, and it successfully encouraged the United Nations and many states to adopt similar measures. Under conservative leadership for the past nine years, South Korea too has greatly increased sanctions against Pyongyang.

Sanctions critics maintain that North Korea's totalitarian rule, primitive economy, lack of trade, and ability to rely on the PRC for vital imports vitiate sanctions.<sup>18</sup> Some argue that, as North Korea asserts itself, pressure against it has never worked and has only made it more determined. They add that no country has ever been more sanctioned and little else remains to be sanctioned.<sup>19</sup>

Others argue, convincingly, that several other countries, including Iran, have been subject to more stringent and effective sanctions than North Korea.<sup>20</sup> These observers note that some of the most wide-ranging and potentially punishing international sanctions were only imposed in 2016 and have not had time to take full effect. Advocates of this view are, however, not as persuasive in arguing that the United States can overcome or override the PRC's reluctance to increase sanctions on North Korea. It remains to be seen how Beijing will react to U.S. "secondary" economic and financial sanctions on Chinese entities. Beijing may reluctantly acquiesce but it could respond by countering U.S. policy toward North Korea, a risk that contributed to the Obama administration's hesitation to adopt such measures.

Although sanctions have so far not prevented North Korea from pursuing nuclear weapons and missiles, it is not correct to argue that they have had no effect. They have complicated, delayed, and raised the cost of North Korea's nuclear and missile programs. They have contributed significantly to North Korea's inability to grow its economy. Even with a slight uptick in the North and a slowdown in the South in recent years, the South's annual *margin* of economic growth is probably larger than the *entire* North Korean economy. The imposition of sanctions also reinforces the global nuclear nonproliferation regime.

North Korean leaders must regard their economic situation as strategically disastrous. It weakens popular support at home and results in the South becoming ever stronger relative to the North. Evidence for this is contained in the regime's statement on Kim Jong-un's execution of his uncle Jang Song-taek. Jang allegedly told his interrogators: "I attempted to trigger off discontent among service personnel and people when *the present regime does not take any measure despite the fact that the economy of the country and people's living are driven into catastrophe* (italics added)."<sup>21</sup> The statement, starkly at odds with Pyongyang's propaganda, also suggests a high degree of psychological stress and factionalism within the regime due to external pressures.

### **Negotiations**

The main argument of some critics is that U.S. administrations have erred in being unwilling to negotiate with North Korea. Since the failure of the Leap

Day deal, the Obama administration has insisted it will not negotiate with North Korea unless it demonstrates that it would engage in genuine talks about ending its nuclear weapons program. Critics, however, say the only way that the North Korea problem can be resolved peacefully is if Washington and Pyongyang engage in intensive negotiations to understand each other's interests and find a way to bridge their differences. At a minimum, they say, negotiations would serve to reduce tensions and the risk of North Korean provocations. What harm could it do, they ask rhetorically.

But it is the critics who err, in both their understanding of the situation and their policy recommendation. Since 1992, the United States has not opposed negotiation in principle with North Korea. The issue has been, not only for the United States but for North Korea as well, not *whether* to negotiate but on *what* terms. The United States is not willing to negotiate on the basis of North Korea being a legitimate nuclear weapons state, and North Korea is not currently willing to negotiate on any other basis.

If the United States negotiated unconditionally under the current circumstances, the international community would rightly regard it as evidence that the United States was moving toward acceptance of North Korea as a legitimate nuclear weapons state. The United States would lose credibility in the eyes of its allies and partners, and North Korean leaders would interpret the American move as proof their strategy was working. Even if the United States soon abandoned the negotiations, as it would likely do when confronted by North Korean intransigence, considerable damage to American interests would already have been done.

The critics are correct that it is important to understand Pyongyang as well as possible, but negotiations are not the only way of doing this. The United States government can engage in diplomatic dialogue with North Korea at the United Nations (the "New York channel") and elsewhere. American private citizens, including former senior officials, meet with North Korean diplomats. The United States engages in public messaging to North Korea and closely follows North Korea's public statements. The United States also has access to a great deal of information about North Korea from foreign sources, including those in direct contact with Pyongyang. The current problem is not that Washington and Pyongyang do not know and understand their respective policies and aims; it is that they know them *all too well*.

### ***The Freeze Mirage***

Some argue that North Korea will never give up nuclear weapons and thus the United States should accept indefinitely what they regard as the second-best

outcome, an agreement to limit the proliferation, scope, and technical development of its nuclear and missile capabilities.<sup>22</sup> Even outgoing National Intelligence Director James Clapper recently suggested publicly that he agreed with this view. (The State Department promptly repudiated his remarks.)<sup>23</sup>

While a freeze on North Korea's nuclear and missile development would be highly desirable, the closer one examines the concept, the less plausible it becomes. The most recent U.S. effort at a negotiated freeze was the 2012 Leap Day deal. Almost immediately, North Korea spectacularly violated it. Fundamental issues with a freeze remain unanswered by its advocates. For example, even if North Korea entered into another freeze, would it be willing to apply it to *all* its facilities? Do we even know where all of them are? Would it allow verification? How long would Pyongyang maintain a freeze?

Moreover, freeze advocates are vague about what the United States should be willing to provide North Korea in exchange for a freeze. What would Pyongyang demand from the United States to enter into a freeze? What else might it demand to continue it? What carrots and sticks could the United States wield if Pyongyang violated the freeze? In the Leap Day deal—five years, three nuclear tests, and scores of missile launches ago—the Obama administration was willing (or able politically) to provide only food aid in exchange for a North Korean pledge of a moratorium on nuclear tests and missile launches. Now, North Korea would almost certainly demand far more for a freeze, including, as it recently did, an end to U.S. military exercises with South Korea and a peace treaty on Pyongyang's terms.<sup>24</sup>

Most importantly, the international community would regard a negotiated freeze as tantamount to U.S. acceptance of North Korea as at least a limited nuclear weapons state for the indefinite future, because currently almost no one believes North Korea is willing to give up the nuclear weapons it already has. Counterarguments that the freeze would serve, or could be argued to serve, only as a stepping-stone to complete denuclearization would be thoroughly unconvincing. The consequences for mutual trust and confidence within longstanding U.S. allies, especially the ROK and Japan, could be devastating. The damage to the global nuclear nonproliferation regime would also be severe. It would increase the likelihood that Iran would break its own nuclear deal in the future and continue nuclear weapons development. Finally, North Korean leaders would interpret a freeze deal as strong evidence of a lack of American political will. They would either increase their demands for maintaining it or withdraw from it, in the expectation of an even better deal at another stage as they continued nuclear and missile development.

### ***U.S.-ROK Military Exercises and a Peace Treaty***

Two of North Korea's most-repeated and longstanding demands are for an end to U.S.-South Korean military exercises and the conclusion of a peace treaty. If the United States and the ROK are to be able to deter and defend against a North Korean attack, however, they must engage in regular military exercises of their plans, personnel, and communications. Because most U.S. military personnel are assigned to South Korea for only one year, exercises must be held annually to familiarize them with the terrain, their ROK allies, and U.S.-ROK military plans. North Korea conducts its own regular large-scale military exercises but gives no indication it would be willing to reduce, much less end them. A suspension or reduction of U.S. exercises would also be interpreted by Koreans north and south as an indication of American naiveté and lack of fortitude. It would weaken the alliance and only reinforce the North Koreans in their current course.

Pyongyang's call for a peace treaty is not intended to achieve an effective and sustainable peace mechanism to replace the Armistice Agreement but to facilitate a negotiations process aimed at ending the alliance. If Pyongyang were interested in a genuine peace treaty, it had an ideal opportunity to achieve one during the Four Party Talks from 1996 to 1998. Initiated by the ROK's Kim Young Sam and the Bill Clinton administrations, along with the PRC, precisely to establish a peace regime, these intensive negotiations achieved absolutely nothing. The consistent North Korean position was that all that was needed was for the United States to sign an otherwise blank sheet of paper entitled "Peace Treaty between the Democratic People's Republic of Korea and the United States of America." All entreaties to the North Korean diplomats to discuss tension-reduction and confidence-building measures to give substance to a peace treaty were ignored.

### ***Human Rights and Humanitarian Aid***

Since the end of the Cold War and even more so since the advent of the World Wide Web, the international community's focus on North Korea's abhorrent treatment of its own people has increased dramatically. No longer regarded as simply a subset of the free world's confrontation with the communist "bloc," North Korea stood out like a sore thumb in a democratizing world in the 1990s. The Internet and, later, smartphones, made it possible not only to develop a great deal of information about North Korea, but also to store, share, analyze, and act upon it. Under conservative governments for the past nine years, South Korea has played a leading role in this effort, but nongovernmental organizations focused on the problem have emerged all over the world and are cooperating closely.

The U.S. government was reluctant to press the human rights issue forcefully because it believed that would undermine its efforts to achieve a negotiated end to the nuclear problem. U.S. leaders also doubted they could do much to improve the human rights situation. But increasing pressure from U.S., South Korean, and international human rights organizations and the Obama administration's apparent loss of all hope that the North Korean regime might seriously negotiate even limited denuclearization steps led to the turnabout.

In recent years, the United States has helped lead efforts to condemn North Korea's human rights practices in the United Nations and elsewhere in the international community. It has also supported programs to document North Korean practices. In response to new U.S. legislation in 2016, the United States took the unprecedented step of designating Kim Jong-un as personally responsible for the North Korean human rights situation. Most observers do not fully appreciate how fundamental this is. It is a threat to put Kim Jong-un and his top officials on trial. It will be very difficult to roll back this measure even if it later becomes desirable for strategic reasons to do so. Also, recent statements by Washington and Seoul challenging the legitimacy of the regime are based not only on its defiance of UNSC resolutions against its nuclear and missile programs but also on its failure to protect its own people.

The U.S. and ROK governments have given almost no humanitarian aid to the people of North Korea for many years now, although they have allowed private organizations to do so. It makes little sense to provide official humanitarian aid to North Korea as long as the regime prioritizes the development of weapons of mass destruction over feeding its own people. This is especially so because global supplies of aid are insufficient to care for equally needy people elsewhere, as the World Health Organization's world "hunger map" illustrates.<sup>25</sup>

## RECOMMENDATIONS FOR THE TRUMP ADMINISTRATION

It will take a great deal of attention, resources, and determination to defend U.S. interests on the Korean Peninsula in the coming years. The following recommendations are not intended to be comprehensive but to contribute to the Trump administration's policy review by outlining a realistic general strategy and highlighting some opportunities and pitfalls.

The United States must maintain its position of never accepting North Korea as a legitimate nuclear weapons state, not even as a limited one. This means that the United States must increasingly impose sanctions and other pressures on Pyongyang as the regime engages in provocations. The United States must not

negotiate a freeze until it has a reasonable expectation that Pyongyang is prepared to engage in genuine denuclearization negotiations. If the United States adheres to this approach, its position with its allies and partners should be sustainable for the foreseeable future.

To end North Korea's nuclear threat peacefully, the United States must go further and lead North Korea's leaders to conclude that their strategy will not work. They must come to believe that the United States will ensure that North Korea will lose far more than it will gain by pursuing weapons of mass destruction. This will require a careful analysis of the domestic and international imperatives as seen by Kim Jong-un and other leaders of the regime, and the shaping of American pressures and inducements accordingly. The United States should not *gratuitously* seek to frighten or anger North Korea's leaders. The question the administration should always ask about U.S. policy measures is: will they serve to move the North Korean leadership in the direction we desire?

The optimal balance of pressures and inducements will increase the likelihood of a strategic recalculation by Pyongyang's current leaders or the emergence of a new leadership configuration more favorable to American interests. It will also maximize international support for the U.S. position. The United States should thus underline its desire for genuine negotiations that will not only denuclearize North Korea but will also address the regime's *legitimate* concerns and needs. The United States should consider being more specific about incentives for denuclearization, but only where possible to do so without encouraging Pyongyang to think that it can get even more, and need to give even less in return, by waiting longer or engaging in more provocations. A peace treaty should be negotiated only in the context of denuclearization talks, not before.

Washington should remain in periodic working-level communication with Pyongyang but not engage in formal negotiations under the current circumstances. Washington should inform Pyongyang that, as far as it is concerned, the New York channel always remains available to exchange information and views. The United States should also be receptive to holding official meetings occasionally in third countries to maintain communications and ascertain if there has been any change in Pyongyang's positions. American delegates must enjoy the full confidence of the president and always be authorized to engage in limited informal exploratory discussions if it seems to them that there might be movement on Pyongyang's part.

The human rights situation must continue to be pursued but care should be taken not to burn all bridges to the regime. To the extent consistent with the overall policy outlined here, the United States should do its best to avoid inflicting additional suffering on ordinary North Koreans. In any case, it should not resume humanitarian aid to North Korea under the current circumstances.

The policy outlined here will contribute to greater appreciation of U.S. policy on China's part. Beijing will nevertheless likely continue to resist imposing pressures on Pyongyang that it fears might cause instability. The United States should underline that its aim is not instability but North Korea's strategic recalculation and that it is far from eager for another crisis on the Korean Peninsula. In any event, the United States may yet achieve its aims with something less than the PRC's complete cooperation.

The United States should redouble its efforts to explain and justify its policy at home and abroad, especially in South Korea. Perhaps the greatest challenge to U.S. policy toward North Korea will come if South Korea elects a progressive president next year. If so, the ROK will likely pursue an updated sunshine policy. The United States cannot embrace such a policy but would need to seek a compromise approach with the new government. Inability to display a united public front with South Korea would risk the complete failure of the United States' North Korea policy and even its position in Northeast Asia. The United States should also undertake efforts to prevent a recurrence of the vicious cycle of history-related and territorial disputes that undermined ROK-Japan cooperation until recently.

Finally, the United States should ask Congress to approve major increases in personnel and budgets for all aspects of North Korea policy. These include defense, intelligence, diplomacy, sanctions implementation, human rights, and public relations, including getting more outside information to the North Korean people.

## CONCLUSION

The approach outlined above appears to be generally consistent with the policy views that Mr. Trump expressed as a candidate and since his election.

- Above all, this approach accords with Mr. Trump's emphasis on acting from a position of strength. The only hope of peacefully ending North Korea's nuclear and missile programs is to induce its leaders to realize that not giving them up will endanger their position more than keeping them. That will require a display of strength and determination, and a mix of carrots and sticks, that Pyongyang has not seen from Washington.
- President-elect Trump's expressed willingness to engage in dialogue and make fair deals could provide the basis for continuing to offer Pyongyang a negotiated "way out" while perhaps offering more specific inducements for complete denuclearization.
- Mr. Trump's criticism of the Iran nuclear deal strongly suggests he will agree that pursuing a North Korean nuclear freeze agreement is not in American interests.

- To obtain greater cooperation from Beijing on the North Korea problem, however, President Trump should reconsider some of his statements about PRC policy, including his call for high tariffs on PRC imports.
- Mr. Trump's strong support of human rights in places such as Cuba suggests he may give priority to the situation in North Korea as well. In doing so, he should keep in mind the possible trade-offs between targeting top leaders in Pyongyang on the human rights issue and their potential cooperation on the nuclear issue.
- With the Republican Party in control of both houses of Congress, President Trump can and should obtain the budget and manpower allocation to give top priority to the North Korea problem.

For North Korea's leaders, dealing with the United States is potentially a life-and-death matter and thus a top priority. They take it very seriously and are a much more formidable adversary than many imagine. The time has come for the United States to be equally as serious about Pyongyang. With a well-founded strategy and the political will to implement it, the United States can defend its interests and achieve its goals on the Korean Peninsula.

## ENDNOTES

- <sup>1</sup> President-elect Trump said of his November 10 meeting with President Obama: "... what I wanted to focus on [in the meeting] was—the Middle East, North Korea..." "President-elect Trump speaks to a divided country on 60 Minutes," November 13, 2016 (date of airing), <http://www.cbsnews.com/news/60-minutes-donald-trump-family-melania-ivanka-lesley-stahl/>.
- <sup>2</sup> In a recent example, former chairman of the joint chiefs of staff Mike Mullen said that "... if Beijing doesn't lead this [denuclearization effort], we're going to get to a point where he's [Kim Jong-un] going to be able to put a nuclear weapon on top of a [sic] intercontinental ballistic missile that could hit the United States, and that's *unacceptable* [italics added]." ABC TV, "This Week with George Stephanopoulos," broadcast November 27, 2016, <http://abcnews.go.com/Politics/joint-chiefs-leader-encouraged-trumps-cabinet-picks/story?id=43804170>.
- <sup>3</sup> Thomas Lee, "U.S. Presidential Candidates Comments on the Korean Peninsula," Korea Economic Institute, <http://keia.org/us-presidential-candidates-comments-korean-peninsula>.
- <sup>4</sup> One of the most prominent among recent wise men reports on North Korea policy is Mike Mullen and Sam Nunn, "A Sharper Choice on North Korea: Engaging China for a Stable Northeast Asia," Council on Foreign Relations, Independent Task Force Report No. 74, New York, September 2016, <http://www.cfr.org/north-korea/sharper-choice-north-korea/p38259>. Seven of the seventeen members wrote dissents.
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- <sup>6</sup> "Memorandum of Conversation, Wednesday, February 23, 1972 - 2:00 p.m.-6:00 p.m.," [http://nsarchive.gwu.edu/nsa/publications/DOC\\_readers/kissinger/nixzhou/13-17.htm](http://nsarchive.gwu.edu/nsa/publications/DOC_readers/kissinger/nixzhou/13-17.htm).
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- <sup>8</sup> The Six Party Talks in Beijing, initiated by the George W. Bush administration in 2003, had failed in late 2007 over Pyongyang's refusal to allow verification of its nuclear pledges.
- <sup>9</sup> "Memorandum of DPRK Foreign Ministry," Korean Central News Agency (KCNA), November 21, 2106, <https://kcnawatch.co/newstream/1479729751-569782885/memorandum-of-dprk-foreign-ministry/>.
- <sup>10</sup> Parts of this study elaborate on the author's arguments in the lecture, "North Korea Policy: Why the Obama Administration is Right and the Critics are Wrong," Stanford University, May 13, 2016, <http://aparcs.fsi.stanford.edu/events/north-korea-policy-why-obama-administration-right-and-critics-are-wrong>.
- <sup>11</sup> Siegfried S. Hecker, "The real threat from North Korea is the nuclear arsenal built over the last decade," *Bulletin of the Atomic Scientists*, January 7, 2015, <http://thebulletin.org/real-threat-north-korea-nuclear-arsenal-built-over-last-decade7883>.
- <sup>12</sup> Ken E. Gause, *North Korean House of Cards: Leadership Dynamics Under Kim Jong-un* (Washington, D.C.: Committee for Human Rights in North Korea, 2015), [https://www.hmk.org/uploads/pdfs/Gause\\_NKHOC\\_FINAL\\_WEB.pdf](https://www.hmk.org/uploads/pdfs/Gause_NKHOC_FINAL_WEB.pdf). Gause provides a detailed examination of Kim's role in the North Korean regime's power structure and the challenges he faces.
- <sup>13</sup> For example, in calling for an alternative security structure for Asia in May 2014, President Xi Jinping said, "To beef up and entrench a military alliance targeted at a third party is not conducive to maintaining common security," [http://www.fmprc.gov.cn/mfa\\_eng/zxxx\\_662805/t1159951.shtml](http://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1159951.shtml). Cited in Zhou Fangyin, "The U.S. Alliance System in Asia: A Chinese Perspective," *Asian Politics & Policy*, Vol. 8, Issue 1 (2016): 207-218.
- <sup>14</sup> Recently a few journalists have at least addressed the issue. See, for example, Max Fisher, "Maybe North Korea's Nuclear Goals Are More Serious Than Once Thought," *The New York Times*, July 13, 2016, [http://www.nytimes.com/2016/07/14/world/asia/maybe-north-koreas-nuclear-goals-arent-a-farce-after-all.html?\\_r=0](http://www.nytimes.com/2016/07/14/world/asia/maybe-north-koreas-nuclear-goals-arent-a-farce-after-all.html?_r=0).
- <sup>15</sup> In a recent restatement of some of North Korea's demands, its ambassador to the United Nations in Geneva declared: "If he (Trump) really gives up the hostile policy towards DPRK, withdrawing all the military equipment from South Korea, including the U.S. troops and coming to conclude the peace treaty, then I think it might be an opportunity to discuss the relations as we did in the 1990s." Stephanie Nebelay, "North Korea says could renew ties with U.S. under Trump if troops go," Reuters, November 17, 2016, <http://www.reuters.com/article/us-korea-north-nuclear-envoy-idUSKBN13C2GK>.
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- <sup>20</sup> See especially the in-depth analyses of Joshua Stanton, including in his blog *One Free Korea*, <http://freekorea.us/sanctions/#sthash.FBVYhZkQ.dpbs>.
- <sup>21</sup> “Full text of KCNA announcement on execution of Jang,” *North Korea Tech* (blog), December 13, 2013, <http://www.northkoreatech.org/2013/12/13/full-text-of-kcna-announcement-on-execution-of-jang/>. See also Gi-Wook Shin and David Straub, “North Korea’s Strange, Bloody Mistake,” *Bulletin of the Atomic Scientists*, December 20, 2013, <http://thebulletin.org/north-korea’s-strange-bloody-mistake>.
- <sup>22</sup> Dr. Siegfried S. Hecker, a Stanford University professor and former director of the Los Alamos National Laboratory, is perhaps the most prolific freeze advocate. See, for example, Siegfried S. Hecker, “Lessons learned from the North Korean nuclear crises,” *Dædalus*, Winter 2010, pp. 44-56, <https://cisac.fsi.stanford.edu/sites/default/files/Hecker.pdf>. See also Steve Fyffe, “Hecker assesses North Korean hydrogen bomb claims,” *Bulletin of the Atomic Scientists*, January 7, 2016, <http://thebulletin.org/hecker-assesses-north-korean-hydrogen-bomb-claims9046>.
- <sup>23</sup> David Brunnstrom, “Getting North Korea to give up nuclear bomb probably 'lost cause': U.S. spy chief,” Reuters, October 26, 2016, <http://www.reuters.com/article/us-northkorea-nuclear-clapper-idUSKCN12P2L7>.
- <sup>24</sup> “‘Still valid are all proposals for preserving peace and stability on the peninsula and in Northeast Asia including the ones for ceasing our nuclear test and the conclusion of a peace treaty in return for U.S. halt to joint military exercises,’ North Korea’s official KCNA news agency cited a spokesman for the country’s foreign ministry as saying early on Saturday.” Tony Munroe et al., “North Korea says peace treaty, halt to exercises, would end nuclear tests,” Reuters, January 16, 2016, <http://www.reuters.com/article/us-northkorea-nuclear-usa-idUSKCN0UT201>.
- <sup>25</sup> The World Food Program’s world “hunger map” may be found at <http://www.wfp.org/content/hunger-map-2015>.

## AUTHORITARIAN REGIMES AND ECONOMIC SANCTION EFFECTIVENESS: THE CASE OF NORTH KOREA

Dursun Peksen

### ABSTRACT

North Korea has been under several rounds of economic sanctions since the beginning of the Korean War in 1950. Economic coercion, however, has had no major effect on the Kim regime’s political stability and nuclear program. Drawing from the literature on the survival of authoritarian regimes and sanction effectiveness, this article focuses on key domestic policies the regime has employed to survive foreign pressure. I posit that Pyongyang has been able to remain defiant against foreign pressure through the use of two main domestic strategies: positive inducements and repression. I specifically argue that the North Korean regime has evaded the negative effects of sanctions by offering selective rewards to the small ruling coalition in exchange for loyalty and quelling opposition through the total surveillance of society and efficient institutions of repression. The analysis suggests that neither comprehensive economic sanctions targeting the entire economy nor selective sanctions aiming at the ruling elites have been fully successful in achieving the ambitious goals of regime change and denuclearization in North Korea. Extensive sanctions might have even done more harm than good by further worsening the dire living conditions of ordinary citizens. The U.S. and other major sanctioning countries should have instead sought alternative policies to empower average citizens to create a strong domestic opposition pushing for political liberalization and other reforms. Selective sanctions targeting the regime’s nuclear and military capabilities could still be useful to slow down the development of advanced nuclear weapons and contain aggressive state behavior.

**Key words:** *North Korea, economic sanctions, sanction effectiveness, authoritarian regimes, coercive diplomacy*

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Dr. Dursun Peksen is an Associate Professor of Political Science at the University of Memphis.

## INTRODUCTION

Economic sanctions are popular policy tools in foreign affairs. The U.S. in particular has threatened or imposed sanctions against more than 100 different countries since 1945, more than any other state.<sup>1</sup> Policymakers initiate sanctions to deal with a wide spectrum of foreign policy issues such as nuclear proliferation, human rights violations, terrorism, and trade disputes. Despite the frequent use of sanctions, there is some consensus among scholars and policymakers that sanctions rarely attain their intended policy goals. Scholars estimate that sanctions fail 65-95 percent of the time.<sup>2</sup> Existing research on the consequences of sanctions suggest that economic coercion might even become a counterproductive tool causing major economic distress, humanitarian crises, and human rights violations in target countries.<sup>3</sup>

North Korea has been one of the main targets of international sanctions since the onset of the Korean War in 1950. Pyongyang has been subject to several rounds of sanctions in the form of trade embargoes, financial restrictions, aid cuts, and travel sanctions. The U.S.-led sanctions during the Cold War intended to destabilize the authoritarian Kim regime and maintain peace on the Korean Peninsula. The UN, the U.S., and other countries have levied additional sanctions in the post-Cold War era to stop the regime's nuclear program. Sanctions have inflicted major economic damage over the years and excluded North Korea from the global economy. The country today has very limited trade and financial ties with the rest of the world. In fact, just one country, China, accounts for about 90 percent of North Korea's foreign trade.<sup>4</sup>

Though Pyongyang has been under foreign economic pressure for over six decades, the sanctions have had no major impact on the regime's stability and nuclear program. It appears that regime change may not occur in the near future as the regime under the leadership of Kim Jong-un faces no major domestic opposition. Further, the defiant North Korean leadership does not seem to be deterred by the sanctions directed at its nuclear program and military capacity. To prove its resilience, the regime responded to foreign pressure by conducting more nuclear and ballistic missiles tests in recent years.

