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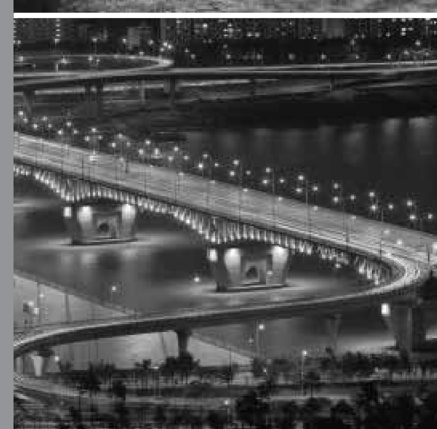

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PREFACE

November 2012

Dear Readers,

Last year saw the redesign of *Korea's Economy* exterior and the introduction of a series of short commentaries by leading scholars and government officials. With this year's edition, we hope to build on last year's improvements to *Korea's Economy* with a new interior look and the introduction of abstracts to allow our readers to quickly get a feel for what each article is about.

The 2012 edition of *Korea's Economy* may be one of our most ambitious yet. With the uncertain future of the euro as the background, we take a series of looks at how Asian economic integration is proceeding and what the region can learn from the experience of Europe.

On the trade front, we look at the future of trade policy in Korea now that the KORUS FTA is implemented. One significant new announcement covered in this section is the Korea-China FTA, which is now under negotiation. At the same time, with Korea now negotiating or having completed FTAs with most of its major trading partners, we look at the question of whether it is best for Korea to continue to pursue free trade agreements or if it is time for Korea to return its focus to the multilateral trading system.

Additionally, we look at Korea's role in development. Korea's own economic development was one of the great success stories of the 20th century and it became the first former aid recipient nation to join the OECD's Development Assistance Council. While Korea is a relatively new player on the development stage, that also provides it with a unique opportunity to blaze its own path on this issue and to find ways to bring lessons from its own experience to this important issue.

Of course, given the changes in North Korea over the last half year, we would be remiss to not consider what the transition to Kim Jong-un might mean for the future of the Korean economy north of the DMZ.

We hope that you enjoy the changes that we have introduced in this edition of *Korea's Economy* and the articles in this year's edition. We look forward to continuing to enhance this publication in the years ahead to provide the best possible insights into Korea's economic relations.

Dr. Abraham Kim
President (Interim)

Troy Stangarone
Senior Director of Congressional Affairs and Trade
Editor – Korea's Economy

OVERVIEW AND MACROECONOMIC ISSUES

KOREA'S ECONOMIC PROSPECTS AND CHALLENGES[1]

By Thomas Rumbaugh

Abstract

Following a strong rebound in 2010, growth in Korea slowed down in 2011 to 3½ percent due to domestic factors and weakness in the global economy. While recent data suggest that the economy will bottom out in mid-year and strengthen during the course of 2012, on-going weakness in the global economy represent downside risks to this scenario. Additionally, even if the global economy were to deteriorate further, Korea still has ample fiscal space to respond with a fiscal stimulus package similar to what was done in 2008-09, if necessary. At the same time, headline inflation has decelerated in large part due to government measures and favorable base effects and the external vulnerability of the Korean financial system has significantly diminished since 2010. However, households' high indebtedness has been flagged as another important vulnerability for the financial system, with the household debt-to-disposable income ratio now at 135 percent and Korea is still one of the economies in Asia most exposed to foreign bank funding risks. One of the key medium-term policy challenges is to respond to the public's call for more social spending and inclusive growth. Given the medium-term fiscal consolidation plan, the government should carefully calibrate the scope for raising social spending.

Despite Global Headwinds, Korea's Growth Outlook Remains Positive

Despite some uncertainties in the outlook for global activity, economic growth in Asia seems to be maintaining momentum. In the last quarter of 2011, activity slowed markedly across the region, but in the first months of 2012, leading indicators of activity have strengthened. Meanwhile inflation has picked up in some countries, and capital flows to Emerging Asia have rebounded. As reported in the IMF's latest Regional Economic Outlook for Asia and the Pacific (REO) (http://www.imf.org), Asia is projected to grow at 6 percent in 2012 before rising to about 6½ percent in 2013. Korea's economy is projected to follow a similar trend. Growth momentum was accelerating in 2010 and into 2011 before a deterioration in the global economy led to a slowing of growth in the second half of the year. This somewhat slower growth is continuing in the first half of 2012 but momentum is expected to be restored in the second half of the year.