Why has economic coercion failed against North Korea? What are the possible policy implications of the failed North Korean sanctions? Can sanctions be better designed to extract concessions from authoritarian regimes such as the one in North Korea? Drawing on the literature on the survival of authoritarian regimes and economic sanctions, I posit that economic coercion against North Korea has been ineffective in part because the Kim regime evaded sanctions by pursuing two key strategies: selective rewards and repression.<sup>5</sup> Pyongyang has been able to keep its relatively small coalition intact through supplying selective incentives and rewards in exchange for loyalty. The regime has also been successful in

quelling dissent and opposition. Hence, a cohesive ruling coalition combined with a nonexistent opposition has enabled the regime to stay firm against external demands for policy change. I also argue that both comprehensive and more targeted sanctions have had no major influence on the longevity of the regime and its pursuit of nuclear weapons.<sup>6</sup>

In the next section, I discuss how policymakers in sanctioning countries tend to assume that sanctions work to achieve their intended goals. Then, I explain why economic coercion against authoritarian targets might not operate in practice as expected by policymakers. I specifically discuss how autocrats opt for two key domestic strategies, positive inducements and repression, to defy sanctions. I conclude with a discussion of possible policy implications of the ineffective sanctions against North Korea.

## HOW ARE SANCTIONS EXPECTED TO WORK?

According to traditional understanding of sanctions, economic hardship inflicted by sanctions will undermine both coercive capacity and the support base of the leadership. This would in turn coerce target regimes into conceding to the external demands for policy change.<sup>7</sup> Sanctions are imposed with the expectation that they will impair the target's coercive capacity by restricting its access to essential economic and military resources. Coercive capacity is crucial for any government to monopolize economic and military power and to project its authority over the entire country. As foreign economic pressure denies the regime's access to crucial resources, the expectation is that the leadership will give in to foreign pressure to avoid the erosion of its authority.

The traditional understanding of sanctions also assumes that foreign pressure will undermine the support base of the target leadership. Supplying positive inducements to key political elites such as high-ranking military officials and business leaders is crucial for the regime to cling to power.<sup>8</sup> These inducements could be in the form of subsidies, tax breaks, and access to goods made scarce by economic sanctions. Economic coercion will decrease the regime's ability to provide economic resources to their key support base, as these are made scarce by the sanctions. Diminished economic capacity to offer positive inducements will result in a loss of support among key groups who are accustomed to receiving these benefits. Further, sanctions will mobilize anti-regime groups against the regime. Sanctions create economic frustration among average citizens as the target economy faces higher levels of inflation and unemployment. Growing economic grievances will subsequently lead to more protest against the government. As a result, according to the traditional understanding of sanctions, mounting anti-government protests combined with a decline in support among regime loyalists will force the target regime to capitulate to foreign demands.

## HOW DO SANCTIONS OPERATE IN PRACTICE?

The logic advanced by the traditional understanding of sanction effectiveness might not apply to most cases involving authoritarian regimes such as North Korea. In this section, I assert that autocratic regimes with a relatively small support base and high degree of institutionalization are likely to evade the anticipated political and economic costs of the coercion. I posit that these autocratic regimes survive foreign pressure by employing two main strategies: selective rewards and repression.

### ***Small Ruling Coalition, Selective Rewards, and Sanction Ineffectiveness***

Economic sanctions might inflict considerable damage on a targeted economy's foreign trade and financial ties. Target economies, on average, experience about a 3 percent decline of gross national product (GNP) and suffer from relatively high levels of inflation and unemployment rates during the sanction years.<sup>9</sup> Yet previous research shows that the target leadership and its support coalition rarely suffer from the sanctions while average citizens disproportionately bear the burden of the coercion.<sup>10</sup> Target regimes respond to foreign pressure by taking control of the economy or intervening in it to affect the distribution of wealth. They do so to divert the cost of sanctions to ordinary citizens and use remaining resources to offer selective rewards to their supporters to shield them from the economic hardship and thus preempt defections from their ruling circle.

Though most leaders facing sanctions might be inclined to provide positive inducements to their followers, their ability to do so could be contingent on the size of their support coalition. Leaders in democratic target regimes rely on a large support base (i.e., all voting-age citizens or a large portion of them) to retain power. Hence, they might lack enough capacity to provide rewards and incentives to satisfy a large segment of society affected by sanctions. They might therefore be more inclined to concede to foreign pressure in order to end the economic suffering of their citizens and thus avoid losing political power. Authoritarian regimes, on the other hand, are dependent on a small group of elites to stay in power.<sup>11</sup> Most dictatorial rulers depend on a cohesive, small group of elites such as party leaders, military officials, and business groups.<sup>12</sup> Because of the small size of the support coalition, authoritarian regimes under sanctions might be better positioned to protect their supporters through positive inducements.

North Korea is a prime example of an authoritarian regime with a relatively small and cohesive ruling coalition. The North Korean regime has been in power for over six decades under the leadership of the Kim family. It is a leader-centric regime with established bureaucratic institutions. The class system, *Songbun*, developed by the leadership determines each citizen's status in society, and access to basic needs and employment opportunities. There are three main classifications

that include the "core class," the "wavering class," and the "hostile class." The regime essentially relies on a coalition of high-ranking military officials, Korean Workers' Party leaders, and top bureaucrats, a large portion of which are members of the extended Kim family. Others who hold prominent military and party posts are members of the "core class" and chosen based on their family background and personal connections with the Kim family.<sup>13</sup>

Although the North Korean economy has long suffered from harsh sanctions and domestic difficulties such as the severe famine of the 1990s, the leadership has been able to insulate its support base from the dire economic conditions. The regime provides various private goods and benefits to its ruling coalition in return for their loyalty. For instance, most members of the ruling circle hold desirable jobs in the capital. They are allowed to have residency in Pyongyang and get special housing benefits. The ruling elites also receive more and better quality food, and have access to scarce goods such as luxury cars, jewelry, and electronics.<sup>14</sup> Thus, the North Korean elites appeared to have suffered disproportionately little from the economic deprivation inflicted by the sanctions over the years.

Some regime loyalists even gain directly from the sanctions by participating in illegal economic transactions. Members of the ruling coalition have long been involved in illicit economic activities to generate revenue and mitigate the adverse effects of global economic isolation due to the sanctions. Major illegal activities include money laundering, arms and human trafficking, and counterfeiting goods and currency. It is suggested that the regime encourages state officials to participate in and profit from underground economic activities by using state-controlled trading companies to coordinate smuggling and other illicit activities.<sup>15</sup>

Overall, there is no strong evidence that the imposed sanctions have succeeded in destabilizing the ruling coalition. On the contrary, foreign pressure might have boosted the allegiance of the ruling elites to the leadership as the regime grants economic rewards and secured access to scarce resources. Since the ruling elites benefit from the current system, they likely have an interest in the survival of the existing regime even though a large majority of North Koreans exist under harsh living conditions which are exacerbated by sanctions.

### ***Coercive State Apparatus, Repression, and Sanction Effectiveness***

In addition to sustaining the allegiance of their support coalition through positive inducements, autocratic leaders might resort to repression to eliminate societal opposition triggered by sanctions. The negative economic effects of sanctions on groups outside of the ruling coalition might create economic grievances and frustration against the state. The international disapproval of current leadership—signaled by the sanctions—might also encourage opposition groups to mobilize dissatisfied citizens against the government. However, existing research on

sanctions suggests that target leaders tend to eliminate growing dissent and opposition using various repressive means such as extrajudicial killing, torture, and political imprisonment.<sup>16</sup>

Democratic target regimes are less likely to suppress growing opposition using repression. Leaders in democracies are unlikely to pursue repressive strategies since they are constrained by institutional mechanisms such as the rule of law and checks and balances.<sup>17</sup> Autocratic leaders, on the other hand, do not face similar institutional constraints to apply violent means. Therefore, dictators facing domestic or foreign threats might be more inclined to use torture, political imprisonment, and other forms of repressive tactics to cling to power.

The North Korean regime is considered to be among the world's most repressive regimes. The government effectively monitors, discourages, and quells opposition. The regime has no tolerance towards even the mildest criticism of the leadership. Citizens are not permitted to hold independent meetings and gatherings without the regime's approval and surveillance. There is also no independent media in North Korea. The state fully controls the media to ensure the dissemination of biased information. The regime has a system of informants to detect organized dissent. Informants are installed at factories, schools, and party offices. Every citizen is part of a neighborhood unit called *Inminban*. Each member of the neighborhood-watch system is required to monitor fellow members and report anti-regime activities to the party authorities. Those who have been suspected of political disobedience and other subversive activities often face harsh punishments such as public executions, torture, and years of imprisonment in prison camps.<sup>18</sup>

Even if the sanctions might create economic grievances and dissatisfaction with the current leadership, ordinary citizens simply lack channels to organize opposition. Its full control over the state apparatus, total surveillance of the society, and efficient institutions of repression help Pyongyang eliminate any challenges to its authority. Thus, the failure of economic coercion against North Korea is consistent with what might be expected given the domestic make-up and practices of the state.

### CAN ECONOMIC SANCTIONS BE DESIGNED BETTER?

In this manuscript, I have argued that economic sanctions have been ineffective against North Korea in part because Pyongyang has been able to shield its support coalition from the economic hardship experienced by the ordinary citizenry, and has employed repression to quell any potential opposition. Can sanctions be better designed to put pressure directly on the ruling circle?

The U.S.-led sanctions during the Cold War were mostly comprehensive measures aimed at fully restricting North Korea's trade and financial transactions with

Western economies. The sanctions in the post-Cold War era, on the other hand, are aimed more at the ruling elites. Some of these targeted sanctions have been on the export of luxury goods and products to Pyongyang and travel sanctions against high-ranking party and military officials. The U.S. also levied financial sanctions on foreign banks that do business with the regime in order to disrupt illicit financial activities. There have also been export sanctions on dual-use technologies which could be utilized in the regime's nuclear program. Yet neither extensive sanctions nor more targeted sanctions have been effective in weakening the coercive capacity of the Kim regime and inducing major policy change.

Comprehensive sanctions against North Korea over the years have deteriorated the already poor living conditions of ordinary citizens as the economic pain has disproportionately fallen on them. Policymakers should avoid extensive sanctions that amplify the economic suffering of ordinary North Koreans while simultaneously doing little to achieve significant behavioral shifts or outright regime change in the capital. On the contrary, sanctions and other policies should seek ways to empower ordinary North Koreans, as they are crucial for a strong civil society and an organized dissent against the current leadership to emerge in the long term.

It also appears to be unrealistic to expect economic sanctions to induce compliance when the target is not economically dependent on sanctioning countries. The U.S. and its two close allies in the region, Japan and South Korea, have very limited economic or diplomatic leverage over Pyongyang. They have either completely cut or minimized their economic and diplomatic ties with the regime due to the sanctions. China is the only major power that maintains relatively strong economic and diplomatic relations with North Korea. Yet, given China's own questionable human rights record and strategic rivalry with the U.S. on the Korean Peninsula, China is unlikely to support any sanctions that promote political liberalization and an eventual regime change in North Korea. Since North Korea is a buffer state between China and the U.S. troops deployed in South Korea, China has more strategic and security interests in the survival of the Kim regime. Thus, the degree of support China will lend to any UN-led and other sanctions would be confined to slowing North Korea's nuclear ambitions and other policies that do not directly threaten the survival of the Kim regime.

While Pyongyang might not trust the U.S. due to their long history of hostile relations, Japan and South Korea could still develop policies that increase the openness of the North Korean economy to the rest of the world. Rather than seeking direct bilateral or multilateral communication with Pyongyang, higher volumes of trade and investment that benefit the North Korean economy in general might be more beneficial. More economic openness might make average citizens aware of better living conditions and basic rights and freedoms enjoyed by citizens of other countries. More exposure to the rest of the world might in turn

prompt North Koreans to demand similar basic rights and freedoms from their own regime.

The failed record of the sanctions does not imply that coercive economic policies should completely be abandoned in dealing with Pyongyang. Export sanctions on dual-use technologies and other materials used for nuclear purposes could still be partially effective. The ruling elites will not dismantle the nuclear program as it is an important deterrent to external aggression and a security guarantee for the regime's survival. Though selective sanctions targeting the nuclear program will not necessarily result in a reversal of the nuclear program, they might at least impede or delay the regime's ability to develop more advanced nuclear technologies and equipment.

Targeted sanctions on luxury goods could also help put some pressure on the ruling elite if implemented effectively. There have been multiple rounds of UN sanctions on the export of luxury goods to North Korea since 2006. These selective sanctions have, so far, failed as the regime has continued to access most luxury items through illicit trade and the use of intermediaries. There is also evidence that some sanctioning countries, such as China, appear to have failed to strictly enforce the export ban on luxury goods to North Korea.<sup>19</sup> The ban on luxury goods has also not been very effective because there is no consensus among sanctioning countries on what comprise luxury goods, as different countries have different lists of luxury goods. Hence, selective multilateral sanctions on luxury goods and other items would help pressure Pyongyang if the U.S., China, and other sanctioning countries agree on a shared list of luxury goods, create a mechanism to enforce the sanctions, and establish rules and procedures to penalize countries and private actors who breach sanctions.

Financial sanctions on foreign banks could also be used to curb the regime's ability to have access to foreign currency and disrupt its illicit financial activities. For instance, the U.S. Treasury Department's decision to blacklist a Macau-based bank, Banco Delta Asia, accused of money laundering in 2005 forced the government of Macau to freeze North Korean deposits in the bank. Though the impact of the financial sanctions was short-lived, as the regime found other ways to do business through clandestine networks and third-party actors, it still initially restricted the regime's access to hard currency and the international financial system.<sup>20</sup> Thus, financial sanctions such as the recent Treasury Department's designation of North Korea as a "primary money laundering concern"<sup>21</sup> could put more direct pressure on the regime by blocking its access to the U.S. dominated global financial system. Most countries and their financial institutions would be compliant with financial sanctions in order to avoid being kept out of the U.S.-dominated financial system and tarnishing their own reputation by cooperating with countries under financial sanctions.

In conclusion, targeted measures such as financial sanctions and the ban on luxury goods could work if sanctioning countries find ways to effectively enforce them. The biggest challenge with targeted sanctions appears not to be the intention behind them (i.e., pressuring the ruling elites) but rather the difficulties with enforcing them in an efficient manner. The U.S. and other sanctioning countries should devote more attention to the degree of coordination in the enforcement of sanctions and create more sophisticated enforcement mechanisms, such as stricter border controls and financial transaction monitoring procedures, to minimize sanction-busting through overt or clandestine activities.

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EMERGING ISSUES IN SOUTH KOREAN  
FOREIGN RELATIONS



## A FORK IN THE ROAD? KOREA AND CHINA'S ONE BELT, ONE ROAD INITIATIVE

Balbina Y. Hwang

### ABSTRACT

In 2013, two countries in East Asia launched their respective visions for an East-meets-West integrated region: China pronounced one of the most ambitious foreign economic strategies in modern times by any country, “One Belt, One Road” (OBOR), and South Korea launched the “Eurasia Initiative” (EAI). This paper examines the rationale, contours, implications, and possibilities for success of Korea’s EAI within the context of China’s OBOR, because a study of the former is incomplete without a clear understanding of the strategic political and economic motivations of the latter. This paper also draws conclusions about how EAI reflects South Korea’s national and regional aspirations, as well as the security implications for the relationship and interaction between the two countries’ alternate visions for a Eurasian continent. While Korean and Chinese visions superficially share a broad and similar goal of connecting two separate regions, ultimately their visions diverge fundamentally on conflicting understandings about national and regional security, and the political and economic roles that each country plays in achieving their ambitions.

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Balbina Y. Hwang, Ph.D., is Visiting Professor at Georgetown University.

## INTRODUCTION

If the 21st century ultimately fulfills its predicted destiny as the “Pacific Century,” future historians may mark 2013 as the watershed year in which the gravity of world power shifted decisively towards the Asia-Pacific. In this year, the revival of the ancient “Silk Roads” suddenly reemerged to captivate the attention of policymakers around the world, and to spark the imagination of countless scholars and analysts who speculate about the emergence of a “New Great Game” over power and influence in the dynamic but uncertain region.

The sheer number of great powers and their potential ambitions in the Asia-Pacific are contributing to complex regional dynamics: among these are Russia’s “Eastern Dream,” India’s “Act East” policy, Japan’s “Free and Open Indo-Pacific Strategy,” and even the U.S. “Pivot to Asia.” Yet, perhaps the two most intriguing and notable visions for the region may be China’s “One Belt, One Road” (OBOR), and South Korea’s “Eurasia Initiative” (EAI). While the former clearly overshadows the latter—and frankly all other regional initiatives—due to the overwhelming breadth and scope of China’s ambitious plans, the relatively tiny South Korea’s aspirations may ultimately hold the key to the success or failure of China’s grand vision.

In September 2013, China’s President Xi Jinping officially initiated one of the most ambitious foreign economic strategies in modern times by any country: OBOR. If fully realized, it will fundamentally alter the economic, political, and social relationships between Eastern and Western societies. Notably, just one month later in October, South Korea’s President Park Geun-hye articulated her own vision for an East-West connection. Her call for an “Era of Eurasia” echoed the image of building a “Silk Road Express” which calls for physically linking the Western European continent with the farthest eastern end of the Asian continent, the Korean Peninsula.

Neither of these ideas is particularly original or new as they have waxed and waned over the centuries since the original Silk Road two thousand years ago allowed the flow of enormous quantities of goods, people, and ideas between the two continents. Today, as in previous eras, integration efforts are being driven largely by the multiplicity of great powers with strategic interests and equities in the Asia-Pacific. And as in the past, their ambitions and actions have profound consequences for the myriad smaller states and societies that occupy strategically valuable geography that separates the great powers. One notable difference in the present era is that South Korea for the first time in its 1,000-plus year history (previously united until 1948) as an independent state, finds itself an indisputable regional and global “middle power.”

Since 1996 when the Republic of Korea (ROK – South Korea) joined the Organization for Economic Cooperation and Development (OECD), this new and

unfamiliar status as a “modern” and significant country has profoundly altered South Korea’s national ambitions and broadened its ability to achieve them, even as the regional power structure and its attendant security challenges have remained largely unchanged and constant. Thus, regardless of its middle-power heft today, South Korea—and indeed the entire Korean Peninsula—has and always will be overshadowed by far larger powers which surround it geographically and imposes an inescapable sense of vulnerability for the Peninsula.

Exacerbating South Korea’s insecurity in particular is the peculiar challenge posed by North Korea, which since its very inception as the Democratic People’s Republic of Korea (DPRK) in September 1948, has posed an existential threat to the ROK, and vice versa. Moreover, because the DPRK occupies the northern half of the Korean Peninsula, its continued existence effectively makes the ROK a geographic island, physically cut off from the Asian continental landmass. Thus, South Korea has unsurprisingly maintained a remarkably consistent national security strategy, given the persistent threat from the North since the Korean War ceased with an Armistice in 1953 rather than a permanent peace treaty.

Conventional wisdom dictates that small powers—such as the two Koreas—have little freedom to forge independent foreign policies, particularly when situated in a region dominated by much larger powers, because they are hindered by the overwhelmingly disproportionate power of regional neighbors. Nevertheless, both Koreas have separately demonstrated exceptional ability to leverage their respective limited relative power into surprisingly independent strategies. For South Korea, the primary driver of its foreign policy orientation, particularly since the end of the Cold War, has been an internally-based shift in its self-perception of national power. This in turn has been reinforced and shaped by changes in the external environment despite its core national interests remaining steadily focused on independent survival.<sup>1</sup>

Notably, North Korea has also adopted a new self-perception of its own national power, fueled—perhaps unrealistically—by its relentless pursuit of nuclear weapons and their delivery systems. The North’s dangerous pursuit of national power is similarly embedded firmly in an overarching focus on its own version of independent survival. But in contrast to the South, the North persistently refuses to allow the external environment to shape its internal development, exacerbating South Korea’s existential dilemma and future regional and global stability.

Given such security constraints, this paper examines South Korea’s EAI and considers its rationale, contours, and possibilities of success within the context of China’s OBOR. An analysis of the former cannot be divorced from the latter because of OBOR’s profound regional and global impact and its direct relationship to the EAI. In examining OBOR, China’s goals and rationale for this strategy must be studied, but rather than focusing on OBOR’s economic parameters about

which much has been written already, the analysis here prioritizes the political and strategic motivations for the explosion of initiatives both from within and outside the region to integrate the vast Asia-Pacific and to “connect” it with the rest of the world. Finally, this paper draws conclusions about how EAI reflects South Korea’s national and regional aspirations, and implications for the relationship and interaction between the two countries’ alternate visions for a Eurasian continent.

## CHINA’S 21ST CENTURY “SILK ROAD”: OBOR

Since assuming power in March 2013, Chinese President Xi Jinping has made the construction of networks that recreate the ancient silk roads connecting the Chinese empire with the western world a pillar of modern China’s national and foreign policies. Encapsulated in the catchy phrase “One Belt and One Road,” the ambitious project is actually comprised of two separate components that are ultimately to be joined.

The first component is the Silk Road Economic Belt (SREB) which President Xi announced in September 2013 during an official visit to Kazakhstan, and refers to a network of over-land transportation corridors to be developed under Chinese direction. In the last decade, Beijing has steadily built within its own country new roads and rail links from its populated eastern seaboard to vast stretches of still largely undeveloped and less sparsely populated territories in its western and southwestern provinces.

Having connected the nation’s vast western frontiers to its more developed eastern provinces via highways, railroads, pipelines, and telecommunication networks, China now wants to extend these infrastructure connections beyond its own borders across the Eurasian landmass all the way to the Western European mainland. The path includes countries in regions situated on the original Silk Road: Central Asia, the Caucasus, the Middle East, and Southern and Central Europe.<sup>2</sup>

The SREB, however, is far more ambitious than merely reviving the ancient silk routes because it envisions integrating other regions well beyond the historical roads. The new linkages also look northward, to connect China’s northeastern rust-belt with energy-rich Mongolia and Siberia via a modernized rail network. The SREB also looks south towards the Asian subcontinent, Southeast Asia, and even south-west towards Africa, seeking to create a cohesive economic area by creating land transportation networks, broadening trade, and increasing cultural and exchanges.

In 2015, almost \$900 billion in more than 900 projects, involving some 60 countries, was pledged towards building the six primary land corridors comprising OBOR: (1) China-Mongolia-Russia; (2) New Eurasian Land Bridge; (3) China-Central and West Asia; (4) China-Indochina Peninsula; (5) China-Pakistan Economic Corridor (CPEC); and (6) Bangladesh-China-India-Myanmar (BCIM).<sup>3</sup> (see Figure 1)

The second component of OBOR illustrates even further the expansive scope of China’s ambitions. President Xi unveiled the “Road” portion of OBOR one month later in October 2013 as a “21st century Maritime Silk Road” (MSR) during a state visit to Indonesia. While somewhat confusing because the “Belt” refers to land networks while the “Road” plans are for maritime routes, the two components are essentially integrally linked as OBOR envisions ultimately connecting railroad networks with maritime ports and routes.



The MSR seeks to build maritime infrastructures throughout the Indo-Pacific, Middle East, and African coastal regions, linking the Pacific and Indian Oceans with the Mediterranean and Red Seas, via the Suez Canal. These would essentially connect the South China Seas to maritime Europe, to include the east coast of Africa along the way.<sup>4</sup> These maritime corridors will be developed through construction of new ports and surrounding special economic zones to support them. Specifically, MSR includes plans to connect ports in Kenya, Tanzania, and Mozambique with the Indian Ocean; the Chinese government has already announced plan for a \$3.8 billion railroad connecting Nairobi to the Indian Ocean

port of Mombasa.<sup>5</sup> From the east coast of Africa, MSR will then connect to the Red Sea via Djibouti, where China is building a naval base.<sup>6</sup> From there, the maritime connection will continue into the eastern Mediterranean, and eventually central and southeastern Europe.<sup>7</sup>

Spanning some 65 countries, approximately 4.4 billion people or 60 percent of the world's population, and about 40 percent of global GDP if and when fully implemented, OBOR has the potential to make China the driving economic and diplomatic force for a development strategy and framework that will integrate the entire Eurasia.<sup>8</sup>

The sheer expansiveness of OBOR, however, makes the project amorphous and unwieldy, and this is exacerbated by the fact that the Chinese government has not provided a clear definition of the strategy, with no official public announcements even detailing the precise countries and regions involved. Nor are the projects themselves specified other than being reported in Chinese media coverage as involving “infrastructure investment,” but they have included under a broad rubric everything from plans to install signs and information kiosks in Armenia, to the \$46 billion investment pledged to Pakistan in April 2015.<sup>9</sup>

While OBOR is not necessarily a “new” initiative because China has been heavily investing in overseas infrastructure construction across Eurasia for the last decade, it is nevertheless tremendously noteworthy, in great part because it is the Chinese government's first explicit articulation of a single unified vision that coordinates its pattern of promoting massive economic projects abroad. Perhaps more significantly, OBOR is a clear *political* enunciation of foreign economic strategies, and is the country's most ambitious foreign trade and investment project ever articulated.<sup>10</sup>

Furthermore, OBOR reflects a profound shift by President Xi away from China's long-standing foreign policy axiom in place since Deng Xiaoping deemed China's national interests as “keeping a low profile” in international affairs in order to focus on domestic economic modernization and stability. OBOR thus marks the start of a new era that casts aside past taboos against Chinese foreign intervention, including building overseas bases, developing clear spheres of influence, creating buffer zones, and forging alliances.<sup>11</sup>

## OBOR'S MOTIVES AND GOALS

While many skeptics doubt both the feasibility and highly ambitious vision of OBOR especially given the project's opacity, the Chinese government nevertheless has emphasized the strategy's primary purpose as economic in nature. Indeed, the government has been focused on increasing diplomatic coordination to standardize and link trade facilities, create free trade zones, and promote other

trade facilitation policies among countries in the targeted regions. Even more broadly, OBOR calls for financial integration within participating regions—which promotes the global role of the *renminbi*—and enlargement of people-to-people cultural education programs.<sup>12</sup>

Although the focus of OBOR's projects may indeed be targeted towards achieving economic goals, they ultimately serve the country's political objectives of promoting national stability and strength. In turn this contributes to China's dominance regionally, which by OBOR's very objective is to expand the boundaries of the region itself. Specific national goals radiate in priority from the most immediate goal of stabilizing China's struggling domestic economy by opening new markets, generating increased demand for Chinese exports, and boosting the development of increasingly competitive global industries. In March 2015, Xi stated that annual trade with countries along OBOR would surpass \$2.5 trillion by 2025.<sup>13</sup> According to some estimates, OBOR could stimulate as much as \$4 trillion in investment over the next three decades, although only \$230 billion worth of projects are currently in various stages of development.<sup>14</sup>

OBOR's potential to link vast new markets with the Chinese economy will also boost sluggish domestic demand and provide relief for inefficient state-owned enterprises (SOEs) suffering from over-capacity. OBOR's focused emphasis on infrastructure development and investment are meant to ease the tremendous burden on struggling SOEs, and on the government which cannot readily shut them down without instigating severe economic, social, and even political repercussions for the leadership. Moreover, OBOR provides a useful rallying agenda for the Chinese Communist Party (CCP) which has struggled with uncertainty and internal divisions under Xi's toughening “reform” campaign.

Another objective the OBOR serves is to secure energy supplies through new pipelines and other transport lanes—both rail and sea—in Central Asia, Russia, and through South and Southeast Asia's deep-water ports. The countries within the orbit of OBOR account for 70 percent of the world's energy reserves. Energy security has always been a top priority for Northeast Asian countries, especially resource-poor and energy-starved countries such as both Koreas and Japan, making it not just an economic but national security prerogative. But even for relatively resource-rich China, energy sufficiency has been a major concern for the government, increasing exponentially with its economic development and modernization.<sup>15</sup>

Domestic economic growth, however, is closely interwoven with the leadership's preoccupation with political and social stability, and it views promotion of broad stability in all neighboring countries as an integral aspect of reinforcing domestic harmony at home. With the distinction of having the largest number of foreign countries almost completely encircling its territory (fourteen), China

has understandably maintained a hyper-vigilant preoccupation with not only protecting its territorial integrity but being wary of the potential for instability or conflict in any neighboring state.<sup>16</sup>

Beijing's continuous support over the decades of the regime in Pyongyang—both implicit and tacit—despite immense international pressure against such policies further demonstrates China's strategic priority of supporting and protecting its neighbors no matter how unpalatable or high the costs, especially if the overarching goal is to fend off the presence of a major power such as the United States directly on its border. It is clear that North Korea serves as a useful geographic buffer between U.S. military forces which are arrayed on the DPRK's southern border.

In this sense, OBOR can be considered a prophylactic strategy to promote long-term stability in neighboring countries through economic investments to prevent China being “forced” into a military confrontation with another major power. Underlying China's preoccupation with stability both internally and in bordering countries is the CCCP's most immediate concern: eliminating separatist movements that endanger the unity of the Chinese political system and its functioning as a unified state. In a country of over 1.38 billion people, increased agitation among the 11.5 million Muslim Uighurs, the largest ethnic minority, is becoming a serious domestic security concern due to their growing extreme and violent efforts to gain greater autonomy and even independence from Beijing's increasingly harsh authority and oversight.<sup>17</sup>

The possibility of any separatist movement succeeding is anathema to the Chinese leadership and is an unacceptable development because of its potential to trigger a domino effect that could lead to the collapse of the entire state system. Elections this year in Taiwan and Hong Kong have intensified the Beijing leadership's concerns about challenges to its central authority.<sup>18</sup> Movements calling for independence may actually be more threatening to the Chinese leadership than pro-democracy movements, because they are a direct threat to President Xi's dream of building a strong nation-state. While separatist versus pro-democracy agitations may be a distinction without a difference for the much of the world, especially in the West, for the CCP pro-democracy efforts are threatening in great part because they may trigger calls for separatism or independence from ethnic minority groups.

Thus, while some analysts argue that the geostrategic aspects of OBOR are “overstated” because its primary objective is ultimately to “advance key economic goals,” the argument here is that there seems to be little doubt that for Beijing, economic goals are subordinate components of broader national goals, which in turn formulate the basis for geo-political calculations.<sup>19</sup> In essence, OBOR is a manifestation of a new “extra-territorial” project by China that seeks to shape a new informal architecture in surrounding regions which prioritizes stability—economic, political, and social—as the primary goal for nations within OBOR's orbit.

To be explicitly clear, this is not an argument that purports that OBOR is the first step towards Chinese ambition for global hegemonic dominance, at least not yet. Rather, OBOR at least presently, reflects more narrow Chinese goals of expanding the country's influence in surrounding regions in order to shape existing international rules and norms to better reflect its own preferences, which are not always synchronous with global standards.

## FUSING CHINESE ECONOMIC AND POLITICAL POWER

That OBOR is clearly an economically driven initiative to serve the political goals of promoting extra-territorial stability in neighboring regions, is evidenced by the tremendous resources the central government is willing to expend to support it. In this regard, China may be perhaps the only country in the world with the strategic and bureaucratic will and matching resources to even conceive of such an audacious project much less implement it successfully.

Among the many economic instruments at the government's disposal are its ability to corral national “funds” to direct the vast amounts of capital required for OBOR's massive projects. One of these is the “New Silk Road Fund” (NSRF), comprised of some \$40 billion—officially launched in February 2015—whose function is to promote “private” investment in areas along the OBOR but is supported by the nation's foreign reserves, government investments, and state-owned financial institutions.<sup>20</sup>

Another crucial economic tool are the nation's “policy banks” whose explicit missions are devoted to financing infrastructure and other national policy priorities domestically and abroad.<sup>21</sup> They have been the primary funders of the six main corridors of the SREB worth some \$900 billion, and have lent more than \$80 billion on over 1,000 projects in 49 countries related to OBOR.<sup>22</sup> In stark comparison, the Asia Development Bank (ADB) had lent only \$27.1 billion in infrastructure and development projects by 2015.<sup>23</sup>

Beyond the national economic instruments at its disposal to direct funds toward OBOR development is Beijing's growing diplomatic weight and power in its foreign relations. President Xi has personally endorsed numerous bilateral agreements celebrating the cooperation between his country and those who support “partnership with the PRC.” These include strategic agreements with the United Arab Emirates (UAE) in December 2015 establishing a joint investment fund totaling \$10 billion, and the launch of a \$2 billion fund with the Russian Direct Investment Fund, a state-backed asset manager.<sup>24</sup>

Other OBOR projects reflect not only Beijing's diplomatic and economic heft, but their convenient marriage with the domestic political calculations on the part of partnering states pursuing bilateral agreements with China to develop massive

infrastructure projects. One example is the estimated \$45 billion construction in Egypt of a new administrative and business capital on 270 square miles of remote desert land. While no public details have been released, the project is crucial for President Abdel Fattah Al Sisi who took power through a bloody military coup in 2013, and is trying to build political legitimacy and boost his troubled economy through infrastructure development.<sup>25</sup>

Competition with Western, Japanese, and even South Korean interests in key regions is certainly a primary consideration in China's implementation of its OBOR strategy. As such, a third, and perhaps the most significant economic tool utilized by Beijing to support OBOR initiatives is the Asian Infrastructure Investment Bank (AIIB). Officially launched in October 2014 with China providing most of the \$100 billion initial capital, it sought to expand multilateral membership and quickly garnered applications from more than 40 governments from five continents, despite strong disapproval from the United States.<sup>26</sup> Notably, many of the countries that are included in OBOR are also members of AIIB.

China's bold creation of the AIIB has sparked intense debate about its intentions and motives. Ostensibly initiated by China to meet the needs of an admittedly enormous and much-needed infrastructure financing deficit in Asia, there can be little doubt that the AIIB serves as a mechanism to extend Chinese ambitions to increase its geopolitical influence. At least three of AIIB's initial projects will involve expanding transport arteries in Central Asia and Pakistan.<sup>27</sup> Yet the AIIB is hardly a singular financing mechanism for China's OBOR ambitions, as its operations will be expanded gradually, investing only \$1.5 to \$2 billion in infrastructure this year, with a goal of reaching \$10 billion by 2018; these amounts are an insignificant contribution to the \$900 billion projected estimate of OBOR's costs.

Thus, the real significance of the AIIB and its role in OBOR is not really its financial contributions or clout in regional development, but rather that it serves an instrumental purpose to bolster the legitimacy of China's vision of an expanding extra-territorial order. As *The Economist* recently noted, the AIIB "institutionalizes" official Chinese lending abroad which has been "generous, but contentious."<sup>28</sup> By muting Chinese financial contributions to development and infrastructure projects in the region behind the cloak of a multilateral identity, developing countries can become more readily accustomed to accept Chinese economic influence, with less domestic political and social resistance.

Indeed, AIIB is only one part of China's broader strategy of spreading its financial weight to other multilateral institutions in which it plays the lead role. Another is the New Development Bank (NDB), a development organization that replaces the original BRICS Development Bank.<sup>29</sup> China's tactic of organizing multilateral groupings, particularly in its surrounding regions to serve its broader strategic

goals is not limited to financial arrangements. This focus is a relatively new development and reflects China's growing economic power and confidence only in the recent decade.

### EAST MEETS WEST: SOUTH KOREA'S "EURASIA INITIATIVE" (EAI)

Meanwhile, as powers great and small jostle on China's northern, western, and southern flanks to take advantage of the opportunities created by Beijing's economic activism and expansion in the region, China's eastern-most neighbors on the Korean Peninsula have been no less active. As one Russian scholar notes, the surprising source of an "arrow" aimed at strategic expansion into the Eurasian mainland came from an unexpected direction and "the remotest actor of all": South Korea. Moreover, he deems the sheer "scale of the idea [as] breathtaking."<sup>30</sup>

In October 2013, Seoul hosted the "Global Cooperation in the Era of Eurasia" conference where President Park articulated her economic vision for the region with the EAI. One should note that South Korea's strategic interest in, and active engagement of the broader region beyond Northeast Asia is not new, and had been well developed by her immediate predecessor, President Lee Myung-back, under his "New Asia Initiative" (NAI) launched in 2009. In brief, the NAI sought to increase ROK cooperation with "all the countries of Asia," and although it initially focused on Southeast Asia, the initiative contained an expansive definition of the region to include Central and South Asia. At the core of the NAI was the ROK's desire to capitalize on its development experiences and unique middle power role by playing a "bridging" role between large and small regional powers, as well as between developed and developing economies.<sup>31</sup>

Nevertheless, President Park's EAI contains new and more focused elements for regional cooperation by calling for resurrecting the ancient "Silk Road" in order to link energy supplies with key transportation infrastructures, including electricity grids between Europe and Asia. These physical linkages would form the basis for gradually eliminating trade barriers, ultimately leading to the establishment of a vast free trade zone encompassing both continents.

An immediate element of this vision at the time was the realization of an ROK-PRC Free Trade Agreement (FTA) which was signed on June 1, 2015, three years after negotiations began. EAI could then potentially join the ROK's existing FTA with the EU, which entered into force in July 2011, linking the Chinese and European markets through Korea. It is also important to note that beyond the bilateral FTA with China was a broader vision for expanding regional free trade, including acceleration of a Korea-China-Japan FTA, and linking these trade agreements to other areas within and outside Eurasia, such as the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership

(TPP).<sup>32</sup> RCEP is widely considered a partial alternative to TPP because the former includes China, India, and the ROK, not current members of TPP.<sup>33</sup> If fully realized, linkage of the trilateral Northeast Asia FTA with RCEP and TPP would create a “super” free trade area linking not just the European and Asian continents, but the North and South American ones as well.

According to one ROK government representative, EAI when fully integrated will create a “gigantic market accounting for more than 90 percent of the world economy...with the Korean Peninsula [as] the Gateway of Eurasia” linking it across the Pacific ocean to the Americas. It is envisioned as a combined region encompassing almost 55 million square kilometers—or 40 percent of the world’s land area—with 78 countries, and accounting for more than 70 percent of the global population.<sup>34</sup> Most importantly, the eastern-most starting point for the continental Eurasia region is the southern tip of the Korean Peninsula.

While some may be skeptical of the grandiosity of such a boastful vision, it is a fact that South Korea’s advanced port infrastructure and strength in the global shipping industry—notwithstanding the current troubles plaguing Hanjin—provides a natural gateway from the Asian continent to the Pacific, providing maritime and land access points from continental Eurasia to the Atlantic.

Moreover, geographical linkages through Central Asia are key to the fulfillment of this vision, and South Korea has had a relatively long history of economic and cultural ties with the countries of this region. While the immense popularity of the “Korean Wave” of popular culture, or *hallyu*, sweeping through the region is a relatively new phenomena that has certainly raised the profile of South Korea in Central Asia, social and economic ties are deeper.

For example, Uzbekistan is astonishingly home to the fourth largest Korean diaspora population globally (after China, the United States, and Japan), numbering more than 176,000.<sup>35</sup> And remittances to Uzbekistan from the 17,000 ethnic Koreans or *Koryo Saram* who moved to South Korea to work are estimated to exceed \$100 million annually. Uzbekistan has now replaced Kazakhstan as South Korea’s primary trade partner in Central Asia, with \$1.9 billion in trade in 2015. In addition, South Korea’s investments in that country, including the Surgil gas field, the joint construction of a major Uzbek gas processing plant, and development of a natural gas development project in the Bukhara region, are estimated to be worth a combined \$12 billion.<sup>36</sup>

The growing importance of Uzbekistan as South Korea’s strongest economic partner in the region is a strong indication that EAI’s broader goals are to seek benefits beyond merely short-term economic gains. Indeed, the success of EAI’s implementation is implicitly based on the shared understanding among participants that broader strategic considerations can be achieved.

As a land-locked country, Uzbekistan has long felt relatively more vulnerable than its neighbors, and has been the lone holdout against Russian pressure to join a regional customs union (the EEU), fearing loss of sovereignty and the return to a client-state status with Moscow. Such sensitivity to surrounding great powers evokes strategic affinity with Korea’s similar position, and clearly contributed to its welcoming of South Korean economic investments as an alternative to Russian and Chinese influence.<sup>37</sup> With South Korea’s belief that Uzbekistan will be the “hub in the New Silk Road,” declared during President Park’s visit to the country in May 2015, Seoul expects to have a significant role in Uzbekistan’s announcement of five-year \$55 billion plan to modernize its infrastructure by creating new roads and airports.<sup>38</sup>

ROK’s other anchor in its engagement with Central Asia is Kazakhstan, the largest and richest of the five regional republics. With its vast resources of oil and natural gas, Kazakhstan is a natural strategic partner for the highly energy-dependent South Korea. During her state visit to the country in June 2014, President Park secured continuation of three joint large-scale projects worth \$10 billion established under the previous administration—which had been stalled—and agreed to enhance cooperation in construction of oil production facilities and oil field expansion projects worth some \$4.4 billion.<sup>39</sup> Perhaps most crucial for President Park’s EAI, which seeks to expand transportation and energy infrastructure between the European and Asian continents, the two countries signed a memorandum of understanding (MOU) on railroad cooperation, which allows for South Korea’s participation in the modernization of Kazakhstan’s railway system.<sup>40</sup>

Kazakhstan, despite being the most amenable among Central Asian countries to close cooperation with bordering powers Russia and China, nevertheless has historically displayed an affinity for South Korea, which like Uzbekistan, lies in deeper historical and cultural ties that have contributed a powerful sentimental role in Kazakh-ROK bilateral cooperation.<sup>41</sup> And Kazakh President Nursultan Nazarbaev has frequently cited the importance of South Korean involvement in his country’s industrial development after its independence in 1991 from the former Soviet Union, repeatedly invoking South Korea as a model for future modernization.

Such allusions evoke a painful reference to South Korea’s dictatorial past during its massive industrialization period, and perhaps serves as political legitimization of Nazarbaev’s current authoritarian regime. Nevertheless, South Korea’s development into a vibrant and stable democracy today provides a positive and powerful model for Kazakhstan’s potential future development, and is an important strategic advantage and distinction that no other power can offer, certainly not China or Russia, nor the United States which is often considered as demanding unrealistic standards for reform.<sup>42</sup>

The significance of South Korea's confidence that it can play a bridging role between large and small powers, as well as between the developed and developing economies as a rationale and goal for EAI should not be underestimated. This is based on one of the motivating principles of the preceding NAI, in which President Lee asserted that the ROK can play a central role in representing the interests of Asian nations in the global arena in a more plausible fashion than China or Japan, whose occasional over-bearing attitudes have often tainted political goodwill in the region.

Indeed, as a small power that often fell victim to the exigencies of great power competition, Korea's historical experiences carry great resonance with many countries not just in Central Asia but also in Southeast Asia, who have similarly been dominated culturally, politically, economically, and even militarily at some time by Chinese and Japanese empires. Recent Chinese displays of military muscularity in the region, especially in maritime arenas, has only heightened concern about Chinese intimidation among the smaller countries of Southeast Asia. Exacerbating their insecurity is the growing uncertainty about the future of U.S. commitments in Asia in part due to the lack-luster success of the "Asia Pivot"—including increasingly negative rhetoric regarding the TPP, the designated "core" of the Pivot—and the forthcoming change in leadership in Washington. South Korea is therefore, uniquely positioned to be the "honest broker" in furthering the interests of smaller powers in the region.

Thus, EAI's broader ambitions exceed the more narrow interests of obtaining economic gains—for the ROK and participating countries—through merely broadening intra- and inter-regional trade, or even the longer-term benefits of reducing energy insecurities by expanding and connecting natural resource networks in Eurasia. In effect, the ultimate strategic vision of EAI is of achieving a "win-win" outcome for all that creates not just "one continent" but a "continent of peace," according to President Park.<sup>43</sup>

### THE "PIVOT" OF EAI: NORTH KOREA

While EAI's primary objective is clearly to promote closer cooperation within the region also envisaged in China's expansive OBOR, perhaps its most crucial component, is the underlying intention to permanently alter dynamics on the Korean Peninsula. While the economic scope of EAI is miniscule compared to OBOR—predictably so, given China's vast relative economic resources—in one sense President Park's vision is even more grandiose than China's ambitious scheme, due to the ROK's unambiguous prioritization of EAI's *political* goal: to fundamentally alter the geopolitical and security landscape of Northeast Asia.

President Park declared that this is to be accomplished by the "establishment of peace on the Korean Peninsula," thereby unleashing the physical flow of economic,

political, and social interaction from the continent of Europe all the way to the "easternmost pillar of the Asia," the southern tip of the Korean Peninsula. The "division of the Korean Peninsula," she further asserted, "is causing bottlenecks on the path of exchanges and cooperation...to this end, we have to build the Silk Road Express [railroad], which will run from Busan all the way to Europe via North Korea, Russia, China and Central Asia."<sup>44</sup>

Thus, President Park was making explicitly clear that the single impediment to the creation of not just a modern "Silk Road" but a true geographic connection between Europe and Asia necessitated peace on the Korean Peninsula. In this sense, it is an implicit challenge to China's own vision of reviving the ancient Silk Routes by reminding the Middle Kingdom that continental Asia's northeastern peninsula has played the pivotal role in regional stability for centuries, and that without its participation, OBOR is ultimately an incomplete vision for the future of the Asia-Pacific, or the creation of a true Eurasian region.

Suffering the depredations of hundreds of foreign invasions over its 2,000-year history, both Koreas are excruciatingly aware that their territory has always been coveted for its strategic rather than intrinsic value, as the crucial access point both into and off mainland Asia. "Hanging like a ripe fruit for the plucking," Korea has been simultaneously viewed as a "dagger pointed at the heart of Japan" or the bridge providing access to the Asian continent, depending on external orientation.<sup>45</sup>

Thus, South Korea's desire to overcome the existential and geographic barrier maintained by North Korea which prevents its physical connection to Eurasia is President Park's foreign policy priority, and is clearly a vision supported by the United States and its allies such as Japan and Australia, which would all benefit from such an achievement.

Accordingly, President Park unveiled a bold series of proposals towards the North in August 2014, which included an ambitious plan to revive long-stalled inter-Korea railroads (or Trans-Korea Railroad – TKR) connecting Kaesong, near the North-South border, with Sinuiju, a major trading area on North Korea's western border with China, and another with Rajin, an important port on the eastern border with China.<sup>46</sup> This project, among others, was considered a key part of her "*Trustpolitik*" approach towards North Korea, which is based on developing areas of cooperation with North Korea through reciprocal trust-building measures, with the goal of eventually opening the North and thereby altering the regime's interests and behavior, and eventually leading to peaceful reunification.<sup>47</sup>

Undoubtedly, beyond the immense political and security benefits to be reaped, short-term economic gains would also accrue if successful: a trans-continental link to the Eurasian Land Bridge would provide an alternative to trade by ship

transport, for which the ROK's immense trading volume is almost entirely dependent. Furthermore, the potential reduction in overland shipping costs between South Korea to Europe could eventually be reduced up to 30 percent, according to some estimates, providing a much-needed boost to South Korean exports, upon which the economy's growth is still heavily dependent.<sup>48</sup>

Despite these potential economic gains, the primary impetus driving South Korea's EAI is not economic, but political and security motives. This was evident in the subsequent elaboration of the official title to the launch of Park's EAI speech: "One Continent, Creative Continent, Continent of Peace: Opening and Denuclearization of North Korea Through the Peaceful Prosperity of Eurasia."<sup>49</sup> Reinforcing the prioritization of North Korea as the paramount element of EAI's future success was President Park's corresponding launch of the "Northeast Asia Peace and Cooperation Initiative" (NAPCI) articulated during her address to the Joint Session of the U.S. Congress in May 2013.<sup>50</sup> NAPCI was a roadmap for implementing *Trustpolitik* beyond the Peninsula, to increase cooperation and reduce distrust at the regional level, according to Yun Byung-Se, ROK's Foreign Minister.<sup>51</sup>

Indeed, in the months and years following NAPCI's articulation, the ROK government launched a concerted effort to promote policies towards North Korea of "humanity, co-prosperity, and integration." These included the Ministry of Unification's (MOU) August 2014 announcement proposing 96 new inter-Korean projects, including support for North Korea's fishing industry, restoration of ecological systems, and normalization of the Kaesong Industrial Complex, which by 2014 had been reduced after inter-Korean tensions mounted in 2010.<sup>52</sup> The MOU proposal also included plans to consider revitalization of the Kaesong-Sinuiju rail link that had been stalled for years.<sup>53</sup>

Notably, neither *Trustpolitik* nor NAPCI were genuinely new concepts in South Korean approaches towards the North, despite being presented as "bold new" initiatives by the Park government. Indeed, the basic tenets of *Trustpolitik* built upon the principles of "Sunshine Policy" or engagement, initiated by President Kim Dae Jung (1998-2003). And NAPCI's principles had been earlier encoded in the September 19, 2005 Joint Statement of the "Six Party Talks," which formally established and launched one of the five Working Groups: the "Northeast Asia Peace and Security Mechanism" (NEAPSM).<sup>54</sup>

President Park's refinement of previously established policies is a reflection of the continuity of national security priorities that has prevailed in South Korean foreign policies over the decades. EAI's true innovation, however, is the resurrection of the connection between the ROK's regional and global strategies with inter-Korean objectives; such a linkage had been severed with the end of the Cold War and the collapse of the Soviet Union in the early 1990s. At that time, the Kim Young

Sam administration (1993-1998) launched a new foreign policy orientation for South Korea with his "Segyehwa" or "Globalization" policy, which for the first time pursued the ROK's expansion of its foreign relations with the rest of the world independent of developments in or pursued by the DPRK. While such a new orientation did not alter the zero-sum competition between the two Koreas—such a shift would not occur until the "Sunshine Policy"—the new foreign policy orientation was in part a function of the opening provided by the end of Cold War strictures, which allowed South Korea to begin its outward "global" push.

The subsequent dramatic shift of South Korean attitudes and approaches toward North Korea under Presidents Kim Dae Jung and Roh Moo Hyun's "Sunshine Policy," notably did not affect the ROK's global foreign policy approaches with the rest of the world, but rather reinforced them. The culmination of Seoul's aggressive engagement with the rest of the world on the global stage came to fruition under President Lee Myung-back (2009-2013) and his successful "Global Korea" campaign. The noteworthy development during this period is that while the pendulum of South Korean policies towards the North had once again swung away from open engagement, the linkage between inter-Korean developments and the ROK's independent pursuit of regional and global engagement remained disconnected.

Thus, perhaps the single most significant shift in South Korea's national strategies since the end of the Cold War is President Park Geun-hye's reversal of a decades-old orientation of priorities regarding resolution of inter-Korean security issues, which had until then become secondary to the ROK's goal of nation-building. While continuing to capitalize on the progress achieved by her predecessors, particularly at the regional and global levels, she nevertheless boldly reordered South Korea's national priorities by placing primacy on resolution of the inter-Korean division as the commencing point from which radiates all other regional and global cooperation and integration efforts. Indeed, she has purposefully wielded South Korea's status as a middle power with sufficient global influence to rally other states and the international community to jointly press against North Korea's increasingly aggressive behavior.

North Korea's fourth nuclear test in January 2016 followed by a fifth test in September, as well its steady barrage of missile development and launches this year seem to have reinforced President Park's determination that resolution of inter-Korean hostilities will not be an outcome of regional integration and cooperation, but a prerequisite for grand visions, such as the creation of a Eurasian region. Notably, she has also revived the single over-arching priority that had dominated the ROK's national goal until its explicit removal under the Sunshine Policy: reunification of the Korean Peninsula. It should be further noted that the goal of unification, on its own terms, has also always been the consistent and unwavering national goal of North Korea since the signing of the Armistice in 1953.

## CONCLUSION

In today's uncertain global environment with new threats and crises emerging with startling frequency, the Korean Peninsula unfortunately remains the focal point of a steady and compelling security problem, as it has for almost 70 years. Aside from the profoundly tragic human costs of the continued division of the Korean people, the political consequences of ongoing tensions and the potential for an outbreak of the Korean War frozen for 63 years has global ramifications, not the least because it could involve military confrontation among the world's three largest nuclear weapons powers—the United States, China, Russia—and of course now North Korea as an “illegitimate” nuclear power. Yet, a permanent resolution of the bitter division of the Korean Peninsula has perhaps equally profound consequences for the future of the entire Asia-Pacific-Eurasia region, and may even hold the key to possible integration of the Eastern and Western worlds.

China has embarked on an astonishingly ambitious path to link several continents under a new informal architecture shaped by its desire to expand extra-territorial stability. Yet, the purposefully limited view westward (and north and south) with the explicit exclusion of its easternmost neighbor, the Korean Peninsula which is economically and strategically crucial for true regional integration, is strikingly stark. It is perhaps further confirmation that for China, maintenance of the status quo—division of the Korean Peninsula—even with North Korea's ongoing pursuit of nuclear weapons programs, serves Chinese strategic goals: ensuring extra-territorial stability especially in its bordering countries.