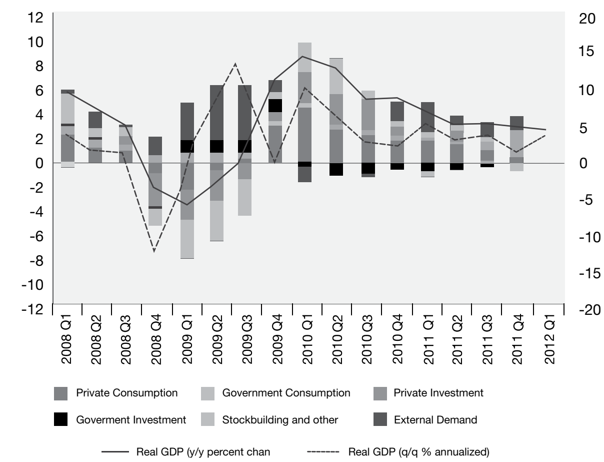
The remainder of this article is organized as follows. The first section focuses on economic developments in 2011 and the outlook for 2012-13. The second section discusses Korea's progress in strengthening financial resilience in the face of global volatility. The third section elaborates on the medium-term challenge of increasing social spending and creating a more inclusive growth model.

Balancing Growth and Inflation

Following a strong rebound in 2010, growth slowed down in 2011 to 3½ percent because of a housing supply overhang, sluggish investment, the withdrawal of fiscal stimulus, the impact of high household indebtedness on private consumption, and weakness in the global economy. Growth surprised on the upside in the first quarter of 2012, with broad-based recovery in domestic demand, but may be slowing again in the second quarter in line with weakness in the global economy. Recent data, and our projections, suggest that the economy will bottom out and strengthen during the course of 2012. Korea's diversified export base will help cushion the impact of weakness in the advanced economies. The recently ratified free-trade agreement with the United States, and Korean exporters' expansion into the growing markets of developing countries, will also help. On the domestic demand side, staff expects investment to recover, and private consumption to return to its trend growth. Accordingly, we have forecast Korea's economy to grow at 3 to 3¼ percent in 2012 before rising to about 4 percent in 2013.

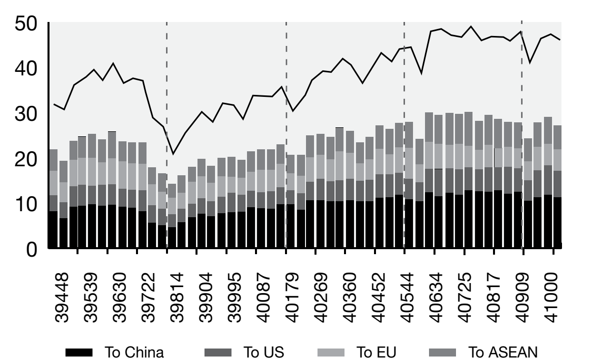
Elevated inflation was a key policy challenge confronting the Bank of Korea in 2011. Headline inflation remained stubbornly high and above the Bank of Korea's (BOK) 2-4 percent target band for most of 2011, despite weak activity in the last quarter of the year. Food price inflation peaked in the middle of the year and fell sharply in the second half,

Figure 1 Contributions to GDP Growth (as a %)



Source: CEIC Data Company Ltd.; and IMF Staff Calculation

Figure 2 Exports Value by Destination (in U.S. billions)



Sources: CEIC Data Company Ltd.; and IMF Staff Calculation.
Malaysia, Philippines, Thailand, Indonesia, Singapore, and Vietnam included for ASEAN.

but this decline was not able to offset the inflationary pressures from increasing prices of housing and transportation. A sharp exchange rate depreciation in the third quarter also contributed to elevated inflation.