Such entrenched Chinese interests are increasingly at odds with South Korea's own vision for the region, supported by its growing confidence as a solid middle power. Exacerbating Korean skepticism about Chinese regional ambitions has been Beijing's increasing boldness in asserting its power in the region, as evidenced by China's unilateral declaration of an Air Defense Identification Zone (ADIZ) in November 2013, which shocked many South Koreans because of its inclusion of Ieodo (or “Parangdo” by Korea), a rock that China claims as part of its territorial rights (Suyan Rock).<sup>55</sup> Thus, the ROK's “Eurasian Initiative,” despite purporting to share similar goals with OBOR of reviving the ancient Silk Roads to promote economic benefits for all involved, is far more likely to be divergent paths than a shared road.

Yet, more than the potential loss of long-term regional benefits, the divergence between the two visions for extra-regional integration signal a deeper and troubling disparity in fundamental views about regional security. China's refusal

to acknowledge the obstructionist role that North Korea plays not only against regional integration but stability on the Peninsula is being acknowledged and challenged by the South Korean leadership, and increasingly by the public. The negative Chinese reaction to Seoul's decision to deploy the U.S.-led THAAD (Terminal High Altitude Area Defense) system, while unsurprising, was startling in its vehemence, and has only served to increase South Korean suspicions about Chinese ambitions.

Indeed, Chinese willingness to insert itself into the domestic debate on South Korea's sovereign right to defend itself is indicative of the extent to which China's preoccupation with stability in its extra-territorial regions is crucial to its own perception and needs regarding its national security. Meanwhile, North Korea's ability to assert its own independent actions despite regional and global pressures highlight the opportunities for exploitation created by the inability of regional powers to cooperate when national security interests diverge. Thus, the respective grand projects promulgated by China and South Korea to revive the ancient Silk Roads in order to promote regional integration may paradoxically unleash greater divisions in the Asia-Pacific, and fail to deliver the regional stability both nations are striving to achieve.

## ENDNOTES

- <sup>1</sup> For a more detailed discussion of South Korea's “independent” foreign policy development, see: Balbina Hwang, “The U.S. Pivot to Asia, and South Korea's Rise,” *Asian Perspective*, “Special Issue, No 1,” 2017 (forthcoming).
- <sup>2</sup> Two major rail projects are already in the planning stages: one will likely link China's Henan and Sichuan Provinces and the Xinjiang region to hubs in Serbia, Hungary, Poland, Germany, and the Netherlands by way of Central Asia, Iran, and Turkey. The other major rail connection links China to Europe by way of Russia via the “New Eurasian Land Bridge.” (Jan Mount, “Spain to China By Rail: A 21st Century Silk Road Riddled With Obstacles,” *Fortune*, December 24, 2014.)
- <sup>3</sup> Both CPEC and BCIM have not been officially classified as part of OBOR strategy, but the Chinese government has stated they are “closely related to the OBOR Initiative.” (“China, India fast-track BCIM Economic Corridor Project,” *The Hindu*, June 26, 2016).
- <sup>4</sup> “Prospects and Challenges on China's ‘One Belt One Road’: A Risk Assessment Report,” *Economist Intelligence Unit Report*, 2015.
- <sup>5</sup> Nayan Chanda, “The Silk Road: Old and New,” *Global Asia* (Vol. 10, No. 3) Fall 2015.
- <sup>6</sup> The naval base in Djibouti – opened in 2016 – is the PRC's first foreign military base since it withdrew its military forces from North Korea in 1958. In addition, a new counter-terrorism law passed at the end of 2015 legalized for the first time the dispatch of Chinese military forces for combat missions abroad without a UN mandate; this is considered a precursor for more active foreign military operations in the future. (Charles Clover and Luna Lin, “FT Big Read: China Foreign Policy,” *Financial Times*, September 1, 2016.)
- <sup>7</sup> Although all of these corridors have not been officially identified as part of MSR, China has already pursued projects that serve as key components of these routes; for example, the Greek government agreed to sell a 67 percent stake in Piraeus, the country's largest

- port, to China Cosco Holding Company, a Chinese state-owned enterprise (SOE). Cosco already operates two container terminals in Piraeus under a 35-year concession it acquired in 2009. (Nektaria Stamoulim "Greece Signs Deal to Sell Stake in Port of Piraeus to China's Cosco," *Wall St. Journal*, April 8, 2016.)
- <sup>8</sup> Bert Hofman, "China's One Belt One Road Initiative: What We Know Thus Far," East Asia on the Rise, December 4, 2015; <http://blogs.worldbank.org/eastasiapacific>.
- <sup>9</sup> "The Grand Design of China's New Trade Routes," STRATFOR, June 24, 2015.
- <sup>10</sup> OBOR officially became embedded in formal Chinese national strategy in March 2015, when the National Development and Reform Commission, along with the Ministries of Foreign Affairs and Commerce, released an extensive joint "blueprint" for OBOR. It was further reinforced in the country's official 13th "Five-Year Plan," announced in October 2015 (Djankov, *Ibid.*)
- <sup>11</sup> Clover and Lin.
- <sup>12</sup> Jacob Stokes, "China's Road Rules: Beijing Looks West Toward Eurasian Integration," *Foreign Affairs*, April 19, 2015.
- <sup>13</sup> Sui-Wee Lee, "China's Xi: Trade Between China and Silk Road Nations to Exceed \$2.5 Trillion," *Reuters*, March 29, 2015.
- <sup>14</sup> STRATFOR.
- <sup>15</sup> Energy demand in China has exploded by more than 500 percent since 1980, and the country is now the world's largest energy consumer, and as of 2014 a net importer of oil. Additionally, its heavy reliance on coal – approximately 40 percent of the nation's heating and electricity – has strained the environment. (Djankov, *Ibid.*) Moreover, with Beijing's recent commitment to the Paris Global Climate pact, the government must implement ambitious plans to move away from coal to cleaner imported sources of energy.
- <sup>16</sup> China share borders with 14 sovereign countries, more than any other country: Afghanistan; Bhutan; India; Kazakhstan; North Korea; Kyrgyzstan; Laos; Mongolia; Myanmar (Burma); Nepal; Pakistan; Russia; Tajikistan; and Vietnam.
- <sup>17</sup> The government officially recognizes 56 ethnic groups comprised of some 105 million people; the Han represent the largest ethnic group comprising nearly 92 percent of the population.
- <sup>18</sup> "Elections in Hong Kong: A Not-So-Local Difficulty," *The Economist*, September 10, 2016.
- <sup>19</sup> Christopher K. Johnson, "President Xi Jinping's 'Belt and Road' Initiative," Center for Strategic and International Studies, March 2016: p. 20.
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## THE MIDDLE EAST REOPENS FOR BUSINESS BUT WITH OLD AND NEW HAZARDS FOR SOUTH KOREA

Alon Levkowitz

### ABSTRACT

The Middle East offers huge trade opportunities to South Korea, especially after the P5+1 agreement with Iran. President Park Geun-hye's May 2016 visit to Iran has demonstrated this economic potential very clearly. However, Seoul should be aware that it is not the only state that is looking for business opportunities in the region. Seoul should likewise take into account the political and security threats stemming from some of the Middle East states especially after the Arab Spring (for example, Syria and Yemen), which might endanger South Korean assets and investments in the region. This paper will analyze the current South Korean Middle East policy and offer recommendations. The Middle East should not be perceived as one unified region, particularly in light of the rising tension between Iran and Saudi Arabia and the military involvement of the superpowers in the region. Seoul would be advised, therefore, to customize its Middle East policy to allow it to maximize its economic benefits while minimizing the security risks. Seoul should try to maximize trade with the stabilized states in the region, while paying attention to the regional implications. South Korea should consider offering assistance to the post-Arab Spring states to stabilize their economy and political system but without getting involved in internal and regional conflicts. In the destabilized states in the Middle East, rather than interfering in these conflicts, Seoul could help prepare contingency plans for their rebuilding once the civil wars end.

**Key words:** *Middle East, South Korea, trade, security, energy*

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Dr. Alon Levkowitz is a Lecturer and the Coordinator of the Asian Studies Program at Bar-Ilan University.

## INTRODUCTION

In December 2014 the South Korean Foreign Minister Yun Byung-se declared 2015 as the “Year of the Middle East.”<sup>1</sup> A few months later President Park Geun-hye said: “The Middle East can be the answer to our prayer for economic revitalization.”<sup>2</sup> “The Second Middle East Boom” was the term subsequently coined to describe Middle East–Korea relations. The volume of trade between the Middle East and Korea, the importance of the Middle East as a vital source of oil and gas and the huge infrastructure and construction contracts in the Middle East being awarded to South Korean companies make the region a vital economic partner. Petroleum was about 39 percent and natural gas 16 percent of South Korea’s total primary energy consumption in 2014. The importance of the Middle East as an energy source for South Korea can be seen in these figures. Seoul imports more than 80 percent of its crude oil from the Middle East: Saudi Arabia 34 percent, Kuwait 16 percent, UAE 11 percent, Qatar 10 percent, Iraq 8 percent, and Iran 5 percent.<sup>3</sup> The lifting of the sanctions on Iran after the P5+1, which will increase Iran’s oil exports to Korea, embody Seoul’s aspirations for strengthened ties in the Middle East.

The P5+1 agreement with Iran opens a window of opportunity for South Korean companies to compete for infrastructure, construction, and energy sector projects in Iran. It will allow the Republic of Korea to double its trade with the Islamic Republic of Iran, which was constrained for several years due to the sanctions imposed on Iran by the United Nations, the European Union, and the United States. Seoul was bound by the United Nations Security Council sanctions and by pressure from Washington to abide by UN and U.S. sanctions on Iran. As a result, the trade between Iran and South Korea decreased from \$10,045 million in 2013 to \$6,098 million last year.<sup>4</sup> Now that this last sanctions barrier has been removed, South Korean companies are returning to Iran to do business without fear of violating any UN-imposed restrictions. The Islamic Republic of Iran is currently looking for opportunities to develop its economy after several years of sanctions which crippled their GDP growth.<sup>5</sup>

South Korea is not, however, the only country seeking business opportunities in Iran. In January 2016, Chinese President Xi Jinping visited Iran—the first visit by a Chinese president in ten years<sup>6</sup>—sending a clear message that Beijing is also looking for potential business ventures. Japan, Germany, France, Britain, and India are other important competitors, all looking for billions of dollars of contracts in the Iranian market.<sup>7</sup> Once Washington eases the restrictions on U.S. companies, it is likely that they too will be in the market.

Official state visits to the Middle East by President Lee Myung-bak in 2012 and President Park Geun-hye in 2015 and 2016 demonstrated the centrality of the Middle East in general, and not just Iran, for South Korea. However, due to the

lingering political instability caused by the Arab Spring in 2011, the civil war in Syria, and militant threats to the stability of other Middle Eastern states, Seoul has had to reconsider its strategy in the Middle East. In order to maximize the potential economic benefits while minimizing security risks, South Korea must customize its approach to the three groups of countries which currently constitute the region. These groups are the relatively stabilized countries, post-Arab Spring countries that are still at risk of destabilization, and destabilized countries.

## THE RELATIVELY STABILIZED STATES

The relatively stabilized countries in the Middle East consist of Saudi Arabia, Kuwait, Qatar, Oman, United Arab Emirates, Oman, Iran, and Israel.<sup>8</sup> The dominant players in the region with a strong influence on the security, economics, and politics of the region are Saudi Arabia, Iran, and Israel. At the core of South Korea’s relationship with these countries is trade, particularly in the energy sector, which is in the interest of South Korea and these partners to promote. However, the volume of trade is influenced by oil prices and regional stability; in other words, tensions between Iran and Saudi Arabia on the one hand and in Syria and Yemen on the other. Seoul’s Middle East policy needs to take into account not just its economic interest in one of these states but also the regional interactions between the different states. For example, Seoul should pay attention how the conflicts in Syria and Yemen will influence the tensions between the Iran and Saudi Arabia.

The price of oil could be influenced by a number of factors, including the failure of OPEC to control the oil market, the reentry of Iran into the oil export market after the lifting of sanctions, Iraq’s renewed oil production, the U.S. lifting the ban on crude oil exports, and the reduced dependency of the U.S. on Middle East oil production.<sup>9</sup> The tension between Iran and Saudi Arabia in the OPEC Doha meeting on April 17, 2016 and the June 2, 2016 meeting in Vienna was one indication of how disagreements between the two states on issues such as Syria and Yemen influence the functioning of OPEC and prevent any agreement on oil price increases.<sup>10</sup> If current estimates that the price of a barrel of oil will range from \$25 to \$50 in 2016 are correct,<sup>11</sup> this might have a negative effect on the volume of trade between South Korea and the Gulf Cooperation Council (GCC), as will be discussed later. Low oil prices and the need to find other income sources will, however, reveal huge potential for new Korean investments in the GCC and other regions of the Middle East, leading to increased trade between the Republic of Korea and the Middle East in the long term.

OPEC cannot force its members to decrease their oil production in order to increase oil prices. Iran, especially after the sanctions, and Iraq are anxious to get back in the oil market and produce oil. News reports from Doha hinted that Saudi

Arabia was not willing to limit its oil production.<sup>12</sup> Both the disagreements between OPEC members and oil production in Iraq and, particularly, Iran will keep oil prices relatively low at \$25-45 a barrel. This will affect the state income of some of the oil-producing countries that are dependent on oil, for example, Iran and Saudi Arabia. Likewise, low oil prices will force Saudi Arabia to consider its balance of payments, thus forcing a reduction in expenditure or a search for alternative incomes; otherwise it is likely to face internal economic and political problems in the next few years.

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Export	4,026	5,253	3,857	4,557	6,964	9,112	8,828	8,288	9,482
Import	21,164	33,781	19,737	26,820	36,973	39,707	37,665	36,695	19,561
Total	25,190	39,034	23,594	31,377	43,937	48,819	46,493	44,983	29,043

Source: Korea International Trade Association [www.kita.org](http://www.kita.org).

In the last two years Saudi Arabia and Korea have signed deals to increase their trade and cooperation including, among others, hiring South Korean engineers for the state oil refinery<sup>13</sup> and expanding Korea-GCC<sup>14</sup> trade to other sectors beyond oil, gas, and construction. Examples of this include health, tourism, information and communication technology (ICT),<sup>15</sup> and the energy sector,<sup>16</sup> including the selling of South Korean nuclear power plants in billions of dollars to Saudi Arabia. Another opportunity for expanding trade between Korea and Saudi Arabia is the first Saudi Arabia produced car, Ghazal 1, which was unveiled by Saudi Arabia's King Abdullah in 2010.<sup>17</sup> A Middle Eastern high quality car designed and produced by Saudi Arabia has a potentially huge market among the GCC and beyond. The South Korean car industry could leverage its expertise to increase its involvement in the Saudi car industry, thus boosting exports while at the same time improving trade relations between Korea and Saudi Arabia. Seoul should be aware that both European and Japanese car companies are also likely to try and take their share. The new Saudi Arabia 2030 vision launched by Mohammed bin Salman also opens a new window for economic cooperation between South Korean companies and the rising Saudi Arabian private sector that is expected to play an important role.<sup>18</sup>

Iran represents another large, strategic trading partner in the region. President Park Geun-hye's visit to Iran in May 2016 with representatives from 236 South Korean companies sends a clear message that South Korea is ready to expand business ties with Iran, which were constrained during the era of sanctions.<sup>19</sup> This was the first meeting between leaders of the two countries since 1962, emphasizing the importance of President Park's visit. As seen in Table 2, Korea's trade with Iran was doing very well prior to the imposition of sanctions. South Korea's total trade with Iran was greater, for example, than its trade with the UK or France.<sup>20</sup>

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Export	3,266	4,343	3,992	4,597	6,068	6,257	4,481	4,162	3,731
Import	6,482	8,223	5,746	6,940	11,358	8,544	5,564	4,578	2,367
Total	9,748	12,566	9,738	11,537	17,426	14,801	10,045	8,740	6,098

Source: Korea International Trade Association [www.kita.org](http://www.kita.org)

It should be noted that Iran was one of South Korea's oil sources (about 5 percent),<sup>21</sup> and this is one of the reasons why Korea began to consider boosting crude oil imports from Iran and expanding economic relations to include other fields of cooperation as soon as the sanctions were lifted.<sup>22</sup>

Park's official visit to Tehran offers great opportunities for South Korean companies to realize the potential of the projects and collaborations that they had already begun discussing with the Iranians prior to Park's visit in the financial sector and the car industries among others.<sup>23</sup>

South Korea and Iran are looking to boost the trade between the two states from \$6 billion to \$18 billion. They signed as many as 66 basic agreements that will allow for the expansion of economic relations. These agreements will be accompanied by individual contracts between the different companies in both countries. It is forecasted that President Park will manage to succeed in achieving the "Second Middle East boom" even while parts of the Middle East remain unstable due to the Arab Spring. The agreements and understandings attained during the Iran visit will boost both the construction and energy sectors, with the worth estimated to be as high as \$45.6 billion.<sup>24</sup> Iranian economic benefits from implementation of the P5+1 agreement will, it can be assumed, increase the income of Iranian citizens and thus heighten the demand in Iran for South Korean high tech and electronic commodities.

South Korea is also hoping that the P5+1 agreement and Iran's ensuing economic benefits will encourage Pyongyang to pursue the P5+1 Iranian model which would grant similarly huge economic benefits. Iran is, of course, committed by the P5+1 agreement to halting its nuclear military program for at least ten years. The North Korean case, however, is more complicated because it has already become a nuclear state, and it would therefore be more difficult to convince Pyongyang to give up its nuclear arms for financial gains. It should be recalled that Seoul has consistently abstained from using its economic trade with Iran as leverage on North Korea.<sup>25</sup> If Seoul decides to use its economic relations with the Middle East as a form of diplomatic pressure on Pyongyang, this would represent a change in Seoul's foreign policy towards the DPRK and the Middle East.

Seoul should be aware, however, that its new partnership with Tehran might raise some questions in Riyadh.<sup>26</sup> There is a delicate diplomatic chess game going on in the region that includes not just the dyadic relations between Iran and Saudi Arabia but also the conflicts in which both states are involved, namely, Yemen and Syria. Yemen and Syria are both embroiled in civil wars in which Tehran and Riyadh, ostensibly non-players in the conflicts, are involved directly, by sending forces into the battlefield, and indirectly, by supporting the militants who fight against the government or the militant groups who fight alongside the government forces. South Korea should, therefore, be aware of the consequences of getting involved in one of these conflicts. For now, with the exception of the influx of refugees from Syria to Europe, the conflicts in Syria and Yemen have, on the whole, been contained to these two countries. Nevertheless, the conflict in Yemen could spill over to Saudi Arabia if the Houthi forces (backed by Iran) in Yemen perceive that they are losing the battle and choose to attack strategic sites in Saudi Arabia in order to convince Riyadh to withdraw its forces from Yemen. Such attacks on Saudi's oil refineries would increase the price of oil and greatly affect foreign trade. For the time being, Seoul has been able to continue its Middle East policy without being perceived to take sides in the ongoing tensions between Iran and Saudi Arabia.

Likewise, South Korea would be wise not to forget that the honeymoon currently being enjoyed between Iran and the world's nations might come to an end if Iran decides to violate the P5+1 agreement by developing a nuclear weapon. For now, however, Iran lacks any incentives to breach the agreement and risk the billions of dollars in contracts that are important to its economy.

Although Israel is located near the Middle Eastern states that were affected by the Arab Spring, it was able to minimize the aftershocks of the Arab Spring on its security and economy, but potential security threats still exist. Economic cooperation between Israel and South Korea is improving each year. Israel cannot offer South Korea oil or huge infrastructure and construction projects as the GCC states might. However, it can offer high technology that South Korean companies are looking for, R&D centers, and military cooperation. Both states have declared their intentions to negotiate a free trade agreement after years of postponement due to South Korean geopolitical reasons. The announced FTA negotiation demonstrates the importance of the economic interests to both states.<sup>27</sup> Nevertheless, one should wait and see if Korea will approve the FTA with Israel before signing FTAs with other Middle Eastern states in order to not endanger their economic relations with the rest of the region. South Korea will continue to balance its economic and political interests in a way that will allow it to continue its economic and diplomatic relations with Israel without being criticized by the Arab states for having a pro-Israeli policy.

## POST-ARAB SPRING COUNTRIES

Some post-Arab Spring states are continuing to overcome the economic slowdown and political instability that came in the wake of the Arab Spring, such as Egypt and Libya. Although trade and investments in some of these countries carry economic, political, and even security risks, South Korea, as a middle power state that is not seen in the Middle East as a threatening force, could play a more dynamic role by supporting these states. This would, at the same time, benefit its economic and security interests.

Egypt is facing an economic slump due to both destabilization caused by the Arab Spring and militant attacks on tourist attractions, which led to a sharp decrease in foreign tourism,<sup>28</sup> and on strategic sites such as gas pipes, mainly in Sinai. The Egyptian President, Abdel Fattah el-Sisi, is hoping that foreign investment in Egypt will help him to develop the economy and reduce political unrest caused by the economic decline. Both President Xi Jinping's recent visit to Egypt and Saudi Arabia's King Salman's official visit, which followed closely, dealt with strategic relations and investments in Egypt and demonstrated the need for foreign investments.<sup>29</sup> Despite the security threats and the fear that militant Islamic groups might try to undermine President el-Sisi's initiatives to increase foreign investments in Egypt, South Korea should nonetheless consider increasing its infrastructure and construction investments in Egypt and not just out of economic interests.<sup>30</sup>

South Korea should recognize its obligations as a middle power state to prevent an escalating crisis which could lead to regional instability. Korean investment in Egypt could assist economic stabilization and the subsequent resumption of democracy.<sup>31</sup> Korea cannot replace China, the U.S., or Europe, but by using its expertise from implementing projects in developing countries,<sup>32</sup> it can exploit its non-superpower image to assist the Egyptian economy without raising fears that it is looking to take control.

While not having participated in the Arab Spring, Jordan was directly affected by the turmoil in the Middle East. This is mainly due to the influx of over half a million refugees fleeing the civil war in Syria, threatening Jordan's social and economic stability. Another factor threatening the stability of Jordan is the interaction between Israel and the Palestinian Authority. The limping peace process influences political and social forces within Jordan that call for new policies against Israel.

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Export	386	734	1,019	1,266	1,224	1,396	1,317	1,383	849
	48	55	31	36	74	69	67	78	78
Total	434	789	1,050	1,302	1,298	1,465	1,384	1,461	927

Source: Korea International Trade Association [www.kita.org](http://www.kita.org)

Although trade between Jordan and South Korea is relatively limited, as Table 3 demonstrates, Jordan is one of the Middle Eastern states that South Korea can assist without the need to send military forces which might inadvertently drag it into regional conflict. Seoul could help to prevent a crisis that might damage the stability of Jordan or other countries in the region, for example by increasing South Korea's official development assistance (ODA) to Jordan to help provide humanitarian assistance for the Syrian refugees. The South Korean government could, in addition, offer loans and subsidies to South Korean companies that establish research and development centers in Jordan, thus providing employment for Jordanian and Palestinian engineers. These centers will make Jordan an important R&D hub and improve its image in the region.

## DESTABILIZED COUNTRIES

The destabilized states in the Middle East will pose a threat to South Korea's interests in the region if it decides to get militarily involved in these conflicts. Seoul would thus be advised to continue with its neutral policy towards these conflicts, all the while preparing a contingency plan for the day after. Once the wars in these states end, they will need to rebuild their countries, and South Korea could be there to offer both experience and financial assistance to fund the construction of new infrastructures.

Syria (along with Libya and Yemen) is an example of one of the destabilized Middle Eastern countries. As shown in Table 4, trade between South Korea and Syria is quite limited, and, due to the Syrian civil war, has decreased yet further. It should be noted that due to its diplomatic relations with Israel, South Korea does not have diplomatic relations with Syria.

The involvement of Russia and the U.S. in the Syrian war can be seen as the new "semi-Cold War" arena, and South Korea would be well advised to remain uninvolved. Russian military involvement has increased tension with the U.S. and other Middle Eastern states (Saudi Arabia, Turkey, Israel); it is perceived as Moscow's attempt to tip the balance of power in the Middle East toward a Moscow-Tehran-Damascus axis.<sup>33</sup> Although Moscow has withdrawn most of its forces from Syria, it continues to be active in the region. Washington, Riyadh,

and Ankara still support the forces opposing Assad, although there is some disagreement between Turkey and the U.S. regarding which opposition forces to support.

Seoul has managed to remain neutral on Middle East-related issues, which has served its economic and political interests. It should continue to avoid being perceived by the superpowers and the different regional states as identifying with one or other of the axes. Provided it is not interpreted as support for any political goals in Syria, Seoul should send humanitarian help to the Syrian refugees fleeing Syria for Jordan and Turkey. Once the civil war ends, Syria will need to rebuild the cities that were destroyed by the government and rebel forces. When that time comes, South Korean companies will be in a position to offer their long experience.

The conflicts in Syria and Iraq have also created a new problem for intelligence communities around the world including in Korea.<sup>35</sup> Syria and Iraq have become destinations for European, Russian, African, and even Asian volunteers who want to join ISIS, al-Qaeda, and other militant groups. Some of these volunteers do not even have the Islamic background that might partly justify their willingness to fight alongside these Islamic militant groups. Although the number of Koreans who have joined the war in the Middle East is marginal, there was the case of one South Korean teenager, described as an outsider, who flew to Syria and of a few foreigners who worked in Korea and later went on to join ISIS. It is possible, albeit unlikely, that additional South Korean volunteers might join these militant groups.

The volunteers present an additional layer of threat once they return home or move to another country equipped with knowledge and military experience gained during their fighting in Syria, Iraq, or Afghanistan. The November 2015 terrorist attack in Paris and the March 2016 attacks in Brussels are two examples of the damage that these volunteers can cause in Europe, the U.S., or even Korea. These people, who know how to live undetected in their hometowns, have become a major challenge for the different intelligence agencies. Without international intelligence cooperation, the battle against terrorism is doomed. For now, South Korea is not perceived as a target for terrorist attacks; Europe, Israel, and the U.S. are the main targets. Nevertheless, Seoul should reconsider upping its cooperation with international intelligence agencies in order to be ready for any unlikely but not inconceivable threats on Korean soil or on South Korean companies working in the Middle East.