More recently, headline inflation has decelerated in large part due to government measures and favorable base effects. Headline inflation has come off to 2¼ percent in June 2012, below the midpoint of the target band. However, this reflects temporary measures as the decline was largely driven by government subsidies on childcare and free school meals, as well as base effects. Around one-half of a percentage point of the decline in headline inflation can be attributed to these government measures. Food price disinflation, which contributed to declining inflation earlier, appears to have run its course. Core inflation also fell to 2 percent in March from 2½ percent during the previous month.

Despite the recent moderation in inflation, inflation pressures are projected to resurface in 2013. We expect inflation to be about 3 percent for 2012, slightly above the mid-point of the BOK's target band. Downward movements in headline inflation are unlikely to continue as there are no plans to implement additional administrative measures. Despite the drop in headline inflation, certain components of the Consumer Price Index basket with large weights (such as housing, transport and clothing) continue to see strong increases. Food price-led declines have troughed, implying that food prices will not contribute to a further drop in headline inflation. And despite declining headline inflation, inflation expectations remain close to 4 percent. Furthermore, there are upside risks to the inflation outlook from the need for utility price hikes going forward.

Guarding against risks to growth, while shepherding a soft landing for inflation, requires a delicate mix of policies. The current macro policy mix combines an accommodative monetary policy and a broadly neutral fiscal stance. On the fiscal policy side, the objective is to support growth—including by fully allowing automatic stabilizers to work—while not derailing medium-term efforts to restore fiscal space. The government appropriately chose to front-load 60 percent of its 2012 budget in the first half of the year given the weaknesses in the global economy. Even if the global economy were to deteriorate further, Korea still has ample fiscal space to respond with a fiscal package similar to what was done in 2008-09, if necessary. On the monetary policy side, we continue to believe it will be necessary to resume a normalization of monetary policy through interest rate increases in 2013 based on a forecast closing of the output gap (the difference between actual and potential economic output), continued risks to inflation, and to further build policy space and enhance credibility.

Safeguarding Financial Stability

Korean banks' large external short-term borrowing and their exposure to foreign exchange volatility were key vulnerabilities prior to the Global Financial Crisis (GFC). Korea's exposure to European banks on the funding side is among the highest in Asia. However, since 2008, the external vulnerability of the Korean financial system has significantly diminished, reflecting higher reserves to short-term debt cover, lower reliance on wholesale funding, reduced foreign exchange liquidity mismatches, diversification of the foreign investor base in domestic bond and onshore dollar funding markets, and the adoption of a series of macroprudential measures since 2010. These measures include: a 100 percent cap on the *won*-denominated loan-to-deposit ratio; ceilings on banks' foreign exchange derivative positions; tighter foreign exchange liquidity standards complemented by more frequent stress tests; stricter regulation of domestic foreign currency lending; a macroprudential levy on the foreign currency-denominated non-core bank liabilities; and a withholding tax on foreign investors' interest income on government bonds.

The initial set of post-GFC measures targeted banks' active use of short-term foreign-exchange liquidity and the resulting increase in the maturity and currency mismatches on banks' balance sheets. The underlying concerns reflected banks' strong reliance on non-core liabilities. The introduced measures included: (i) an increase in the ratio of long-term foreign exchange funding to foreign exchange lending, enacted in November 2009 and set at 90 percent; (ii) a cap on the value of forward foreign exchange contracts between banks and domestic exporters, introduced in November 2009 and set at 125 percent of export revenues; and (iii) a maximum loan-deposit ratio of 100 percent for domestic banks, introduced as a guideline in December 2009, and expected to be implemented by end-2013. During this initial phase, the Korean authorities also introduced more stringent capital requirements on bank holding companies to ensure sufficient absorption of potential losses.