## CONCLUSION

In order to maximize the potential of the Middle East to the South Korean economy, the customization of Seoul's Middle Eastern policy according to economic,

political, and geopolitical factors is imperative. The economic indicators of each state are clearly crucial when making decisions regarding investment in the Middle East; however, the conflicts in Syria and Yemen, the tension between Tehran and Riyadh, and the militant destabilizing forces in the region which might influence the outcomes of any economic benefits cannot be ignored. The Korean government would, therefore, be recommended to consult with South Korean companies about the political and security dynamics of the Middle East. These issues must be taken into account but should not prevent South Korea from boosting its gains in the Middle East for the sake of mutually improved economic relations.

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## TRANSBOUNDARY AIR POLLUTION IN NORTHEAST ASIA: THE POLITICAL ECONOMY OF YELLOW DUST, PARTICULATE MATTER, AND PM<sub>2.5</sub>

Matthew Shapiro

### ABSTRACT

This paper details the nature of transboundary air pollution in Northeast Asia, employing an analytical approach rooted in the political economy of the region. To measure public perceptions of the air pollution problem, it is shown that the Korean media largely frame transboundary air pollution in the region as a problem emanating from China. While it is true that the pollution originates in China and is carried eastward on the trade winds, China is not the sole contributor to this problem. Rather, Korean investments in China and the subsequent exports of goods from firms in China all play a role. The impacts can be quite severe and long lasting for individuals prone to respiratory problems. The economic costs are thus framed largely in terms of health costs in Korea, providing strong incentives for policy makers to effect change. Using correlation analysis, it is shown that China's pollution levels are positively associated with both Korean FDI flows to China and Korean respiratory deaths. The path forward must of course account for continued FDI flows from Korea to China, but it must also include greater levels of coordination between Korea and China on the issue of transboundary air pollution. Several existing institutions provide a solid foundation, but the curation and sharing of China-based emissions data with the Korean government will facilitate the tracking of high-polluting Korea-invested enterprises in China. In terms of preventative measures, Korea and China must coordinate on the development of technologies related to the reduction of air pollution.

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Dr. Matthew Shapiro is an Associate Professor of Political Science at the Illinois Institute of Technology, an East Asia Institute Fellow, and a Research Affiliate at the Joint Center for Energy Storage Research at Argonne National Laboratory.

## INTRODUCTION

Korea is faced with periodic environmental disasters in the form of pollution blowing from China.<sup>1</sup> In the winter, excessive burning of coal for heating has effects as far away as the U.S., shown in Figure 1, where cities like Los Angeles receive the equivalent of one extra day of pollution per year from China's production of goods for export.<sup>2</sup> In the fall and spring, western trade winds sweep up yellow dust from the deserts of northern China and Mongolia, to which soot and carcinogens from China-based industrial processes attach,<sup>3,4</sup> shown in Figure 2 (<http://www.eanet.asia/product/RSAP/RSAP.pdf>). The health-related consequences are more deleterious than those produced from traditional air pollution. Indeed, the long-term health consequences of particulate matter 2.5 micrometers or less in size ( $PM_{2.5}$ ) is particularly concerning, as  $PM_{2.5}$  is so small that it can directly enter the bloodstream after being inhaled. Such dust is laden with pathogens,<sup>5</sup> lead, cadmium, and arsenic,<sup>6</sup> and East Asia's concentrations of  $PM_{2.5}$  pollution are the highest worldwide.

Figure 1. Percentage and distribution of black carbon in 2006 from Chinese export industries

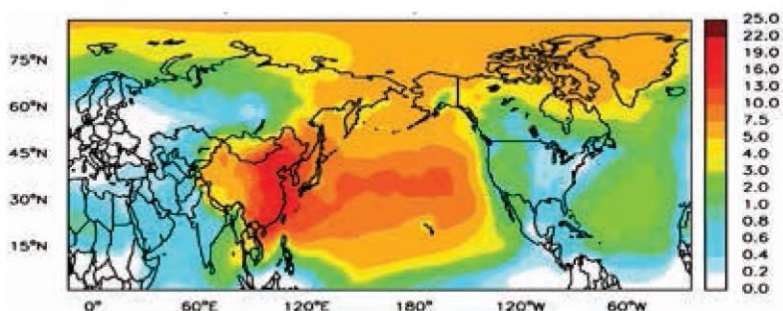
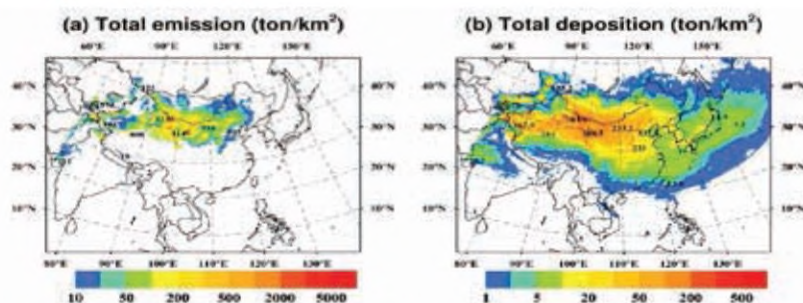


Figure 2. Spatial distributions of annual emissions and deposition of yellow dust in 2010



Source: <http://www.eanet.asia/product/RSAP/RSAP.pdf>

The movement of toxic  $PM_{2.5}$  beyond China's borders is technically in violation of the United Nations Convention on Long-Range Transboundary Air Pollution, but the fact that both natural and anthropogenic processes are at work makes it difficult to establish practical policy prescriptions. This dilemma of shared resources represents a classic commons problem, meaning that individual countries in Northeast Asia are reluctant to pay for the costs of abatement and clean-up because the benefits will be shared. This is confounded by regional politics, which has been known to trump the ecological interdependence of Northeast Asia, although the Chinese Academy of Sciences has now definitively acknowledged that China-based sulfur dioxide and nitrogen oxides must be effectively controlled.<sup>7</sup>

The problem is also confounded by Korea's trade and investments with China. Like much of the world, Korea imports heavily from China. At the same time, outflows of foreign direct investment (FDI) from Korea to China are massive, representing an average of 6-10 percent of China's FDI inflows. In short, Korean investors – both SMEs and large multinational firms – are quite possibly exporting a portion of their pollution-producing entities to mainland China where weaker environmental standards and lax enforcement (not to mention lower labor costs) provide a more advantageous profit margin. This process is consistent with what is known as the “pollution haven” hypothesis, i.e. the claim that businesses target locations for their manufacturing operations in order to, among other reasons, avoid higher environmental enforcement costs at home. Higher transportation costs, human capital concerns, green field investment costs, etc. are all offset by the opportunity to produce without internalizing the firms' domestic environmental costs.

Nothing is unequivocal about the international political economy of Northeast Asian transboundary pollution. Evidence confirms the pollution haven status of China,<sup>8,9,10</sup> but it is conditioned by the type of regulated pollutant and the specific province under analysis.<sup>11,12</sup> These varied findings are also a function of different assumptions about the nature of FDI and ultimately the need to address the underlying political economy of transboundary air pollution.<sup>13,14</sup> For example, some argue that multinational firms play a role in improving the Chinese environmental regime, and there is evidence that Chinese firms with international ties are more compliant with environmental regulations than those lacking such ties.<sup>15</sup> Could the answer be simply to make an appeal to foreign firms in China to be environmental standards setters and transfer pollution-reducing technology to local Chinese firms?<sup>16</sup> Unfortunately, that is not possible, particularly when considering the poor record of corporate social responsibility worldwide.<sup>17,18</sup> Yet, as I will ultimately prescribe, it is precisely through such technology transfers that China's air pollution can be most directly addressed.<sup>19,20</sup>

There are several factors that must be understood before prescribing policy alternatives that address transboundary air pollution in Northeast Asia. First, and maintaining the Korean focus, we must examine the role of the media in affecting

Korean public opinion on the subject of transboundary air pollution from China. *Are Koreans aware of their contribution to China-based air pollution?* Differences in the discourse and imagery used by those communicating information can be deliberately employed to promote a particular interpretation of events that ultimately impact policy decisions. Second, we must consider FDI and trade data while acknowledging the role of regional environmental institutions. *How do these institutions lay a foundation for further coordination between Korea and China?* Third, we must analyze Korea's internalized health costs associated with transboundary air pollution from China. *Are these costs increasing over time, and how are they associated with FDI flows from Korea to China and with exports from China?* The mechanisms are not entirely understood between air pollution and health-related effects,<sup>21</sup> but epidemiological research has identified a relationship between particulate matter concentrations and increased human mortality and morbidity.

Though the Korean media tends to lay the blame for the costs of transboundary air pollution on China, Korean firms operating in China in fact play a role in contributing to the problem. Indirectly, thus, Korea's investments in China are negatively impacting health outcomes at home and increasing health costs overall. This is an urgent problem, requiring the cooperation of both countries to manage what is ultimately a regional pollution issue.

## MEDIA FRAMING AND PUBLIC OPINION

The framing of yellow dust and particulate matter by both traditional and new media provides the basis for understanding how transboundary air pollution can be interpreted by the public.<sup>22</sup> Framing, however, is not merely a function of media reporting but also involves the public's attention to air pollution. I invoke Downs' "issue-attention cycle" to explain the overall attention received by the media and the public, which states that fluctuations in public and press attention are a function of the cycles that narratives take as issues of public concern evolve in media coverage over time. In stage one of Downs' cycle, people are unaware of the problem; in stage two, dramatic events focus people's attention on the problem; in stage three, the costs of solving the problem become clear; in stage four, there is a steady decline of public interest; and, in stage five, the issue is no longer central to the public's concern.<sup>23</sup>

What is remarkable about particulate matter/yellow dust is the seasonal and thus periodic nature of the problem. This represents an exceptional characteristic in the context of the Downsian cycle in that news about this problem cycles with the natural blowing of the dust and other seasonal phenomena such as the excessive burning of coal in China for the heating of homes during the winter. Whether information about China in the Korean media is similarly cyclical will diminish the importance of the problem, perhaps preventing the issue from advancing to stage three of Downs' cycle.

Before discussing how the issue is framed by the Korean media and thus the Korean public's opinion about transboundary air pollution, we should engage in a corresponding examination of the Chinese case. Implied by the Downsian cycle, if there is no media-based discussion or if there is no interest in FDI flows in relation to pollution, the Chinese government will be less incentivized to respond. However, our analysis of the Chinese media is limited by the government's excessive media censorship.<sup>24</sup> Reporters without Borders (<https://rsf.org/en/ranking>) ranks the Chinese media as 176<sup>th</sup> out of 180 countries in terms of media transparency and freedom of the press. This was certainly apparent when China's central propaganda department suddenly blocked online viewing of the documentary covering China's air pollution crisis, "Under the Dome," after hundreds of millions of people viewed it in the few days that it was first publicly available.<sup>25</sup> If air pollution-related content is discussed in the media, it should be expected that it would take on attributes similar to health-related content,<sup>26</sup> focusing on the individual rather than institutions. This would manifest in media reports calling for increased bicycling, better insulation of homes, and maintenance of automobiles in order to limit carbon monoxide emissions. We should thus not expect there to be explicit discussion about environmental regulations.

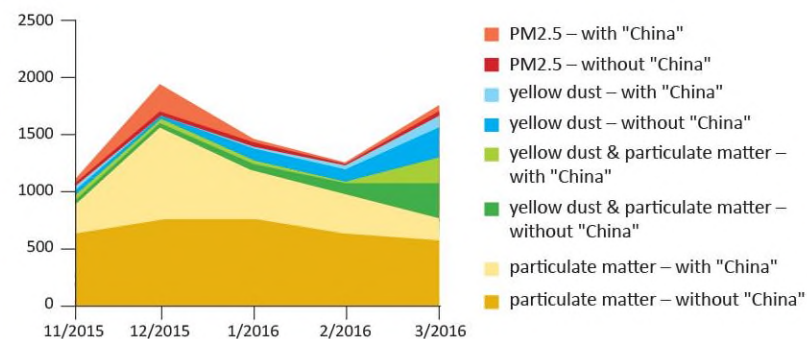
In terms of public opinion, surveys of the Chinese public in spring 2015 found that air pollution and water pollution are the public's second- and third-most important problems. Seventy-six and 75 percent of respondents, respectively, felt that air and water pollution were either a very big problem or a moderately big problem. Approximately one third of respondents expect air pollution (and water pollution) to get even worse in the next five years. This expectation is even more pronounced in Beijing and Shanghai, where 53 percent of the public expects air pollution to get worse over the next five years.<sup>27</sup> These opinions may have been affected by the viral viewing of "Under the Dome," which Environmental Minister Chen Jining stated was China's "Silent Spring-moment."<sup>28</sup>

Turning now to Korea, my analysis of the media is based on data curated from the National Information Agency's (NIA) media search tool. NIA's search tool summarizes all news articles, social media, and online blog posts from approximately 300 Korean news companies.<sup>29</sup> While new/social media afford increased opportunities for the public to contribute to the corpus of news through reposts on Facebook, YouTube, Twitter, etc.,<sup>30</sup> I limit the sample to all Korean-based traditional media and online blog posts. A longitudinal analysis of media content patterns is employed, consistent with existing analytical approaches.<sup>31, 32</sup>

Korean media content is examined in terms of whether yellow dust, particulate matter, the combination of yellow dust and particulate matter, or PM<sub>2.5</sub> are discussed concurrently with China. If China is mentioned in the context of one of these three (or more) topics, I assume that it is being attributed as the source of the pollution.<sup>33</sup> Figure 3 presents an overview of Korean media content from

November 2015 through March 2016 on the topics of yellow dust and particulate matter. As we can see, yellow dust is presented in the media to a significant degree only when the actual dust is blowing, specifically from February and into March (and likely increasing in April). There are no clear differences between those reports mentioning yellow dust or yellow dust/particulate matter with and without China. Media reports covering particulate matter are present throughout the news cycle, indicating that the topic is important and not yet passing into stage four of Downs' issue attention cycle. We should also note the December increase in content mentioning China in combination with particulate matter/PM<sub>2.5</sub> is a likely function of China's increased use of coal for heating.

Figure 3. Korean media coverage of yellow dust/particulate matter



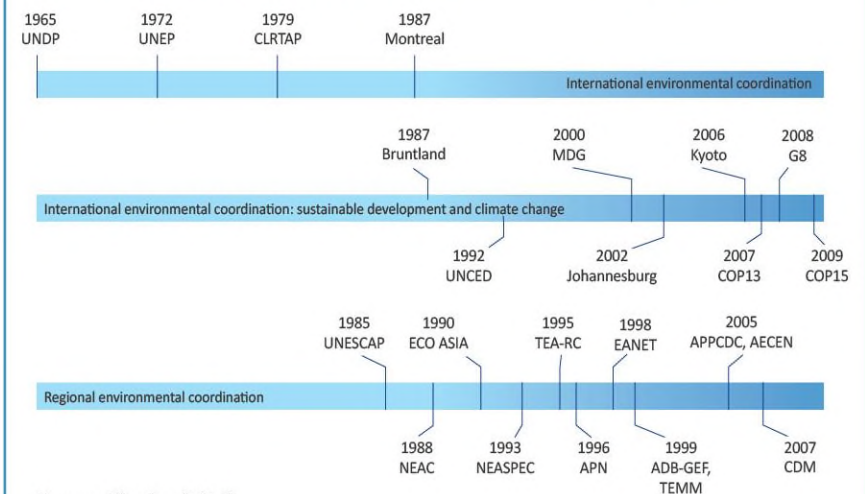
A keyword analysis of these 7,000 articles and blogs reveals a number of differences in how the media covers air pollution.<sup>34</sup> It was found that yellow dust-related media content is primarily focused on health-related information and preventative measures. These include topics such as dust masks, air purifiers, humidifiers, advisories, and respirators. This is consistent with efforts by the Korean Medical Association to understand preventative measures for pulmonary diseases through the use of masks with filters, promoting the restriction of outdoor activities, and communicating the risks of exposure to the dust to the public.<sup>35,36</sup>

Media reports covering particulate matter and PM<sub>2.5</sub>, however, highlight the Chinese influence. Virtually all articles on these topics were international in nature. The media thus present the yellow dust problem from an epidemiological perspective while particulate matter/PM<sub>2.5</sub> is framed as a China-based problem. More importantly, there is virtually no discussion in the media about the holistic nature of the yellow dust/particulate matter problem; i.e. that FDI from Korea and Korea-China trade may exacerbate the transboundary air pollution problem. The campaign for the hearts and minds of the Korean public – if one exists – is dominated by the Korean medical and epidemiological community.

## TRANSBOUNDARY AIR POLLUTION AND THE ROLE OF INSTITUTIONS

The solution for common problems such as transboundary air pollution is negotiation and problem-solving among a handful of invested and capable individuals. In Northeast Asia, this occurs through formal negotiations and discussions, such as meetings of the annual Tripartite Environmental Ministers Meeting (TEMM), one of many attempts to deal with environmental concerns across the region, as shown in Figure 4. Indeed, at the 2001 TEMM, environmental ministers of China, Korea, and Japan stated explicitly that action needed to be taken regarding the yellow dust problem; yet, there has been no binding commitment to action, and the participating countries make reference to TEMM's infringement of national sovereignty. Another option, also presented in Figure 4, is the Acid Deposition Monitoring Network in East Asia (EANET), which is a regional initiative to install air pollution-related monitors across the region to improve data quality and analysis. Like TEMM, however, China has voiced concerns about EANET's challenge to its national sovereignty. In past years, this has resulted in its refusal to share large portions of its pollution and environment-related data.<sup>37</sup> Similarly, Korea has attempted to limit Japan's dominance of EANET by opposing the placement of EANET's network center in Japan. Despite these challenges, the region has effected coordinated management as well as a host of multilateral organizations.<sup>38,39</sup>

Figure 4. Key regional and Northeast Asia-specific environmental policies



Source: Shapiro (2014).

Within China, the most readily available tool for addressing transboundary pollution is regulatory enforcement. Enforcement has been, however, a chronic problem for the severely understaffed environmental and energy ministries in China.<sup>40</sup> There are several notable updates. First, in early 2016, one-quarter of the 191,000 firms violating environmental regulations in 2015 were either shut down or forced to suspend operations. Environmental Minister Chen Jining stated that “many companies [are] still behaving illegally and local governments [are] still hampering enforcement efforts” of the central government.<sup>41</sup> This represented a continuation of the Supreme People’s Procuratorate’s 18-month investigation and prosecution of more than 2,100 corrupt government officials from January 2014.<sup>42</sup> As well, Minister Chen oversaw the closure of 3,400 companies, 3,700 construction sites, and 3,100 workshops in 2015. This was preceded in 2014 with the allocation of \$1.6 billion for air pollution prevention and control. Coal mining facilities were also to be shut down in order to improve the quality of coal, natural gas supplies were to be made more stable, and clean energy and energy efficient buildings were to be promoted. As a result, nitrogen oxides are expected to be reduced by 5 percent.<sup>43</sup>

These changes in China’s regulatory landscape, if prolonged, will likely impact foreigners’ decisions to invest there. The exact effects are not necessarily clear, as stronger regulations can lead to increases in FDI,<sup>44</sup> or FDI can yield stronger regulations overall.<sup>45</sup> These results represent the challenges of establishing causality between FDI and regulations and, overall, the complex relationship between FDI and trade relations, a topic to which we now turn.

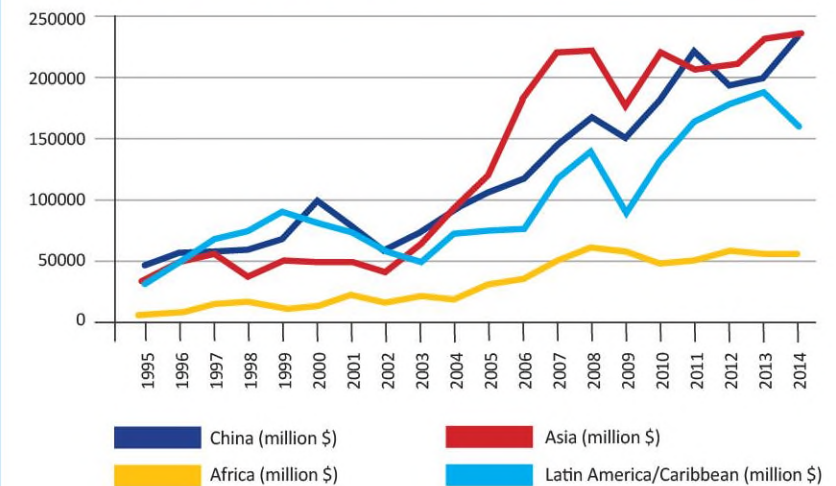
## CHINA’S INWARD FDI & BILATERAL TRADE WITH KOREA

The pollution haven hypothesis can be verified in a number of ways. The crucial piece of evidence is that pollution levels increase after multinationals or other international actors invest in the purportedly environmental institution-lacking country. Connecting FDI to pollution haven activities is plagued with obstacles, but updates now confirm that such a connection is both present and clear.<sup>46,47</sup> It is also worth examining the relative levels of pollutants produced in the manufacturing of goods for export, as emissions arising from foreign-invested enterprise exports are higher than those arising from Chinese-owned enterprise exports.<sup>48</sup> In 2006, approximately one-third of sulfur dioxide, one-quarter of nitrogen oxides, one-quarter of carbon monoxide, and exactly 17 percent of black carbon were the result of China’s export-related manufacturing. One-fifth of each of these can be attributed to exports destined for the U.S.<sup>49</sup> This is a story that has slowly played out in China since the 1997 economic stimulus plan stimulated the widespread use of fossil fuels.

In terms of FDI levels, shown in Figure 5, China is the single largest recipient of FDI in the world.<sup>50</sup> Figure 6 describes the source countries, led as of 2012 by

Japan’s 16 percent, followed by Korea, the U.S., and Taiwan, each representing approximately 6 percent of China’s overall FDI inflows. To put it another way, one-third of all FDI flows to China originate in the areas that are most likely to be affected by China’s transboundary air pollution. (The most recent activity shows that Japan’s 2013 FDI to China decreased while Korea’s increased, coinciding with strengthened diplomatic ties between Beijing and Seoul.) Samsung Electronics and Kia Motors Corporation are the primary contributors from Korea in the most recent years.<sup>51</sup> There are no guarantees that larger firms will introduce the more expensive and less polluting production process when setting up operations in China, as shown in a 2005 assessment of Fortune 500 companies operating in China.<sup>52</sup>

Figure 5. FDI inflows for major geographies

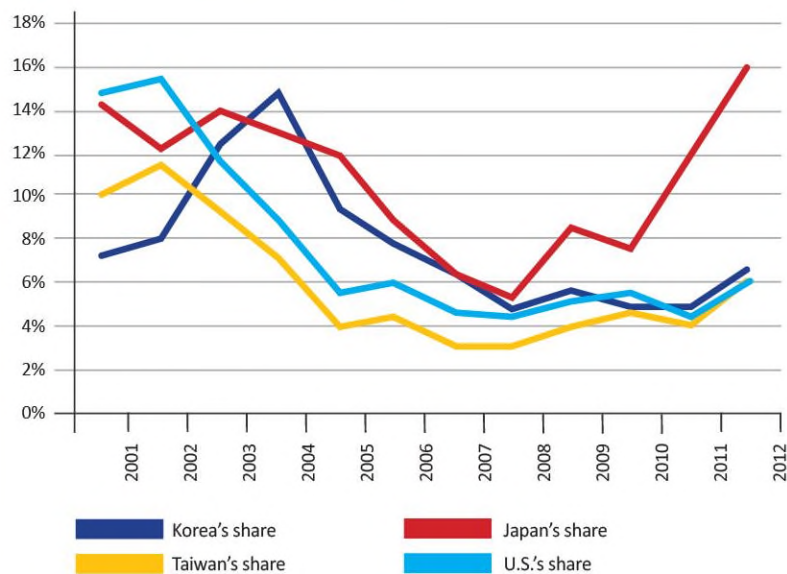


Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

Note: “Asia” excludes both China and Japan. China-based FDI data include FDI inflows to Hong Kong.

There is much at stake for Korea if FDI to China drops. Given the significant relationship between Korea’s FDI to China and Korea-China bilateral trade, shown in Figure 7, changes in FDI flows will likely impact Korea’s trade balance with China. It should be noted that Korea is unique among all of China’s trading partners in that Korea operates on a trade surplus, and the surplus appears to be increasing over time. Yet, if FDI and thus bilateral trade drops, so too would a portion of China’s pollution generation. The implication is that trade-related losses could be measured against the frequently undercounted and less understood health consequences of transboundary air pollution.

Figure 6. Sources of China's FDI inflows



Source: UNCTAD FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)), based on data from the Ministry of Commerce (MOFCOM).  
Note: China-based FDI data include FDI inflows to Hong Kong.

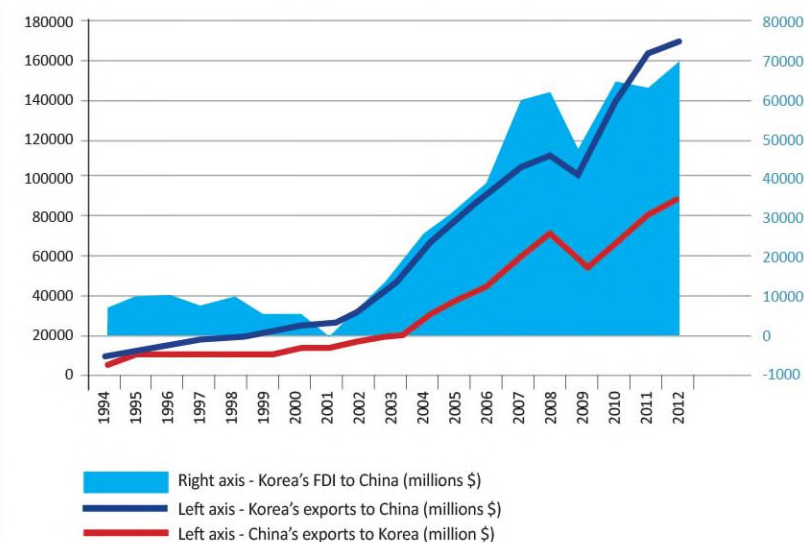
## COST ASSESSMENT

One can assess the economic costs of transboundary air pollution in East Asia in terms of GDP or any of GDP's constituents. For example, pathogens hitching rides on Saharan dust impact agricultural crop yields in the Caribbean and the Americas.<sup>53</sup> As well, transboundary acid rain deteriorates metal machinery and structures. Less well known but nonetheless important for the national income accounts are health effects and its attendant costs. These costs are quite high, equivalent to 80 percent of the total air pollution costs.<sup>54</sup> They also contribute to the creation of the compelling media frame identified earlier that, in turn, has influenced public opinion about the health effects of transboundary pollution.

The health effects associated with specific air pollutants vary according to temporal variance and pollutant type. Short-term effects of the combination of particulate matter and nitrous oxide include an increase in mortality, hospital admissions, and asthma symptoms. For particulate matter alone, there are also cardiovascular effects as well as lung inflammation; for nitrous oxide alone, there is an increase in allergic inflammation. Long-term effects for the combination of both pollutants include a reduction in lung function and an increase in respiratory

symptoms. For particulate matter alone, long-term effects also include an increase in chronic obstructive pulmonary disease, lung cancer, diabetes-related effects, and a risk of myocardial infarction.<sup>55</sup> The mechanisms are not fully understood between outdoor air pollution and morbidity and mortality linked with respiratory and cardiovascular diseases,<sup>56</sup> but existing evidence identifies the relationship between dust and human health and, specifically, particulate matter concentrations and increased human mortality and morbidity.<sup>57,58</sup>

Figure 7. Korea's FDI to China and Korea-China bilateral trade



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).  
Note: China-based FDI data include FDI inflows to Hong Kong.

Based on data drawn from the Asian Regional Emission Inventory, premature mortality from  $PM_{2.5}$  for all of East Asia in 2005 was 520,000 and will range from 450,000 to over 1 million cases in 2020 depending on policy scenario.<sup>59</sup> In Japan specifically, the health effects of yellow dust have been found to increase the potential of heart disease and pneumonia mortality.<sup>60</sup> In Korea,  $PM_{2.5}$  due to high levels of yellow dust is associated with cardiovascular mortalities.<sup>61</sup> This is consistent with an internal report from 2003 by the Chinese Academy of Environmental Planning estimating that 300,000 people die each year from ambient air pollution as well as a 2005 report by Chinese environmental experts estimating that annual premature deaths from air pollution would reach 380,000 in 2010 and 550,000 in 2020.<sup>62</sup> In sum, and based on a World Bank- and Chinese State Environmental Protection Administration-authored report, the economic costs of air pollution in China are as high as or more than 3.8 percent of China's GDP.<sup>63</sup>

In East Asia, we are discovering both temporal and constitutive differences between the effects of  $PM_{2.5}$  and larger forms of particulate matter.<sup>64</sup> For example,  $PM_{2.5}$  has been found to lead to more chronic diseases of the lung and heart than  $PM_{10}$ .<sup>65</sup> Mean annual exposure to  $PM_{2.5}$  for Korea and China is presented in Figure 8, showing 25 percent growth in China from 1990 to 2013.<sup>66</sup> Given that fossil fuel use plays a big part in of particulate matter concentrations and that China-based nitrogen oxides are especially prone to travel across borders,<sup>67,68</sup> Figure 9 presents data on China's and Korea's fossil fuel energy consumption (as a percentage of total energy consumption) and nitrous oxide emissions in the energy sector (as a percentage of total emissions). While nitrous oxide emissions as a percentage of total energy sector emissions have increased more rapidly in Korea vis-à-vis China, fossil fuel energy consumption as a percentage of total consumption has increased in China while it has decreased in Korea. Finally, in Figure 10, I present longitudinally the number of respiratory deaths in Korea and the per capita consumption of tobacco in Korea, the latter acting as a control for respiratory conditions in general. There has been a decline in tobacco use over time while the number of respiratory deaths has increased.

For purely exploratory purposes and without claiming causality, I have also conducted a correlation analysis of the aforementioned measures as well as several others. Among those correlations that are significant, the number of respiratory deaths in Korea was found to be negatively associated with FDI flows to China. Respiratory deaths were also found to be negatively associated with trade between Korea and China. Respiratory-related deaths are, however, positively associated with increases in Korea's electrical production from oil, gas, and coal. They are also positively associated with China's fossil fuel energy consumption. Korea's, not China's, nitrous oxides emissions are strongly associated with Korean respiratory-related deaths. FDI flows from Korea to China are positively associated with decreases in Korea's fossil fuel energy consumption and positively associated with China's fossil fuel energy consumption. At the same time, Korea's fossil fuel energy consumption is negatively associated with China's electrical production from oil, gas, and coal, with China's fossil fuel energy consumption, and with China's nitrous oxide emissions.

On the basis of just these associations, one could argue – and with great trepidation given modeling deficiencies – that Korea's FDI flows to China are not on their own responsible for Korea's health costs as measured by the number of respiratory-related deaths. Yet, given the positive relationship between Korea's FDI flows to China and China's increased fossil fuel energy consumption – the latter of which is positively associated with respiratory deaths in Korea – one could tentatively claim that the pollution haven-related behavior of Korean investors is connected to Koreans' overall health. We of course cannot ignore the fact that Korean respiratory deaths are also positively related to Korea's electrical production from oil, gas, and coal, but the presentation of these data establishes crucial connections among health effects, FDI flows, and transboundary air pollution.

## PRESCRIPTIONS AND CONCLUSIONS

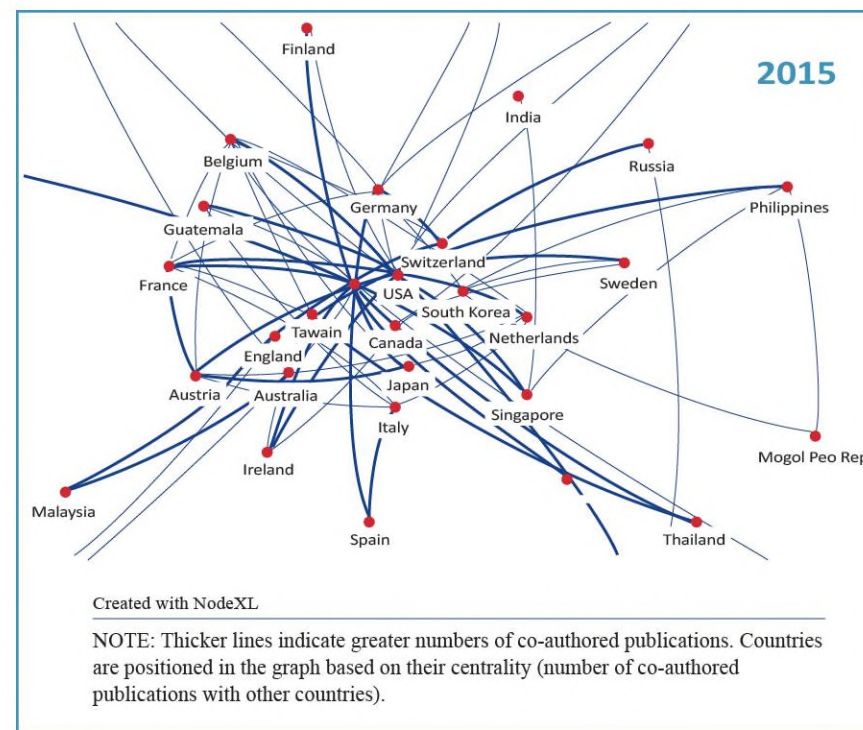
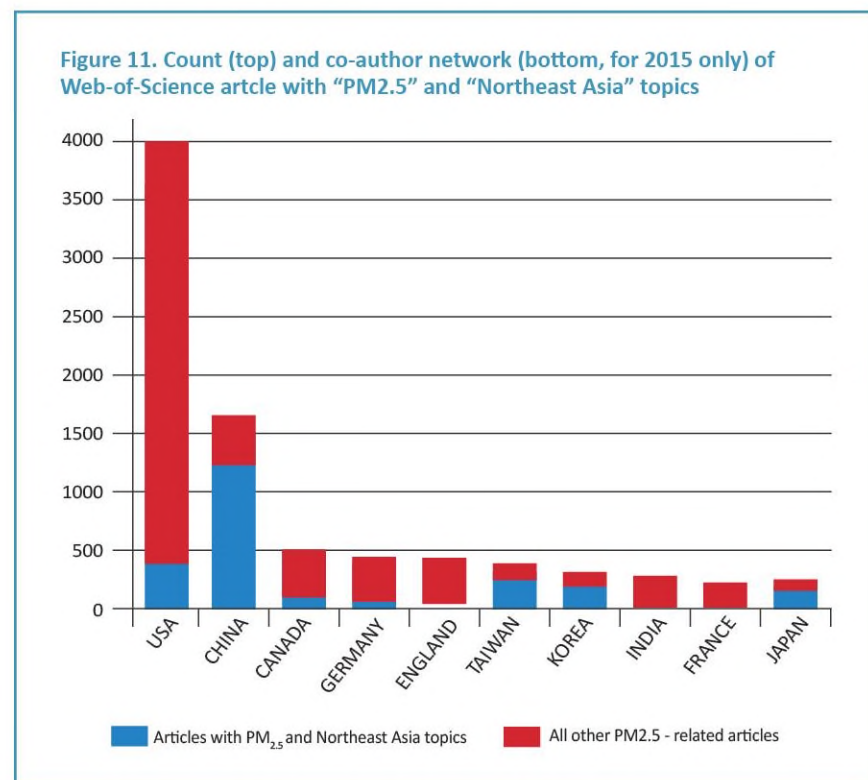
The pollution generated in China is not solely China's responsibility despite the fact that this frame dominates media-based reporting on the issue. I have shown that trade and FDI from Korea are connected to transboundary air pollution, and that there are likely health consequences for Koreans; i.e. exported pollution ultimately results in internalized health costs. Whether this is because Korean companies are investing in China chiefly for lower environmental regulations or to benefit from lower labor costs is of little consequence. It all points to a simple but untenable solution: Korea must decrease its FDI in China. The better, more practical solution is the further deepening of Korea-China cooperation, building upon TEMM and EANET while focusing expressly on opportunities for technology transfer and international R&D collaboration. Indeed, FDI can ultimately contribute to crucial technology transfers.

Korea must support China's efforts to rein in violators of Chinese environmental laws. This can occur through the release of official statements of support from the Korean Ministry of the Environment and the Korean Ministry of Trade, Industry & Energy whenever high-polluting China-based enterprises – particularly those in which Koreans are heavily invested/own – are identified and forced to close or improve their production processes. Indeed, this will greatly change the domestic media-based frame from one that highlights China as the source of pollution to one that details the complex connections between international economics and transboundary air pollution. Second, these same Korean ministries should more actively support the Chinese government's development and dissemination of a comprehensive emissions report that can be used to identify the sources at home, namely Korean investors in high-polluting enterprises in China. These polluters can subsequently be targeted in Korea as well as in China. This process would rely on a more elaborate version of EANET, as there will need to be many more air pollution monitoring stations across China, some situated very close to the Korean-invested enterprises.

China must continue to work internally as well as look abroad for technological solutions to the transboundary air pollution problem, as effective and sustained growth will ultimately be a function of continued manufacturing for exports while reducing pollution emissions. This effort would thus build on the \$220 billion invested in China in wind, solar, hydropower, and clean-coal technologies during the 2008-09 recession.<sup>69</sup> From the Korean perspective, the technology sharing process can be incentivized for Korean investors in China-based enterprises, particularly those that are energy intensive in their production process. Such incentives may include subsidized intellectual property licensing payments or a health cost offset. These technological solutions are building on basic research efforts that identify specific innovation needs.

On that front, an analysis of the co-authorship network of scientists and researchers in the region reveals that there is a network within and extending beyond Northeast Asia that focuses on the region's PM<sub>2.5</sub> problem, shown in Figure 11. When research is oriented around air pollution, as is the case in cross-national research collaborations in Northeast Asia,<sup>70</sup> a foundation is laid for collaborative patenting efforts and the creation of a growth trajectory reliant upon green technologies.

Future research about transboundary air pollution must continue to be holistic in nature. With sufficient understanding, our knowledge of the Northeast Asian case will prove useful for other transboundary air pollution geographies, such as the Saharan dust that disperses in much larger quantities and over much greater distances than Asian dust.<sup>71</sup> The lessons learned from Northeast Asia can become yet another model for economic and sustainable development in parts of the world faced with similar environmental conditions.



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UNDERSTANDING THE  
SOUTH KOREAN ECONOMY



## LABOR MARKET RIGIDITIES AND SOCIAL INEQUALITY IN KOREA: THE ROLE OF LEGAL, ECONOMIC AND SOCIAL GOVERNANCE

Vladimir Hlasny

### ABSTRACT

This study explores the organization of the Korean labor market, systemic faults in it leading to undesirable outcomes and their determinants, and consequences for workers and employers. Long-term implications for the arrangement and cohesion of society at large are discussed. The study has three specific objectives: 1) to describe the present labor relations, structure and governance of the Korean labor market through the prism of imperfect/regulated competition theory, with a focus on rigidities and systemic faults in the present organization; 2) to identify structural determinants of the faults, and their intermediate- and long-term consequences; and 3) to inform regulatory and legal reforms in order to achieve superior modes of governance and market organization.

The study focuses on understanding of the role of social, structural and regulatory constraints on effective matching of workers and jobs – their sources, manifestations, and consequences. Implications of market rigidities are evaluated vis-à-vis workers' skill-acquisition decisions and outcomes, their social and intergenerational mobility, and firms' long-term prospects. Existing policies and policy proposals are reviewed in regard to their impacts. The ultimate aim is to identify opportunities for economic regulation, legal governance and market norms to help overcome the existing faults in labor relations and market organization, and to transition to a more flexible, transparent, equitable, and sustainable form of market organization.

**Key words:** *Labor market organization, dual markets, Korea*

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Dr. Vladimir Hlasny is Associate Professor of Economics, Ewha Womans University.

## INTRODUCTION

Korea faces the challenges of low and stagnating factor productivity, rising social inequality, and unsustainable demographic change while striving to maintain economic growth. Until the 1997 financial crisis, Korea experienced rapid growth with a modest level of economic inequality and healthy population growth. In the 1990s and 2000s, the Korean manufacturing sector expanded its production, exporting capability, and factor productivity. The services sector followed its lead in the 2000s when financial and technology firms joined the international market for high value-added services. Korean firms' success is to a large degree due to rapid upskilling and high motivation of the Korean workforce.<sup>1</sup> Correspondingly, workers' earnings and working conditions have improved dramatically in the past two decades.<sup>2</sup> These positive trends have not, however, been equally distributed across economic sectors and groups of workers. Notable pockets of systematically underutilized workers have arisen, through a mismatch between their skills and jobs. This affects labor productivity as well as – through workers' skill-acquisition and family-planning decisions – long-term demographic trends.

The gap between the rich and the poor in Korea has risen, and the relative poverty rate doubled during the 2000s and has stagnated since.<sup>3</sup> Deprivation among marginalized workers – such as the elderly, youth and women – is stubbornly high, and social mobility is low. Moreover, over the past decade, the Korean population has rapidly aged as the baby-boom generation reach retirement age and the fertility rate drops to all-time lows following years of government family-control policies and various constraints that child-bearing women faced in the labor market. An aging population stands to negatively impact economic growth, labor-market productivity and social inequality in the decades to come, as the economy fails to adapt and integrate the elderly, childbearing women, and other nontraditional workers effectively.<sup>4</sup>

This lack of effective labor integration is partly due to patchy laws and structural barriers in the labor market that prevent workers from effectively demonstrating their skills or negotiating their working conditions, and limit firms' human resource management (HRM) to options made available to them by sector-specific regulations and norms. The labor market is not sufficiently flexible to assign all workers to best-fitting jobs, or to guide them to invest in the needed sets of skills. Women who get married or return from maternity leave are relegated to non-regular jobs, rather than being put on an alternative schedule or being retrained. Elderly workers whose utility to employers may potentially diminish or increase non-pay costs face similar circumstances.<sup>5</sup>

In general, workers are trapped in particular industrial sectors and career paths, with predetermined working conditions, not because of their existing skills and potential, but because of HRM constraints and path dependency. Workers have

been effectively divided between a primary and a secondary labor market, and offered regular or non-regular working status.<sup>6</sup> The primary market consists of too-large-to-fail shareholder-owned employers and firms with a government stake in them, known as the *chaebol*, which remain at the forefront with access to the best business opportunities by being innovative and dynamic, but also operate under the spotlight of regulation. The secondary market is populated by small and medium-sized enterprises (SMEs) that rely much less on innovation and compete more on cost than on value of their product, and are regulated much more loosely. Jobs in the primary sector are secure, carry generous benefits and opportunities for professional growth, and are subject to strong protection of labor standards and equal opportunity laws. Secondary sector jobs, on the other hand, are insecure, largely without benefits, and are regulated much more loosely. They offer workers wages, but little longer-term income security or social protection. Workers from disadvantaged backgrounds, childbearing-age women, the disabled, and the elderly are largely excluded from participating in the primary labor market, and have consequently lagged behind in their earnings, non-pay benefits and various opportunities for advancement. This in turn reduces their incentives for skill acquisition in the first place.

Such a state of segmentation, or dualism, endures in many sectors of the Korean economy. Markets for factors of production, intermediate goods and final goods – and particularly labor markets – are fragmented into segments that do not compete directly with one another, and that effectively trap resources from flowing across market segments and from finding their best uses. This study therefore starts by observing that it is the systemic faults in the organization of labor market and rigidities in labor relations that cause the market outcome to exhibit duality and persistent inequality. The study concentrates on understanding the role of social, structural, and regulatory constraints on effective matching of workers and jobs – their sources, manifestations, and consequences. It reviews workers' and firms' objectives in labor relations, and constraints and information asymmetries that prevent them from achieving mutually more desirable, socially beneficial, and sustainable outcomes. The study then catalogs manifestations of rigidities in labor relations, including chronic un- and under-employment among marginal workers, cases of skills–jobs mismatches, strategic adjustments to firms' and workers' practices, the distortionary role of third-party recruiters, skill certification agencies and trade unions, and other impediments. Implications of these conditions are evaluated vis-à-vis workers' skill-acquisition decisions and outcomes, their social and intergenerational mobility, and firms' long-term performance. Existing policies and recent policy proposals are reviewed in regard to their impacts. The ultimate aim is to identify opportunities for economic regulation, legal governance and norms prevailing in markets to help overcome the existing faults in labor relations and social organization, and to transition to a simpler, more flexible, equitable, and sustainable form of labor market organization.

## PRESENT LABOR MARKET ORGANIZATION AND ITS FAULTS

Labor markets are typically not paragons of perfectly competitive markets that would be predicted to produce welfare-maximizing outcomes. In Korea, the imperfections are accentuated by a unique interdependence between business conglomerates (*chaebol*), SMEs, and the government; by a system of inconsistent unevenly-enforced laws; and by inadequate social protections. Several features of the present organization of Korean labor markets cause particular rigidity in labor relations, prevent effective coordination of the supply and demand of skills, and yield inequitable and inefficient outcomes for workers and employers. This section reviews these faults.

### **Chaebol vs. SMEs**

First, as has been widely documented in existing studies, a state of dualism exists in the business climate faced by firms, namely between the *chaebol* and SMEs. The *chaebol* are capital-intensive, export-oriented, typically manufacturing firms that remain at the forefront by investing in innovation and dynamism. The *chaebol*, thanks to their formal qualifications and perceived reliability, have access to the best corporate and government tenders, credit lines, retail space, and other factors of production. By their nature they have a holdout (monopsony) power over their suppliers. They also operate under the spotlight of regulation and customer scrutiny, and for the most part comply with equal opportunity laws and government-mandated or recommended labor standards. Their position hinges on their ability to avoid government crackdowns and customer backlashes.

SMEs rely much less on dynamism and reputation, and compete more on cost and output than on value of their product. They are to a large extent labor-intensive service firms, whose typical customers are local residents and the *chaebol*. One problem is that service firms face heavy product-market regulation relative to manufacturing, which adversely affects their earning capacity and costs.<sup>7</sup> At the same time, their HRM is regulated much more loosely, in part due to their numerousness, and in part because regulators and disgruntled workers know that it is not worth filing complaints. Bankruptcy and reorganization rates are high. Workers at SMEs are typically barred from associating, receive significantly lower non-pay benefits, and face insecure employment.

The *chaebol* and SMEs face systematically different distributions of skills in their applicant pools, and different incentives and constraints on the procurement and management of human capital. Workers clearly prefer being hired by the *chaebol*, and only consider SMEs once they fail with the former group of employers. In this respect, one may distinguish primary and secondary labor markets, in which employers and workers compete within their segments but not across the fault lines. Once workers join the secondary labor market, they face an uphill

battle switching to the primary sector later in their career. Given their working conditions and prospects for advancement, many secondary market workers can be categorized as engaging in informal employment.<sup>8</sup>

As with workers, firm mobility across the fault line is virtually nonexistent, because of the established system of exclusive access to tenders, suppliers and infrastructure, and reputation with workers. Essentially all small firms remain small (if they survive at all), and all medium-sized firms remain medium-sized. Primary and secondary market firms end up with chronically different workforce composition and hierarchy.<sup>9,10</sup>

### **Regular vs. Non-Regular Workers**

Another fracture in the Korean labor market is the distinction between regular and non-regular workers. Approximately 60 percent of Korean workers are classified as non-regular. Moreover, temporary workers – fixed-term, on-call, and temporary agency workers – account for more than one-third of that, near the top among OECD countries (Figure 1). The persistently high number of non-regular workers and their unstable economic conditions represent a problem in the Korean society. They earn only about 60 percent of the average hourly wages of regular employees, and are often excluded from benefits such as medical insurance, severance pay, welfare subsidies, and training opportunities available to regular employees.<sup>11</sup>

The dualistic state came into existence in the labor market in the late 1990s after the financial crisis. Companies started using non-regular workers for non-core positions in the organization with the aim to preserve labor flexibility and cost advantage in the face of rising global competition.<sup>12</sup> They took advantage of an exception in the strict employment-protection legislation that applied to permanent workers only. In years since the 1997 crisis, non-regular employment arrangements spread throughout the economy, particularly in the service sector and at SMEs where workers do not have to undertake intensive firm-specific training and are easier to replace.

The problem with the non-regular work scheme is that it places a discrete wedge between the cost of regular and non-regular workers, even though productivity is distributed continuously across workers. Under the scheme employers have the prospect of earning economic rents from the labor-cost differential across different categories of workers, all with similar productivities.<sup>13</sup> They can hold out on hiring regular workers or on filling non-regular positions with less productive applicants. Combined with the requirement that non-regular workers be converted to regular status after two years of service, the scheme most gravely affects the working conditions and employment stability of marginal and unproven workers such as fresh graduates, women returning from maternity leave, and the elderly. Youth under- and un-employment have become entrenched. Relatedly, growth of

temporary and part-time employment diminishes firms' incentives – and workers' own capability – to invest in workers' human capital.<sup>14,15</sup> Finally, growth of non-regular employment leads to an enduring dispersion in incomes and working conditions in the economy. This is exacerbated by the erosion of disadvantaged workers' skills and by the consequences for the opportunities of workers' families and children.

### ***Unresolved Uncertainty Over Workers' Productivity***

Another typical failure of labor markets – causing particular rifts in Korea under existing market norms and regulations, as this section will argue – is the inability of firms and workers to effectively resolve the uncertainty over workers' productivity. In recruitment and in the ensuing employer-worker relationships (in granting promotions or other career-advancing opportunities), employers cannot rid themselves of the risk of making wrong selections and HRM decisions. While firm performance depends crucially on their ability to select the best-qualified people and manage them through the workers' tenure with the firm, the employers' ability to assess, select, and nurture talent is limited by patchy anti-discrimination regulations and imprecision of the available signals for workers' skills. Employers are prohibited from using some types of personal information for workers in their HRM decisions, but enforcement is uneven across various types of information collected, and across employers in the primary versus secondary labor markets, regular versus non-regular workers, and employers versus recruiting agencies. Screening a candidate's personal characteristics is prohibited, but looking into their family background is tolerated. Legal loopholes and special concessions also breed duality in the labor markets, whereby some firms and workers have better opportunities than others. Regular or unionized workers are protected at the expense of non-regular workers or job applicants. Typically only primary-sector employers are inspected by regulators. If firms face significant restrictions on their practices, they outsource to HRM companies that are largely unregulated.

Employers' problems are compounded by workers' self-selection, whereby only workers with the best observable signals – but possibly mediocre productivity – apply for positions where those signals are screened, and moral hazard, whereby workers' behavior or usable skills change once they are hired. This represents a particularly large risk if workers' effort and skills are difficult to assess, and if workers are shielded from repercussions such as termination by their permanent-employment contracts. An inadequate conflict resolution system between employees and firms prevents the parties from fully agreeing to terms of employment before hiring, or settling disputes efficiently. Corporate norms and regulations provide for limited arbitration, and impose limited civil damages for law violations and contract breaches. Coupled with the lack of systematic enforcement of anti-discrimination laws, this leaves employers with only non-transparent informal ways – reliance on a set of imprecise signals or

costly bypasses – to ensure hiring productive workers. Employers rely on third-party certifications, internal or external references, or family background such as parents' work history as signals for uncertain skills and personality traits of workers. These practices are costly to employers and/or amount to worker profiling and discrimination. Although they are effectively sanctioned by the state of regulation, they are socially costly and unfair toward some workers and firms.

Inefficient and fragmented markets typically create opportunities for intermediaries such as recruiting agencies or trade unions. They are involved in matching workers to jobs, but by internalizing only some of the consequences of hiring choices (e.g., employer's short-term satisfaction) and externalizing others (e.g., worker's long-term performance, career growth, and dedication to employer) recruiting agencies make different recommendations than well-informed employers might. Similarly, unions have a stake in getting only particular types of workers hired, thus performing their own profiling and discrimination. If workers become whistleblowers or cause other trouble to employers or unions, they may be blacklisted from working in the industry.

Cultural acceptance of the status quo exists among employers, workers and regulators. Employers have no means to unilaterally change their practices if their competitors continue using them and workers act under rational expectations that the practices will prevail. Workers are also powerless, given that whistleblowing could lead them to be fired or black-listed in the industry.<sup>16</sup> Regulators accept the lack of formality and transparency in the face of a needed overhaul that would be met with strong opposition from business and labor groups.