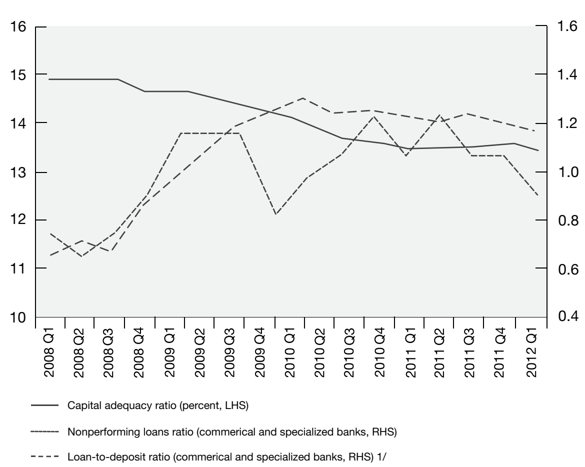
In a second phase, in 2010, the authorities expanded the set of measures to contain banks' short-term foreign currency debt. In October 2010, they established a ceiling on banks' foreign currency derivative positions, including those from foreign exchange forward contracts bought from domestic exporters and asset management companies for currency hedging. The derivatives ceiling was set relative to banks' capital, with domestic banks facing a ceiling of 50 percent of capital and foreign branches 250 percent of capital. The ceilings were subsequently tightened even further in July 2011 to 40 percent for domestic banks and 200 percent for foreign banks. The ratio of forward contracts to underlying export revenues was also reduced to 100 percent. Measures on foreign currency borrowing were bolstered as well. New measures on banks' foreign currency loans were meant to prevent excessive foreign currency leverage in the corporate sector. Taken together, this set of macroprudential measures was meant to reduce the channeling of bank funding to foreign currency forward positions in the domestic market and guard against an abrupt withdrawal of capital. The Korean authorities also re-introduced a withholding tax on foreign purchases of treasury and monetary stabilization bonds in January 2011. In essence, this aligned the tax with the equivalent for resident bond purchases. The only explicit exemption was provided for official investors.

Households' high indebtedness has been flagged as another important vulnerability for the financial system, with the household debt-to-disposable income ratio now at 135 percent, similar to levels in advanced economies such as the U.K. and the U.S. Household exposure to interest rate and rollover risks, therefore, present vulnerabilities despite relatively stable house prices, favorable net asset positions, and low loan-to-value ratios. However, one unique feature of Korea's housing market could lead to inflated levels of household debt. The Jeonse system requires tenants to place a refundable deposit of 50-70 percent of the price of a rented house to landlords at no interest. This arrangement pushes up both household liabilities and assets but has no impact on the net-asset position which remains relatively strong.

The banking system's exposure to foreign exchange liquidity risks has also decreased sharply. This decrease reflects both strengthened regulation of foreign currency liquidity risks and reduction in banks' external short-term borrowing, which had been partly driven by the demand for hedging by Korean shipbuilders and other exporters. Moreover, the foreign investor base in domestic bonds (who also supply dollar liquidity in the onshore swap markets) has broadened to include official investors (notably some regional central banks). The diversification has reduced the risk of market herding behavior, given the low correlation between liquidity risks faced by large global banks (which still dominate the base) and those faced by the regional central banks. Because of these changes, Korea's exchange rate volatility, which tended to surge during the past crises, has become less sensitive to global risk factors: the sensitivity of the exchange rate volatility to changes in indicators of global volatility is estimated to have declined by more than a half since the GFC.

Even though the banking system vulnerabilities have diminished since 2008, it is important to remain vigilant. The negative impact of euro-area bank deleveraging has so far been limited. However, Korea is still one of the economies in Asia most exposed to foreign bank funding risks. In the aftermath of the 2008 crisis, massive capital outflows caused the claims by the Bank of International Settlements reporting banks on Korea to fall by more than 70 billion dollars. As banks were unable to rollover their short-term debt, the

Figure 3 Capital Adequacy, Nonperforming Loans, and Loan-to-Deposit Ratio



Source: CEIC Data Company Ltd.; FSS; and IMF Staff Calculation
1/ Specialized banks are not subject to loan-to-loan deposit limit.

Bank of Korea had to intervene with about 65 billion dollars of reserves to cushion the liquidity squeeze on the economy. Even so, the *won* exchange rate fell by 32 percent, from the pre-crisis peak to trough, while stock prices declined by 35 percent. The financial stress also affected the real economy through slower credit growth. Looking ahead, the possibility of rollover difficulties resulting from an intensification of the euro-zone crisis cannot be ruled out.

In the third quarter of 2011, there was a sudden surge in capital outflows (including from the banking sector). This led to some funding pressures causing depreciation of the exchange rate by 10 percent. Since the beginning of 2012, capital inflows have resumed led by both equity and fixed income flows, although banking capital flows remain subdued. Going forward, the downside risks from intensification of the euro-zone crisis appear to be balanced by the high upside risk for capital flows, particularly portfolio flows, if risk appetite recovers. Given the improved financial resilience and macroprudential policies in place, Korea is well positioned to manage any future bouts of capital flow volatility. Flexibility in macroeconomic policy will also remain an important part of dealing with economic shocks as the extensive macroprudential policies put in place are an important complement but cannot be a substitute for appropriate macroeconomic policy settings.

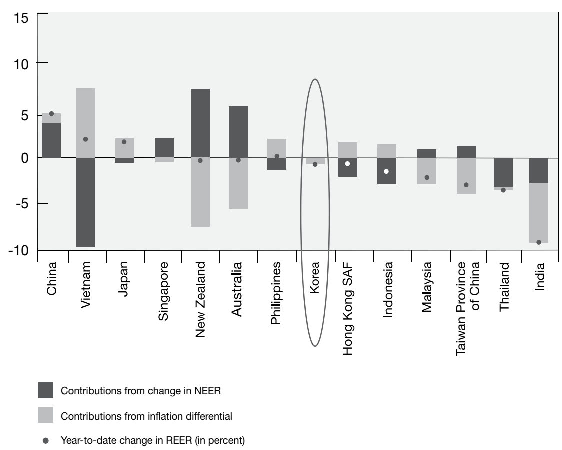
Social Spending and Inclusive Growth

One of the key medium-term policy challenges is to respond, in a careful yet effective way, to the public's call for more social spending and inclusive growth—a particular challenge in this dual election year. Given the medium-term consolidation plan, the government should carefully calibrate the scope for raising social spending; making sure that the bulk of the increase is matched by either additional revenues or cuts in other expenditures. To support this, more work also needs to be done in integrating long-term issues into the fiscal framework. Labor market reforms and raising the productivity of the service sector are key areas of reform to strengthen growth potential.

While Korea has one of the youngest populations in the Organization for Economic Cooperation and Development (OECD), it is projected to shift to among the oldest by mid century, given its low fertility rate and rapid gains in longevity. Although pressures will not show in the near term, given the current age profile of the population, age-related spending will begin to appear in the medium term and accelerate from 2020 with the rapid aging of the population.[2] Meanwhile, during the most recent decade, income inequality has rapidly risen to the OECD average level.

Korea is among five OECD countries singled out for a high degree of inequality originating from the labor market. The

Figure 4 Asia: Contributions to Changes Since Dec 2010 in REER (as a %, Apr 2012)

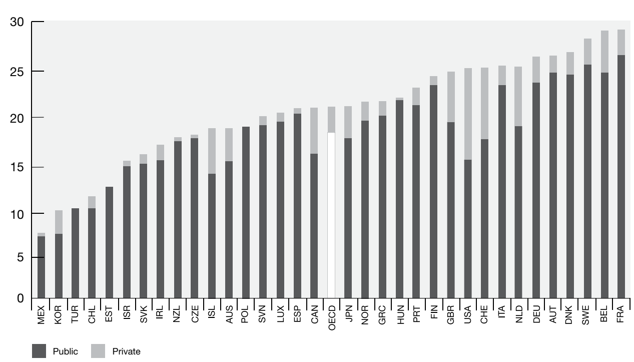


Source: APDCORE; and IMF Staff Calculation.

degree and cost of employment protection for regular workers has gradually risen to a point where companies have begun to shift most new jobs to nonregular workers. As a result, the share of nonregular workers is significantly higher than the OECD average, and they are paid about 40 percent less. The female labor market participation rate (55 percent) is also much lower than the OECD average (62 percent). The government's National Employment Strategy 2010 aims at boosting Korea's employment rate from 63 percent of the working age population in 2010 to 70 percent, including by raising the participation rate of women, the elderly, and youth.