There is presently no private market or government solution for the uncertainty over workers' skills. Compensation policy and employment contracts are typically not subject to negotiation. Employers thus cannot negotiate with workers effectively. They cannot offer inferior benefits or working conditions to less productive or unproven workers beside what the regular/non-regular worker system allows for. Employers also cannot insure themselves against the hiring of undesirable workers, cannot defer payments until workers demonstrate their skills, and are unable to terminate at will regular workers if proved undesirable.

The government, which should help employers and workers to get matched, does not provide reliable information on workers or guarantees for them. In fact, the current regulatory regime contributes to the uncertainty. Enforcement of equal-opportunities laws is lax, and penalties for non-compliance are limited to non-criminal charges. There are no provisions for compensation of discriminated workers. Industry and human rights watchdogs lack the authority to prosecute.<sup>17</sup> Government efforts to usher in more flexible labor relations have also failed to bring transparency and fluidity to the labor markets. By promoting the categories of non-regular and temporary workers, the government has caused a schism in the

labor market. By prohibiting worker discrimination, but enforcing it selectively across sectors and worker types, the government has distorted employers' behavior in harmful ways.

The implications of uncertain worker productivity are that even equally skilled and qualified workers may end up with vastly different careers and lifetime earnings, as workers are not matched efficiently to jobs in which their productivity is highest. Employers may not hire the correct number and type of workers, consequently failing to minimize their operating costs.<sup>18</sup> Workers' incentives regarding skill acquisition are distorted, as they cannot demonstrate their qualities effectively and instead invest in qualities that are easily observable by employers (e.g., physical appearance, certifications of aptitude with computer programs or languages), even if these have little bearing on workers' ultimate productivity at particular firms. The problems due to the lack of opportunities for workers to prove themselves accumulate throughout workers' lives, and even across generations. Fresh graduates with an inferior set of signals such as disadvantaged backgrounds are not in the pool for best starting jobs, which will limit their career paths throughout their lives. These workers thus lack motivation to invest in skills most highly valued by primary-sector employers – regardless of the workers' ability to learn.

### ***Inadequate Social Safety Net and (Re)education Policy***

Another source of inequality and polarization in the Korean labor market is the inadequate system of care and support for disadvantaged workers. Workers trapped in wrong jobs or sectors, as well as workers with interrupted careers, those with children to take care of, and the long-term unemployed presently lack opportunities to be matched to jobs making use of their best potential. Workers who stray off the appropriate career path (considering their true potential skills) are not given a second chance to join it.<sup>19</sup>

Since private markets are traditionally not the best sources of support for unproven workers, and nongovernmental organizations cannot fill that role consistently enough and adequately given their limited budgets and authority, it is the role of legislation and public welfare policy to provide for deprivation-trapped workers, and to facilitate a second chance to workers in order to make use of their potential skills and to match them to best-fitting jobs.

*Employment-assistance and (re)education policy:* Non-regular workers, workers at small businesses, the unemployed and the self-employed, among others, have limited access to skill-improvement opportunities. Mothers returning from maternity leaves fall behind their cohort of coworkers. This contributes to growing polarization in the society, as these workers fail to adapt to skill-biased changes in the labor market, and lag more and more behind other workers in their qualifications. Policies that offer retraining to these marginalized workers, or policies that condition collection of public assistance on participation in

retraining, help to improve the outcomes of marginalized workers and combat this polarization.

*Formal education:* Formal education plays a problematic role in relation to inequality in the labor market. University education is expensive, and the availability of public funding for credit-constrained students from disadvantaged backgrounds and later-life students is limited. Moreover, admission to high-quality secondary, tertiary and post-tertiary schools requires extensive preparation in private after-school academies (*hakwon*).<sup>20</sup> This suggests that students from poor families are limited in their educational opportunities, and the cross-family inequality accumulates at each subsequent educational level.

Educational inequalities are compounded by wage inequalities in the sense that generationally transmitted inequalities in higher education are positively associated with inequalities in wages. Thus, highly educated high-income parents usually seek better education programs for their children. To the extent that this type of skill investment is closely related to future labor market success, early-life opportunities to move up the socio-economic hierarchy diverge between workers from advantaged versus disadvantaged families.<sup>21</sup> Indeed, the Gini index of inequality among Korean urban families with two or more members – one group of interest in the discussion of educational opportunities – rose by nearly four percentage points during the 1997 crisis, and has risen even from that level since then.<sup>22</sup>

While education is often seen as a social equalizer, in a competitive environment where the vast majority of students go to college, even small differences in academic performance – acquired at nontrivial expense – can translate into vastly different career outcomes. Rather than reflecting on the quality of skills obtained, worker's *alma mater* provides a signal of their motivation, of sunk investment vouching for workers' commitment to primary-sector jobs – and of parents' wealth. Income gaps between graduates from top-ranking versus other universities have increased since the 1997 crisis. Employers care about a worker's *alma mater* in what may be thought of as educational elitism.<sup>23</sup> Employers also often prefer workers from the same *alma mater* as themselves, to promote workforce cohesion in a workplace where all colleagues have the same background, or to discriminate based on idiosyncratic tastes.<sup>24,25</sup>

## POLICY RECOMMENDATIONS

Given the various conditions preventing employers and workers from achieving their best potential and trapping them on predetermined paths, an active public policy is needed to break market barriers for firms and disenfranchised workers, encourage hiring and labor mobility across sectors and career paths, and promote transparent and formal market practices. Since the 1997 crisis the government

has enacted a number of laws, market regulations, and social welfare programs to facilitate more equitable and efficient labor market outcomes.<sup>26</sup> Despite these efforts, little equalization across workers has occurred, because laws are poorly enforced using weak sanctions, have loopholes or have unintended consequences. Even today, the climate in which employers and workers interact is permeated with obstacles, as the previous sections outlined, and further policy reforms are warranted. This section reviews recent steps at correcting labor-market faults and outlines promising directions for further policy action. Table 1 provides a brief summary of the problems, existing policy responses, and recommendations for further policy reform.

### ***Chaebol vs. SMEs***

The government has introduced initiatives to increase productivity at SMEs, and to help un-trap SMEs from stagnation by providing financial support and preferential opportunities to them, but the preferential arrangements have for the most part encouraged SMEs to remain SMEs.<sup>27</sup> The government has also promoted cooperation between SMEs and large firms (including publicly-owned organizations) with subsidies and preferential treatment, but these have limited effects on long-term coexistence and relations among firms.<sup>28</sup>

Less attention has been paid to the transition of small firms into medium-sized ones, and their expansion across sectors.<sup>29</sup> The government should work more on leveling the competitive field among different types of firms by removing preferential access to tenders and credit (that the *chaebol* traditionally enjoyed and that SMEs have now received access to), and regulatory exceptions that SMEs operate under. The government has taken steps to encourage competition and equalize opportunities across industries and firm types, by removing product-market regulation and cross-sector regulatory burdens. The Framework Act on Administrative Regulations (amended 2013) and a *cost-in, cost-out* system were implemented under which the overall burden of regulation should not increase, and for any new regulation at least one equally burdensome existing regulation should be struck down.<sup>30</sup> This deregulatory measure is expected to benefit all firms. It is unclear, however, whether SMEs or large firms stand to gain more, and how the relative position of SMEs and their long-term prospects for expansion will be affected.

The government has also provided some support for entrepreneurship and consolidation through encouragement of venture-capital investment and of mergers and acquisitions among small and medium-sized firms. Specifically in relation to high value-added services, the consulting and legal markets have opened up to foreign competition and capital, and medical and educational service markets are on the path to be opened up.<sup>31</sup>

### ***Regular vs. Non-Regular Workers***

In 2007 the government reformed the Fixed-Term Employment Act and the Act on the Protection of Temporary Workers to prevent discrimination against part-time, fixed-term and temporary workers.<sup>32</sup> These acts aimed to address unjustified discrimination against fixed-term and part-time employees and reinforce the protection of their working conditions.<sup>33</sup> Under the revised laws, the length of non-regular employment was limited to two years, with some exceptions, to avoid excessive use of non-regular workers.<sup>34</sup> Labor inspectors were instructed to encourage employers to correct any discrimination they find, even in the absence of worker complaints. The regulation was not effective. While the share of non-regular workers among all workers fell, their absolute number rose. As some fixed-term workers were converted to regular status, companies created a third, essentially overlapping category of employment that did not provide the benefits or the wages of regular workers, while allowing firms to retain workers indefinitely. The rise of regular employment in recent years thus paints an overly rosy picture of the conditions faced by workers in the labor market. The increased shift to regular status for some fixed-term employees also came at the cost of greater job instability for a larger share of fixed-term workers.<sup>35</sup> Moreover, the contracts of many temporary workers are canceled after two years due to the limits under the 2007 reform, rather than changed to regular status. Thus, the 2007 reforms did not resolve job instability for a large number of non-regular workers.<sup>36</sup>

In 2011, the Comprehensive Non-Regular Workers Initiative was enacted to improve social safety net, social insurance coverage, vocational training, and other working conditions of non-regular workers, primarily at SMEs. In 2014, Comprehensive Measures for Non-Regular Workers were put forth to promote the conversion of non-regular workers at SMEs into regular status. Two-year term on temporary workers was extended for some workers to four years to offer more stability to these workers and employers. Trade unions were empowered to act on discrimination cases against non-regular workers. However, these measures are unlikely to solve non-regular workers' underlying problems. By extending the legally sanctioned temporary status, the measures merely postpone the timing of workers' termination or status change, meanwhile lowering the burden on employers of relying on non-regular workers, keeping non-regular workers with unsustainable working conditions and unresolved job insecurity, and hardening the dualism between regular and non-regular sectors. Empowering labor representatives or regulatory bodies will not yield improvement in working conditions in the presence of patchy audits, low enforcement and sanctions, and inhibition on worker input.

Instead of adjusting the time limits on temporary or non-regular employment, policy focus should be on reducing the gap in working conditions, job security, and training opportunities between regular and non-regular workers.

This will facilitate labor mobility across sectors and jobs, and improve dedication and qualifications among non-regular workers, in turn benefiting employers themselves. Intra-firm differences between regular and non-regular workers should be narrowed by streamlining the switching of non-regular workers into regular positions.<sup>37</sup> This should involve some relaxation of employment protection for regular workers while strengthening the protection and enforcing the rights of non-regular workers.<sup>38</sup>

### ***Uncertainty Over Workers' Productivity***

In recent years the government has made various strides toward limiting discrimination by employers and contracting agencies, improving skills of disadvantaged workers, offering subsidies to employers for hiring them, and cleaning up its own act by recruiting workers with nontraditional backgrounds. However, more needs to be done.

The degree of job security of regular workers needs to be reduced to make hiring regular workers a less weighty decision, and to bring the standards closer to those for non-regular workers. The government should educate and encourage firms to introduce negotiable employment contracts under which compensation and working conditions could be up for agreement between employers and individual workers. This will allow employers to offer tentative terms to workers who have not proved themselves, and will allow workers to be open about their own needs, such as receiving time off to take care of dependents.

While discrimination in labor relations has been made illegal, and various channels have been established to identify cases of discrimination, more needs to be done to systematically and meaningfully punish wrongdoers, protect whistleblowers, and empower workers to respond to discriminatory practices in ways that will not disadvantage them and without incriminating themselves (e.g., lie to discriminatory questions during interviews without fearing subsequent termination). Enforcement of equal-opportunities laws should lie with industry and human rights watchdogs (such as the National Human Rights Commission), be systematic and cover all employers and all types of workers, and penalties for non-compliance should include criminal charges and compensatory damages to victims.

### ***Social Safety Net and (Re)education Policy***

The area in which the government is arguably bringing reforms most actively is welfare protection. This section reviews the main existing public programs for the promotion of employment, workers' human capital, and the application of that human capital to the most appropriate uses.

*Employment-assistance services:* In response to soaring unemployment following the 1997 crisis, the government created a nationwide job-information network and expanded a system of Employment Security Centers (ESCs). ESCs provide job seekers with many forms of information and services, from vocational training to information about vacancies.<sup>39,40</sup> However, ESCs have shown poor organizational effectiveness and quality of administrative services. ESCs presently lack employment-assistance, in-depth counseling and job-placement services tailored to individual job seekers. The (re)training services they provide are too rudimentary to improve workers' skills, in part because ESCs are understaffed, under-supported by the central government in terms of autonomy, manpower and budget, and insufficiently connected with employers and other relevant organizations.<sup>41</sup> Due to their weak capacity, only a fraction of middle-aged workers, married women, and the disabled in need of urgent support actually use the centers.

The national Employment Insurance System (EIS) was launched in 1995 to reduce the social cost of unemployment, and to improve the country's employment structure. The EIS strives to provide employment information and guidance enabling a more efficient redistribution and utilization of national manpower.<sup>42</sup> The EIS was designed with three key components: the Employment Stabilization Program (ESP), the Job Skill Development Program (JSDP), and the Unemployment Benefits Program (UBP).<sup>43</sup>

The ESP assists job-seekers at finding jobs according to their aptitude and competency. Through the ESP, the government provides financial support to companies to ease the burden on them and to prevent unemployment in times of short-lived economic downturns.<sup>44</sup> The ESP offers economic incentives to employers who have averted mass layoffs; maintained the same level of employment by retraining and relocating workers or reducing work hours; or employed marginal displaced workers. It also seeks to promote job placement by administering vocational counseling and guidance, and providing accurate information on the labor market. To improve job matching, the ESP supports job placement services. However, the ESP has not produced sufficient improvements in job opportunities, employment stability and efficiency of firms' labor adjustments, due to low utilization of the services.<sup>45,46</sup> More investment should be made to develop the service offering of the ESP in line with the needs of today's labor market, and to improve the convenience for beneficiaries.<sup>47</sup>

The JSDP aims to strengthen firms' competitiveness by providing training opportunities throughout workers' careers. The program provides an institutional framework for the support of lifetime, post formal-education vocational training and job skill development.<sup>48</sup> It offers firms financial incentives to invest in employee training, thereby improving employment stability, marketability of

workers, and firm competitiveness and factor productivity. The JSDP also offers vocational training for the unemployed and low-income workers, including initial training at public training centers and follow-up training at firms.<sup>49</sup> Limitations of this program have included insufficient capacity to provide training, staffing shortages, high turnover rates among clients, and unequal services offered to different groups of workers.

The UBP aims to improve efficiency of the national labor distribution by enhancing the quality of reemployment. It serves as the primary social safety net for the unemployed, granting allowances to those unemployable due to illness, injury, or mass layoffs.<sup>50</sup> Limitations of the UBP are that the legally prescribed duration of benefits and the duration of actual benefit payment are short (up to 210 days, and 110 days, respectively) and eligibility criteria are strict.<sup>51</sup> As a result, many unemployed people are ineligible, and the long-term unemployed receive inadequate support.

*Assistance to the working poor and the self-employed:* Support for the working poor in the secondary labor market, particularly the self-employed in the service sector, is presently insufficient.<sup>52</sup> The self-employed presently lack access to training opportunities because existing programs are not best suitable for them, or because they are ineligible until they become unemployed. Policy solutions for the low-income self-employed would include creation of new middle-income jobs in social services, assisting low-income self-employed workers to build collaborative support networks, providing them with access to re-education, retraining and other safety net features, and improving their access to capital and credit to allow them to grow into medium-size businesses. The JSDP aims to improve the qualifications of marginalized workers, but has not entirely succeeded at bridging the opportunity gap.<sup>53</sup>

The Basic Livelihood Security Program (BLSP) was expanded in 2014, and the eligibility criteria for unemployment benefits have been relaxed. The government plans expanding Employment Security Centers as hubs of employment services in local communities providing counseling and job-placement services. To encourage job seekers to search actively and to participate in available skill-improvement opportunities, the government plans to lower unemployment benefits.

*Childcare assistance:* Working parents face particular hurdles managing their professional and family lives. This is mostly the case of mothers, for cultural reasons and since paternal leave is effectively nonexistent. Working mothers require access to childcare, and shorter work days or flexible working conditions to take care of their children. Mothers re-entering the labor market also face the hurdle of catching up with their cohort of coworkers – and proving their value to their employers given attrition of their skills and gap in experience.<sup>54</sup>

To improve their access to childcare services, in order to lighten the burden on parents and the public, available resources should be consolidated and put into a more effective use through closer cooperation between national and local government levels, and greater initiative and control at the local community level.<sup>55</sup> Possibilities include granting powers to local authorities to raise taxes for social welfare programs supplementing the national funding; and empowering civil organizations to pool community resources. More active partnerships with employers and the private sector are also warranted, such as urging employers and business groups to purchase childcare on behalf of their employees. More flexible choices for childcare programs are currently being rolled out to support parents working on alternative schedules. The government is also revising conditions for maternal and paternal leave, increasing welfare spending, and expanding welfare net and retraining programs for those re-entering employment market.

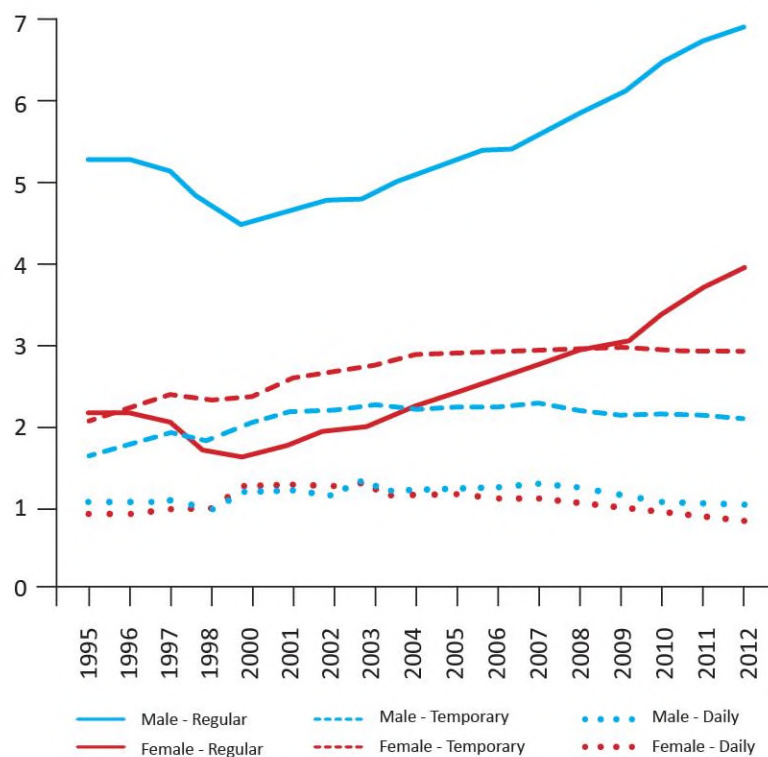
*Industry-labor-government cooperation:* An initial Tripartite Agreement on structural reforms of the labor market was reached between labor representatives, business groups, and the administration in 2015 to promote labor flexibility and to combat market dualism. This should be achieved through: cooperation between small and large firms, and primary contractors and their subcontractors; improving working conditions and prevention of discrimination of non-regular workers; promotion of employment of marginal workers and youth; clarification of employment standards; expansion of the social safety net and unemployment-benefit coverage; support for work–family balance; support of vocational learning and re-training programs, and others.<sup>56</sup> However, the effort in its current state has several limitations. The lack of technical detail, to be agreed over time, and the voluntary nature of the majority of existing articles in the agreement put into question its effectiveness. The uneven roles of the three groups of signatories in complying with and enforcing the agreement puts into question the negotiating power of each party, and the agreement’s power and sustainability. In fact, the country’s second largest labor union did not participate in the drafting of the agreement. Since signing, cracks have appeared between the signatories, with the remaining labor union threatening to pull out. The negotiating process has stalled. Time will tell how effective this flagship agreement will be.

## CONCLUSION

The problem of structural faults in the Korean labor market has various dimensions and involves a number of parties who have a role in it and who must be engaged to identify and reach solutions. Over the past decade the Korean government has taken the problem seriously and attempted to tackle it on multiple fronts, using fiscal incentives, legislative action, regulatory directives, and brokering with business and labor groups. More work clearly needs to be done, since there are as yet unaddressed areas, and some policy responses have proved to be toothless,

slow or misguided. Nevertheless, the concerted efforts of various government institutes to tackling a common problem, and the ongoing tripartite negotiation over the equitable and efficient organization of the future labor market, are a good sign of future improvements to come. The hope is that the voluntary, open-ended, all-parties-inclusive deliberation process itself will help to clarify all positions and stakes, and through the created knowledge-exchange and goodwill will help to heal the deepest faults of labor market structure.

Figure 1. Workers by Employment Status and Gender (Millions)



Source: KOSTAT, Statistics Korea

Table 1. Summary of structural problems, proposed solutions and further recommendations

Structural Problems	Existing/proposed policy	Recommended further action
Chaebol vs. SMEs	<ul style="list-style-type: none"> <li>- Promote competition in manufacturing</li> <li>- Cut red tape using cost-in, cost-out framework</li> <li>- Financial support for SMEs</li> <li>- Preferential treatment for SMEs</li> <li>- Incentives for SME innovation</li> <li>- Support for chaebol-SME cooperation</li> </ul>	<ul style="list-style-type: none"> <li>- Promote competition in services</li> <li>- Leveling of the competitive field across sectors</li> <li>- End to regulatory exceptions for SMEs</li> <li>- Neutral support system for innovation, and employment expansion</li> <li>- Incentives for SME expansion</li> </ul>
Regular vs. non-regular employment	<ul style="list-style-type: none"> <li>- Protect temporary and non-regular workers from discrimination</li> <li>- Extend allowed duration of non-regular employment to 2 years, 4 years for some workers</li> <li>- Provide re-training opportunities for disadvantaged workers</li> </ul>	<ul style="list-style-type: none"> <li>- Narrow the gap in working conditions between regular &amp; non-regular workers</li> <li>- Improve job security and job-training opportunities of non-regular workers</li> <li>- Streamline intra-firm switching of non-regular to regular positions</li> </ul>
Uncertainty over worker productivity	<ul style="list-style-type: none"> <li>- Pass laws prohibiting discriminatory HRM practices, extend their applicability to non-regular workers</li> <li>- Educate employers regarding recommended practices</li> <li>- Provide re-training opportunities for disadvantaged workers</li> </ul>	<ul style="list-style-type: none"> <li>- Enforce laws effectively through systematic audits, referrals to prosecutors, public shaming of wrong-doers</li> <li>- Equalize standards and enforcement across sectors &amp; types of labor</li> <li>- Empower regulatory &amp; human-rights agencies to prosecute</li> <li>- Introduce criminal charges &amp; high compensatory damages</li> <li>- Empower workers to tackle discrimination without facing repercussions</li> <li>- Prohibit industry-blacklisting of outspoken workers, and enforce it</li> <li>- Educate employers and workers about their rights &amp; about sanctions</li> <li>- Encourage flexible negotiation of working conditions</li> </ul>

Structural Problems	Existing/proposed policy	Recommended further action
(Re)education policy and social safety net	<ul style="list-style-type: none"> <li>- Provide employment assistance</li> <li>- Provide support for employment stabilization, hiring expansion, work sharing</li> <li>- Provide re-training opportunities for disadvantaged workers</li> <li>- Expand childcare services</li> <li>- Support reentry of career-interrupted women</li> <li>- Increase incentives of the unemployed to find jobs (by lowering unemployment benefits)</li> <li>- Expand eligibility coverage for unemployment benefits</li> <li>- Extend allowed duration of benefit collection</li> <li>- Encourage dialogue between government, business &amp; labor groups</li> </ul>	<ul style="list-style-type: none"> <li>- Improve funding &amp; quality of services</li> <li>- Improve convenience for beneficiaries</li> <li>- Improve access to &amp; quality of services</li> <li>- Improve provision of childcare without stretching public resources, by engaging local governments &amp; NGOs</li> <li>- Promote paternal leave effectively</li> <li>- Guide the tripartite reform process by stressing technical benchmarks &amp; timeline, formal commitments of all parties, sanctions</li> </ul>

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## EXCHANGE RATE RISK, STOCK TRANSACTIONS AND FINANCIAL INTEGRATION: THE REPUBLIC OF KOREA AND JAPAN

Rajarshi Mitra

### ABSTRACT

This paper examines the short-run and long-run relation between volatility in the real effective exchange rate and stock returns in the Republic of Korea. A trivariate vector autoregressive model is estimated in which the Japanese stock market is included as a variable representing the influence of both international and regional capital markets. All three variables, namely, stock returns in Korea and Japan and the real effective exchange rate are found to be integrated of order 1. The Johansen cointegration test indicates no long-run relation between the variables. Granger causality, however, indicates short-run bidirectional causality between volatility in the real effective exchange rate and stock returns in Korea, between volatility in the real effective exchange rate and stock returns in Japan, and also between stock returns in Korea and Japan. Thus although no long-run relationship between the variables is found to exist, Granger causality indicates a short-term relationship between the stock market and the foreign exchange market in Korea, and also regional interdependence between the stock markets in Korea and Japan. Thus exchange rate policies and stock transactions in Japan will most likely have significant short-term effects on stock transactions in Korea.

**Key words:** *Cointegration, Real Effective Exchange Rate, Stock Index, Unit Root, VECM*

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Rajarshi Mitra is an Assistant Professor in the Faculty of Economics at the National Research University Higher School of Economics.

## INTRODUCTION

In economic theory, the flow-oriented model of exchange rate behavior posits that currency movement affects a nation's international competitiveness and its balance of trade, and consequently, its real output.<sup>1</sup> This affects a company's current and future cash flows and its stock prices. It is generally believed that currency depreciation improves a country's trade balance – exports become cheaper, which increases aggregate demand and raises the level of economic activity. Thus there is a relationship between exchange rate and stock returns, and currency depreciation expectedly increases stock returns in the economy. The stock-oriented model emphasizes the role of capital account in the determination of a country's exchange rate. According to Adjasi and Biekpe, exchange rate equates demand and supply of financial assets such as stocks and bonds; thus, expectations of future exchange rate movements affect the prices of financial assets.<sup>2</sup> In the stock-oriented model, fluctuations in exchange rates affect stock prices. For arbitrage pricing theory, Rashid and Karachi postulate that a rise in the real interest rate will reduce the present value of future cash flows; consequently, the stock returns will fall.<sup>3</sup> But a rise in the real interest rate will increase capital inflow into an economy and cause the domestic currency to appreciate. An appreciation in the domestic currency will then result in a decrease in stock returns. Fluctuations in real interest rates affect exchange rates and stock returns, and the arbitrage pricing theory assumes that movements in exchange rates affect stock returns.