Labor productivity growth is also being held down by rigidities in the service sector. Productivity growth in the service sector has been about 1 percent a year on average since 2001 compared to 6 percent in the manufacturing sector. The government can address this issue by enhancing competition, including in the education and health sectors; expediting bank-led restructuring of small- and medium-enterprises, the bulk of which are in the service sector; and eliminating preferential tax treatment of the export sector.

Figure 5 Public and Private Social Expenditure in Percentage of GDP in 2007



Source: OECD

The Korean government is targeting a balanced central government budget (excluding social security funds) by 2013-14, as part of its fiscal consolidation plan, which is already well advanced. Within this framework, the 2012 budget envisages a 20 percent nominal increase in social welfare spending. The Direction for the Preparation of the 2013 Budget, which was recently approved, also maintains workfare and sustainable growth as core themes. The government's National Fiscal Management Plan for 2011-15 lays out several areas to increase revenues. Going forward, better clarifying medium-term fiscal targets and linking them more directly to future liabilities, including those related to aging, would help ensure that the fiscal objectives are consistent with long-term sustainability. This would also help make them more binding and guide prioritization among fiscal measures. The key policy tools to address these medium-term fiscal challenges include pension and healthcare reform, broadening of the tax base, improved tax administration and some reallocation of public expenditures.

Conclusions

The global economy still remains fragile. Given its high global interconnectedness, Korea must remain vigilant. The main short-term risks to the outlook are the potential re-escalation of the euro crisis and possible increases in energy prices from geopolitical risks in the Middle East.

A re-escalation of pressures in heavily indebted economies in Europe could lead to further deleveraging by European banks, which if disorderly and large scale, could have serious implications for Korea. However, since 2008, the external vulnerability of the Korean financial system has diminished, reflecting higher international reserves, lower reliance on wholesale funding, reduced foreign exchange liquidity mismatches, the entry of new foreign investors in domestic bond and onshore dollar funding markets, and the introduction of macroprudential instruments. The Korean economy is also susceptible to energy price shocks, which could boost inflation and further weaken private consumption.

Korea continues to be one of the most dynamic economies in the most dynamic region of the world. It is, therefore, well placed to take up the challenges that could arise from a volatile global economy. Unlike many other countries, including the most advanced ones, Korea has ample policy space to deal with global shocks, thanks mainly to its low public debt, exchange rate flexibility, comfortable international reserve buffers, and use of macroprudential measures. Overall growth prospects remain favorable, and with the right policy settings, Korea can successfully navigate the still dangerous waters to a path of sustainable growth.

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1 Prepared by Thomas Rumbaugh, Division Chief, Asia and Pacific Department, International Monetary Fund. The views expressed are those of the author and not necessarily those of the IMF.

2 A previous IMF study shows that government gross debt will begin to grow from around 2020 as the initial asset accumulation phase of Korea's still young pension system (which is fully funded) matures. See Feyzioglu, Skaarup, and Murtaza (2008), "Addressing Korea's Long-Term Fiscal Challenges," IMF Working Paper 08/27 (Washington: International Monetary Fund) (http://www.imf.org/external/pubs/cat/longres.aspx?sk=21595.0).

THE POLITICAL ECONOMY OF SOUTH KOREA UNDER THE NEW INTERNATIONAL ORDER

By Pyo Hak-kil

Abstract

The political economy in South Korea changed immensely through a series of internal and external events in 2011 and 2012. At the same time, actual economic performance was disappointing and far less than the 7 percent that President Lee Myung-bak had envisioned. The economic picture also worsened for households and businesses as households saw consumer prices rise by 4 percent, while businesses faced increasingly higher prices for oil. At the same time, household debt surpassed 900 trillion *won* and all of the indicators of income inequality worsened. The National Assembly elections saw both political parties push for increased welfare spending. However, the proposals put forward by both parties may not be feasible due to constraints on the government's total budget. With the global economic condition, continued fiscal troubles in Europe, and a slowdown of economic growth in China, Korea also faces reduced expectations for economic growth in the year ahead.

Introduction

In 2011, the landscape of the political economy in South Korea changed immensely through a series of internal and external events. The earthquake and its aftermath in Japan and the fiscal crisis in Europe were two external events, while the new political syndrome after the election of a new progressive mayor in Seoul and the sudden death of Kim Jong-il were two remarkable events within the Korean peninsula. In early 2012, U.S.-North Korea bilateral talks were initiated by President Obama and North Korea's new leader Kim Jong-un, with an accord made on February 29 to limit North Korea's nuclear activities. But on April 14, less than six weeks after the accord was signed, the new North Korean regime launched a long-range missile equipped with a satellite without regard for a U.N. resolution and paying no heed to the United States and even to its biggest patron, China.

The timing of the missile launch was deliberately chosen to inaugurate Kim Il Sung's 100th birthday on April 15; to celebrate the appointment of Kim Jong-un as the First Secretary of the ruling Workers' Party, the de facto leader of the regime at a special conference on April 11; and to disturb general elections in South Korea on the same day. But the missile launch failed in the early morning of April 14, and there is wide-spread speculation this failure would increase the likelihood of a follow-up nuclear detonation as a face-saving effort. South Korea must face the new realities of this international political order. Instability in the North Korea regime as demonstrated by the failed missile-launch may signal violent confrontation ahead.

In South Korea, the governing New Frontier Party has won the general election with a narrow margin (152 seats) against the opposition coalition of Democratic United Party (127 seats) and United Progressive Party (13 seats). When independent winners are included, the number of conservatives (158 seats) is slightly larger than the number of progressives (142 seats). The opposition coalition gained many more seats in this general election than the previous one in 2008 which was held just after the inauguration of President Lee Myung-bak. The Lee government lost popularity, particularly among younger generations and voters in the Seoul metropolitan area. While the government has claimed that South Korea has escaped from the global financial crisis of 2007-2008 with relatively better recovery than most other nations, public sentiment has been against the claim.

Macroeconomic Performance During 2008-2011

The actual economic performance (3.1 percent average growth of real GDP and 0.45 percent average growth of real investment) during 2008-2011 has been disappointing and far less than the campaign vision of 7 percent real GDP growth. The only bright side of the economic performance was a strong export performance. The f.o.b.-based export amount increased at the average annual rate of 11.7 percent while the c.i.f.-based import amount increased by 12.8 percent. It was largely due to the depreciation of *won* from 938.2 *won* per dollar at the end of 1997 to 1,257 *won* per dollar at the end of 2008 after the global financial crisis and to 1,153 *won* per dollar at the end of 2011. The OECD Economic Surveys (2010)[1] state that the sharp depreciation of the *won* helped to trigger Korea's rebound by significantly improving its international competitiveness, and thus raising Korea from the world's 12th largest exporter in 2008 to ninth in 2009. In summary, the average GDP growth rate of 3.1 percent during the last four years of the Lee government was maintained by export performance through the depreciation of *won* against the dollar and *yen*. But the extra export earnings were not fully channeled to the non-exporting sectors and therefore, the growth of GNI after being adjusted by unfavorable terms of trade effects through increased oil prices remained stagnant. One of the reasons is the concentration of high export performance in a few IT-related products. During the period of 2000-2009, higher IT-intensity manufactures' real exports have increased at the annual rate of 10.06 percent while lower IT-intensity manufactures' real exports increased at the annual rate of 4.09 percent. During the same period, the annual growth rates of real GDP in two sectors were 5.10 percent and 3.78 percent respectively, which implies that export-output ratio was much larger in higher IT-intensity sectors than in lower IT-intensity sectors.