All three models on the relation between exchange rate and stock returns postulate that exchange rate affects stock returns. Under a floating exchange rate regime, currency depreciation expectedly increases stock returns while an appreciation is expected to decrease stock returns. Although most empirical studies have provided evidence of a significant link between exchange rate and stock returns, the direction of impact of changes in exchange rate on stock returns have varied considerably across studies. As discussed in the ensuing section, the relation between exchange rate and stock returns can be either positive or negative depending on economic reasons and also some econometric factors such as the methodology used and the sample period and countries under study. According to Phylaktis and Ravazzolo, the significant relation between exchange rate and stock returns in emerging markets could be attributed to an important variable that acts as a channel through which exchange rate affects stock returns.<sup>4</sup> One such variable is the world capital market, often represented by the U.S. stock market.

The South Korean *won* has recently witnessed a sharp decline in its value against the U.S. dollar. South Korea receives a large fraction of total FDI inflows in Asia; thus the value of stocks traded in South Korea is essential for stable economic growth and development in the region, even more so because of the volume of foreign investment the country receives. In recent times, efforts have been made

to increase political cooperation and bilateral summits have been held between Japan and South Korean stock markets. The question is, has it strengthened stock market integration between the two countries? In fact, a recent study reported weak integration Asian stock markets, even though the financial markets have become more interdependent, especially after the financial crisis in July 1997.<sup>5</sup> Volatility in stock returns due to fluctuations in the real exchange rate may have an adverse effect on foreign investment inflows into Korea. According to Phylaktis and Ravazzolo, foreign currency risk not only affects a domestic firm's cash flows, but also affects foreign investment transactions that are stated in terms of a foreign currency.<sup>6</sup> Most empirical studies have shown that exchange rate is a significant determinant of stock prices. The inconclusive evidence in existing studies on the effects of exchange rate risk necessitates the need to reinvestigate the sensitivity of stock returns to changes in the real exchange rate. From the standpoint of policy implications, it is important for the policymakers to investigate the relation in order to realize the benefits of domestic and foreign private investments. Using a more recent data from 1981-2013, this paper examines the relation between exchange rate risk and stock returns for the Republic of Korea. The paper also examines the degree of financial integration between the stock markets in Korea and Japan.

The Republic of Korea has had a floating exchange rate policy. Figure 1 shows the real effective exchange rate in the Republic of Korea over the period 1981-2013. It shows steady depreciation while the index of total share prices for all shares in Korea, depicted in Figure 2, increased over the same period. Although this appears to be consistent with economic theory, that currency depreciation is followed by an increase in stock returns, it is not possible to ascertain the association and the causality between the variables by simply observing the data. Figure 3 shows the volatility in the real effective exchange rate for Korea. Figure 4 shows the total share price index in Japan over the same period.

The removal of foreign exchange restrictions and the implementation of a floating exchange rate policy in recent years have led to an extensive empirical investigation into the relation between the stock and foreign exchange markets in emerging and developed economies. The results are generally mixed. For instance, Adjasi and Biekpe reported lack of a stable long-run relation between exchange rate and stock prices in South Africa.<sup>7</sup> But Mlambo et al. observed a weak relation between currency volatility and stock market for the same country.<sup>8</sup> The mixed and inconclusive results, therefore, necessitate further research on the relation between the two variables. This paper aims to examine the following key issues: (i) the short-run and long-run relationships between exchange rate volatility and stock returns in the Republic of Korea; (ii) the degree of integration of the stock market in Korea with the capital market in Japan; (iii) the existence of short-term causality

between volatility in the real effective exchange rate and stock returns in Korea; (iv) the implications for the MNCs in investment decisions and foreign exchange exposure. The cointegration technique is applied since it addresses problems related to nonstationarity in the data when examining the relation between the variables in both levels and differences.

### **Literature Review**

This paper builds on Phylaktis and Ravazzolo who studied the short-run and long-run relation between stock prices and exchange rates for five Pacific Basin countries, namely, Hong Kong, Singapore, Malaysia, Thailand and the Philippines.<sup>9</sup> They applied the cointegration technique and performed Granger causality tests for each country. They found a positive relation between the stock and the foreign exchange markets. They also found that the U.S. stock market acts as a channel for the links between the stock and the foreign exchange markets.

Numerous other studies have estimated both linear and non-linear models and examined the relationship between the real exchange rate and stock returns and also between volatility in the real exchange rate and stock returns. For example, Soenen and Hennigar reported a significantly negative relation between exchange rate and stock returns.<sup>10</sup> Roll used daily data on stock returns, found a positive relation between the two.<sup>11</sup> Chow et al. found no relation between monthly stock returns and the real exchange rate.<sup>12</sup> In a study of eight industrial economies, Solnik observed a negative relationship between exchange rate and stock returns.<sup>13</sup> Ma and Kao, studying six countries, reported a negative relationship between domestic currency appreciation and domestic stock prices for the export-dominant country.<sup>14</sup> A study by Choi also confirmed this relationship.<sup>15</sup> Muhammad and Rasheed reported long-run relationship between exchange rate and stock prices for some but not for all countries in his sample of four South Asian countries.<sup>16</sup> Olugbenga reported a significantly positive short-run relationship between exchange rate and stock market performance, and a significantly negative relation between the variables in the long-run.<sup>17</sup>

Some of the earlier studies on stock market volatility include Engle and Bollerslev.<sup>18</sup> In general, empirical studies on the effects of exchange rate volatility on share prices and share price fluctuations have also reported mixed results. For instance, Aggarwal and Soenan and Hennigar observed a significant impact of exchange rate volatility on share price volatility.<sup>19</sup> Najang and Seifent reported unidirectional causal effect from exchange rate volatility to fluctuations in share prices.<sup>20</sup> Ajayi et al. also reported unidirectional causality from exchange rate to share prices.<sup>21</sup> Vygodina reported unidirectional causality from exchange rate to volatility in stock returns.<sup>22</sup> According to Smyth and Nadha, the causality from exchange rate to share price volatility is unidirectional for some countries and bidirectional for others, at least in the short-run.<sup>23</sup> The variables are found to be independent in the long-run.

On the other hand, Ozair reported little evidence of cointegration and causality of exchange rate with share prices.<sup>24</sup> More recent studies on the relation between exchange rate volatility and stock returns include Funyina and Sichoongwe.<sup>25</sup>

Most studies on the Korean economy have reported a short-term causal relation from exchange rates to stock returns even when no long-run association between the variables was found to exist. Abdalla and Murinde estimated a bivariate model using monthly data over the period 1985-1994.<sup>26</sup> They reported unidirectional causality from exchange rate to stock prices. Hwang reported a negative short-run relation between domestic currency devaluation and stock prices.<sup>27</sup> The study also reported unidirectional causality from exchange rate to stock prices for the Korean economy. Doong et al. used data over the period 1989-2003 and found that the financial variables are not cointegrated.<sup>28</sup> But Granger causality showed bidirectional causality between the variables for South Korea. Pan et al. used data over the period 1988-1998 and reported unidirectional causal relation from exchange rate to stock prices for Korea.<sup>29</sup>

Recent studies on stock market integration in Asia include Chiang et al., Cheung et al., Wang and Moore, Cheung et al., Kim and Kim, and Jeong, among others.<sup>30</sup>

### **Data and the Model**

**Data:** Annual data is obtained from the Federal Reserve Bank of St. Louis for the sample period 1981-2013. The variables are: (i) the total share prices for all shares for the Republic of Korea; (ii) the total share prices for all shares for Japan; (iii) volatility in the real effective exchange rate based on manufacturing consumer price index for the Republic of Korea. Share price indices are determined by the stock exchange. A share price index measures how the value of the stocks in the index is changing. They exclude dividend payments. It measures the current market capitalization of the basket of shares in the index. Occasionally central banks compile share indices. In the OECD MEI database, the targeted variable for share prices is national all-share or broad indices.

The total share prices for Korea are obtained from the Korea Stock Exchange (KSE KOSPI) with the currency being the South Korean *won*. It represents the stock market index of South Korea. The total share prices for all shares in Japan are obtained from the Tokyo Stock Exchange (TSE TOPIX). It shows the trend in the stock market in Japan with the currency being the Japanese *yen*. There are three main reasons why the Japanese stock market has been considered instead of the U.S. stock market. Firstly, numerous empirical studies have already considered the U.S. stock market; however, there is hardly any comprehensive pairwise paired study on foreign exchange and stock market integration between Korea and Japan.

Secondly, although efforts have been made to strengthen stock market integration between Korea and Japan, some studies have indicated weak integration between Asian stock markets. Thirdly, the inclusion of the Japanese stock market allows us to also examine the influence of both international and regional capital markets on stock transactions in the Republic of Korea.

The data on the real effective exchange rate is obtained from the Organization for Economic Co-operation and Development (OECD). The real effective exchange rate is the weighted average of the bilateral real exchange rates. An increase in the real effective exchange rate index would imply appreciation while a decrease in the index would imply depreciation. The volatility in the real effective exchange rate is measured by the standard deviation of the real effective exchange rate from the mean.

**The Model:** The lack of a causal relation between real exchange rate and stock returns in a bivariate model is often attributed to the omission of an important variable from the system. The variable omitted is usually stock transactions in a foreign country, which represents the influence of the international capital market. The variable is also found to act as a channel through which the real exchange rate affects stock transactions in the domestic economy. For this reason, a trivariate model is preferred to a bivariate system.

Following Phylaktis and Ravazzolo, the long-run relation between volatility in the real effective exchange rate and the total share prices in Japan and Korea is examined by estimating a trivariate model of the following form:

$$(1) -SPIK_t = a + b(VREX)_t + c(SPIJ)_t + \varepsilon_t$$

The model in (1) shows the long-run effects of the volatility in the real effective exchange rate and changes in the total share prices in Japan on the total share prices in the Republic of Korea.

A vector error correction representation of the model in (1) with  $k$  lags and  $r$  cointegrating vectors with a linear trend in the levels of the data is given by:

$$(2) \Delta Y_t = X + AY_{t-1} + \sum_{i=1}^{k-1} \phi_i \Delta Y_{t-i} + \mu_t$$

**Estimation Method:** The Dickey Fuller-Generalized Least Squares (DF-GLS) unit root test proposed by Elliott, Rothenberg and Stock is first performed to examine stationarity in each variable.<sup>31</sup> The DF-GLS unit root test is performed since it possesses greater power properties than the traditional ADF test. The optimum number of lags for the vector error correction model is selected by Akaike Information Criteria (AIC). The Johansen cointegration

test is next performed with the optimum lag-length chosen by AIC in order to determine the maximum rank of the cointegrating matrix. If the variables are found to be cointegrated, then the VECM is to be estimated with the optimum lag-length selected by AIC and the maximum rank of the cointegrating matrix. The model is to be estimated within the Johansen framework; that is, if the maximum rank of the cointegrating matrix is  $r$ , then at least  $r^2$  restrictions are to be imposed in order to determine the long-run coefficients.<sup>32</sup> If the variables are I(1) with no cointegration, then the short-term causality between the variables will be examined by estimating a first-order differenced VAR model. The diagnostic tests are lastly performed to examine autocorrelation, normality in error distribution and model stability.

## Main Results

**Unit Root Test:** The optimum lag for each variable is determined by the minimum of Schwarz Criterion and Modified Akaike Information Criterion test statistics. The optimum lag length selected for each variable in level form is 1. The test is performed for models that include lags of the first-differenced detrended variables. The Schwert criterion is used to determine the maximum number of lags.<sup>33</sup> The null hypothesis is that the variable has a unit root. The DF-GLS statistics for each variable at levels and first-differences are reported in Table 1.

Table 1. Unit Root Test		
	DF-GLS	Optimum Lag
SPIK	-3.01	1
VREX	-2.13	1
SPIJ	-2.84	1
First-Difference		
$\Delta$ SPIK	-4.84*	3
$\Delta$ VREX	-3.23***	1
$\Delta$ SPIJ	-3.64**	3

\*, \*\* and \*\*\* in Table 1 indicate significant at 1%, 5% and 10% significance level, respectively.

**Johansen Cointegration Test:** The variables are  $I(1)$ . Since the variables are first-difference stationary, the Johansen cointegration test is performed next. Since AIC selected a model with 1 lag, the cointegration test is performed with 1 lag. The results are reported in Table 2.

The maximum rank of the cointegrating matrix is 0; thus the model fails to reject the null hypothesis that there is no long-run relationship between the three variables.

The general form of a VAR model with  $k$  variables that are expressed as linear functions of their own lags and that of other variables is represented by:

$$(3) Y_t = V + A_1 Y_{t-1} + \dots + A_l Y_{t-l} + \mu_t$$

In the equation above,  $Y_t$  is a  $k \times 1$  vector of variables,  $A_1, \dots, A_l$  are  $k \times k$  matrices of parameters,  $V$  is a  $k \times 1$  vector of parameters and  $\mu_t$  follows a white noise process. The errors are distributed with mean 0 and are uncorrelated.

Since the variables are  $I(1)$  with no cointegration, a first-order differenced VAR model is estimated with 6 lags selected by AIC. The results are reported in Table 3.

In Table 3, the short-run coefficient 0.55 for the first difference in share price index in Korea at lag 5 is significant at 1% significance level; the short-run coefficients 0.38, -0.26 and 0.18 for the first differences in exchange rate volatility at lags 2, 3 and 5 are significant at 1%, 5% and 10% significance level, respectively; the short-run coefficients 0.36 and -0.42 for the first differences in share price index in Japan at lags 3 and 4 are significant at 1% significance level. Thus the effects of the past values of the variables on total share prices in Korea are mixed and mostly insignificant. Volatility in real effective exchange rate and total share prices in Japan are thus found to have both significant positive and negative effects on the total share prices in Korea.

The line of causality is examined by performing the Granger causality test. Volatility in the real effective exchange rate, for instance, will Granger cause total share prices in Korea if, given the past values of the total share prices in Korea, the past values of the real effective exchange rate volatility are useful for predicting share prices in Korea. The total share prices in Korea are regressed on its own lagged values and also on the lagged values of real exchange rate volatility. The null hypothesis that the estimated coefficients of the lagged values of real exchange rate volatility are jointly zero is then tested. The results of the Granger causality test are reported in Table 4.

The chi-square statistics reported in Table 4 are significant at 1% significance level. The results indicate bidirectional causality between volatility in the real effective exchange rate and total share prices in Korea, and between volatility in the real effective exchange rate and total share prices in Japan. Bidirectional causality is also observed between the total share prices in Korea and Japan.

Table 2. Johansen Cointegration Test

Maximum Rank	Eigenvalue	Trace Statistic	5% Critical Value
0	–	13.92*	29.68
1	0.21	6.22	15.41
2	0.16	0.59	3.76

Table 3. VAR Estimates

	Coefficient	Standard Error	Probability
$\Delta \text{SPIK}_{t-1}$	-0.08	0.19	0.69
$\Delta \text{SPIK}_{t-2}$	-0.09	0.17	0.58
$\Delta \text{SPIK}_{t-3}$	-0.26	0.16	0.10
$\Delta \text{SPIK}_{t-4}$	-0.18	0.16	0.29
$\Delta \text{SPIK}_{t-5}$	0.55*	0.16	0.00
$\Delta \text{SPIK}_{t-6}$	0.22	0.21	0.29
$\Delta \text{VREX}_{t-1}$	0.08	0.13	0.52
$\Delta \text{VREX}_{t-2}$	0.38*	0.11	0.00
$\Delta \text{VREX}_{t-3}$	-0.26**	0.12	0.03
$\Delta \text{VREX}_{t-4}$	-0.08	0.12	0.49
$\Delta \text{VREX}_{t-5}$	0.18***	0.11	0.09
$\Delta \text{VREX}_{t-6}$	0.14	0.11	0.21
$\Delta \text{SPIJ}_{t-1}$	0.05	0.13	0.72
$\Delta \text{SPIJ}_{t-2}$	0.10	0.13	0.44
$\Delta \text{SPIJ}_{t-3}$	0.36*	0.14	0.01
$\Delta \text{SPIJ}_{t-4}$	-0.42*	0.16	0.01

	Coefficient	Standard Error	Probability
$\Delta\text{SPIJ}_{t-5}$	0.12	0.17	0.46
$\Delta\text{SPIJ}_{t-6}$	0.16	0.15	0.29
Constant	0.82	0.82	0.31

The short-term causality from volatility in the real effective exchange rate to total share prices in Korea indicates a close link between the real effective exchange rate index and stocks traded in Korea. An increase or decrease in the real effective exchange rate index (currency appreciation or depreciation) would lead to an increase or a decrease in stock transactions in Korea. Thus there is a short-term causal link between the stock market and the foreign exchange market in Korea. According to Phylaktis and Ravazzolo, the relaxation of foreign exchange restrictions may be a necessary condition for the link between foreign exchange and stock markets.<sup>34</sup> The degree of exchange rate flexibility may also have a significant role in the causal relation between the foreign exchange market and the stock market in Korea. Thus changes in the exchange rate policy will most likely have an immediate effect on stock market transactions and foreign investment in the Korean economy.

Granger causality further indicates that stock transactions in Japan have a significant effect on the local stock market in Korea. This reflects interdependence and integration of Korea's stock market with the Japanese stock market. There are several factors that influence stock market integration. As Phylaktis and Ravazzolo explained, apart from having access to capital market itself, access to local market information is necessary for international investments to take place.<sup>35</sup> Some determinants of market integration include regional trade openness and market development, trade balance and interest rate differential, total trade, industrial production, inflation rate, short-term interest rate, exchange rate volatility, and bilateral FDI intensity.<sup>36</sup> However, according to Bekaert and Harvey and Levine and Zervos, liberalization may not necessarily attract foreign investment due to home bias in equity portfolio, country-specific risks, and access to local market information on company stocks.<sup>37</sup> Institutional rigidities and international differences in tax laws, as discussed in Feldstein and Horioka, could affect capital mobility across countries and affect the degree of financial integration between countries.<sup>38</sup> According to Levine and Zervos, countries that publish information about a firm, such as its price-earnings ratio more comprehensively and internationally, will have better chances of developing a more globally integrated stock market than countries that do not make such information available to the potential investors.<sup>39</sup>

**VAR Diagnostics:** The results of the Lagrange Multiplier test for serial autocorrelation, the Jarque-Bera test for normality in error distribution, and model stability are reported in Table 5. In LM test, the null hypothesis of no autocorrelation is tested for each of the 6 lags selected by AIC. In Jarque-Bera test, the null hypothesis is that the errors are normally distributed. The stability test is also performed.

The results of the LM test for autocorrelation indicate that the chi-square statistic is less than the 10% critical value 14.68 for 9 degrees of freedom for all lags except lag 4. The results overall indicate no autocorrelation at lag order. For the Jarque-Bera normality test, the chi-square statistic 0.06 is less than the 10% critical value 4.61 for 2 degrees of freedom. This confirms that the errors are normally distributed. An  $R^2$  value of 0.72 indicates that the model fits the data well. The stability test was also performed. All the eigenvalues were found to lie inside the unit circle. Thus the VAR model was found to satisfy the stability condition.

Table 4. Granger Causality

	$\Delta\text{SPIK}$	$\Delta\text{VREX}$	$\Delta\text{SPIJ}$
$\Delta\text{SPIK}$	–	24.29* (0.00)	21.49* (0.00)
$\Delta\text{VREX}$	39.89* (0.00)	–	16.90* (0.01)
$\Delta\text{SPIJ}$	108.54* (0.00)	88.83* (0.00)	–

Table 5. The Model Diagnostics

LM	Chi-square Statistic	Degrees of Freedom	Probability
Lag 1	4.32	9	0.89
Lag 2	10.85	9	0.29
Lag 3	12.15	9	0.21
Lag 4	14.89	9	0.09
Lag 5	6.69	9	0.67
Lag 6	12.99	9	0.16

Normality	chi-square statistic	degrees of freedom	probability
Jarque-Bera	0.06	2	0.97
R <sup>2</sup> : 0.72			

## CONCLUSION

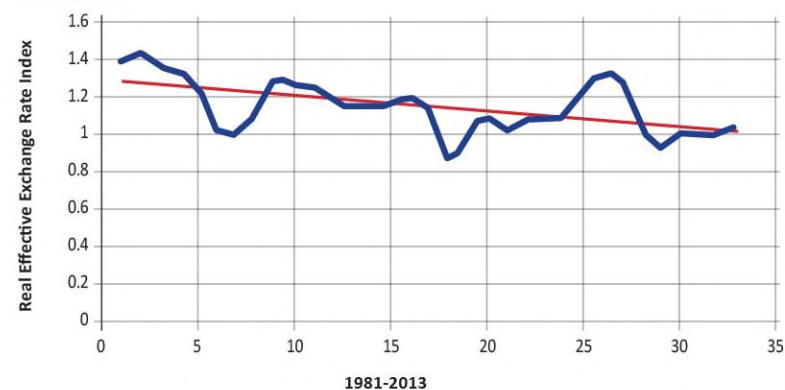
This paper investigates the cointegrating and causal relationships between volatility in the real effective exchange rate and stock transactions in the Republic of Korea. The effects of changes in stock transactions in Japan on the stock market in Korea are also examined. Although the variables are found to be integrated of order one, the Johansen cointegration test does not support long-run relationship between the variables. Thus the variables are found to be I(1) with no cointegration. A first-order differenced VAR model is estimated. Granger causality indicates short-run bidirectional causality between volatility in the real effective exchange rate and stock transactions in Korea. The results, therefore, indicate a close association between the stock market and the foreign exchange market in Korea. Granger causality also indicates short-run bidirectional causality between stock transactions in Korea and Japan. This provides evidence of stock market interdependence and financial integration of the stock market in Korea with the Japanese capital market.

The Republic of Korea has had a floating exchange rate policy over the years. As far as policy implications are concerned, if flexibility in the real effective exchange rate plays a crucial role in the close association between the foreign exchange and stock markets in Korea, then the Korean government can use the exchange rate as a policy instrument to increase foreign portfolio investment in the country. Exchange rate flexibility could therefore play a significant role in the link between the stock markets in Korea and Japan. The design and implementation of appropriate monetary and fiscal policies may further integrate the Korean stock market with the international capital market and attract more foreign investment. Also, cooperation with foreign stock markets may further increase the inflow of foreign capital into Korea and promote sustainable economic growth and development in the region in the long-run. Since exchange rate volatility significantly affects stock returns, it might be necessary for the central bank to intervene when there is excessive exchange rate volatility to restore stability and investors' confidence. According to Sichoongwe, it might also be necessary to use efficient hedging instruments to eliminate the negative effects of exchange rate volatility.<sup>40</sup>

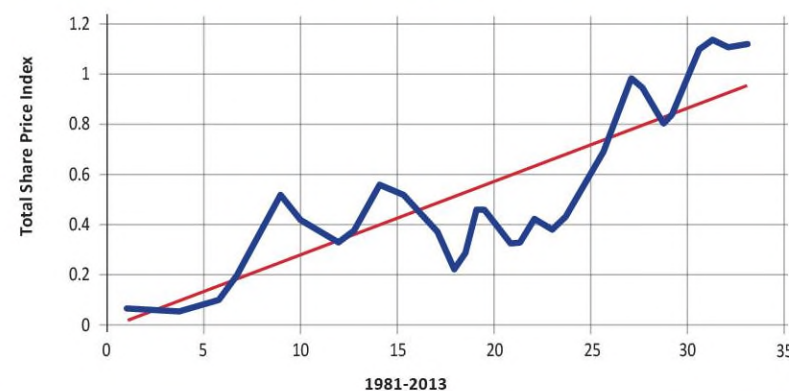
It might be interesting to include more control variables and examine the sensitivity of the short-run and long-run dynamics to the presence of structural breaks in the data. Studies that have examined the relation between exchange rate and stock returns with or without structural breaks in the data have reported short-term causal relation between the stock market and the foreign exchange market. Therefore, the results are consistent with the findings in the existing literature.

In Phylaktis and Ravazzolo, the Asian Financial Crisis had only a temporary effect on the long-run relation between the stock market and the foreign exchange market in the five Pacific Basin countries.<sup>41</sup> Nonetheless, it might still be interesting to account for the Asian Financial Crisis and global economic recession for a more robust inference.

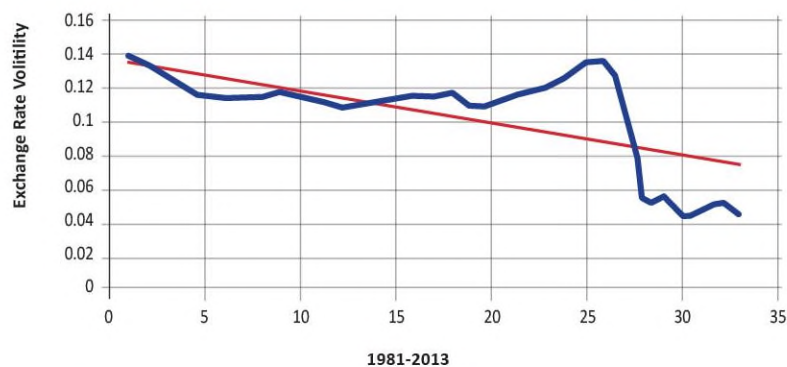
**Figure 1. The Republic of Korea Real Effective Exchange Rate Index: 1981-2013**



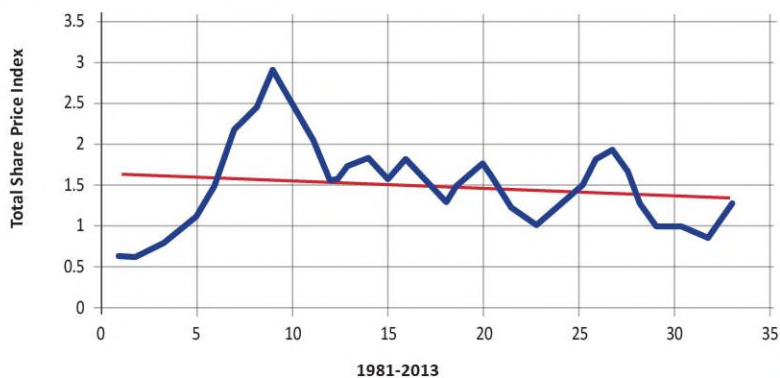
**Figure 2. Total Share Price Index in the Republic of Korea: 1981-2013**



**Figure 3. Volatility in the Republic of Korea Real Effective Exchange Rate Index: 1981-2013**



**Figure 4. Total Share Price Index in Japan: 1981-2013**



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