According to 2011 National Accounts (preliminary) released on March 30, 2012 by the Bank of Korea, 2011 was a disappointing year for both businesses and households. The per capita Gross National Income (GNI) in 2011 was estimated to be $22,489, which is only a 1.5 percent increase due to the worsening terms of trade by increased oil prices and CPI (4.0 percent) and reduced semiconductor prices. The net savings rate by households continued to decline from 4.1 percent in 2009 to 3.9 percent in 2010 and 2.7 percent in 2011. Gross fixed capital formation declined by 1.1 percent from 2010 with construction investment (-5.0 percent) and equipment investment (3.7 percent), which recorded a drastic decline from 2010 (25.7 percent). The growth rate of real GDP in 2011 was 3.6 percent with manufacturing (7.2 percent), construction (-4.6 percent) and services (2.6 percent).

While the Consumer Price Index (CPI) increased by 4.0 percent last year, the price of agriculture, fishery and cattle increased by 9.2 percent. As a consequence, the Engel coefficient which measures the proportion of household expenditure on food and non-alcoholic beverages in total household expenditure, increased from 13.8 percent in 2010 to 14.6 percent in 2011 according to the National Statistical Office of Korea. The Engel coefficient of the first docile (the lowest 10 percent income group) increased from 22.5 percent to 23.5 percent which is a record high and ten percentage points above the average Engel coefficient for the entire household.

Household Debt Overhang and Growth with Inequality

The Bank of Korea announced that total household debt had surpassed 900 trillion *won* by the end of 2011, which reached beyond 70 percent of nominal GDP and 160 percent of total wages and salaries. The switch of commercial loans from the indebted corporate sector to the mortgage-backed household sector by both the primary and secondary banking sectors after the financial crisis of 1997-1998 has been the main cause of the households' debt overhang. Fueled by the low interest rate policy by the government, the real estate market had a boom and a bust during the last decade. The government introduced a set of regulations on real estate loans in order to curb housing inflation and many households are squeezed by inactive real estate transactions and mortgage-backed household loans. According to a report by the Seoul Policy Development Institute, the household debt of Seoul residents is estimated at about 204 trillion *won* and about 60 percent of Seoul households are currently indebted. The ratio of household debt was lower (58.0 percent) when annual household income was above 60 million *won*, compared to household income of 20-30 million *won* (65.4 percent).

According to the National Statistical Office's report on Household Expenditure Survey in 2011, all of the indicators of income inequality have worsened. The relative poverty ratio, which is defined as the ratio of households including one-man households and farm households whose income is less than 50 percent of the median household income, has increased from 14.9 percent in 2010 to 15.2 percent in 2011. The decile distribution ratio, which is defined as the ratio of the top 20 percent income to lowest 20 percent income, has increased from 5.66 to 5.73. In terms of market income, the ratio reached its highest level of 7.86 since this statistic first was complied in 2006. The Gini coefficient has also slightly deteriorated from 0.310 to 0.311. However, the report points out some mixed evidence on income inequality by non-farm households with two-persons and above. The monthly household income in 2011 reached 3,842,000 *won* which increased by 5.8 percent from 2010. But because of a high inflation rate (4.1 percent), the real average monthly income only increased by 1.7 percent. On the other hand, the average monthly consumption expenditure was 2,393,000 *won*, an increase of 4.6 percent from 2010 but only by 0.5 percent in real terms which indicates very little incremental real consumption.

A recent study by OECD (2011) reveals that income inequality among elderly citizens (age 65 and older) in South Korea is the third highest among major economies and that the country's pension system remains relatively insufficient to support retirees. The Gini coefficient for those aged 65 and older in Korea is 0.409: lower than Mexico (0.524) and Chile (0.474) but higher than the U.S. (0.386), Japan (0.348), France (0.291), Germany (0.284) and the Czech Republic (0.188). The Gini coefficient for the age group 18 to 65 in Korea is estimated to be 0.300 lower than most of countries: Chile (0.496), Mexico (0.469), Turkey (0.403), U.S. (0.370), Israel (0.359), Portugal (0.347), Australia (0.324) and Japan (0.323). The large gap in the Gini coefficients between Korea's working generation and senior citizens indicates that there is lack of post-retirement pension fund and therefore, there is a major welfare problem. It reflects that parents of the baby boom generation spent too much money on their children's education, and saved too little money for their own retirement.

Welfare Expenditure Spree and Vision

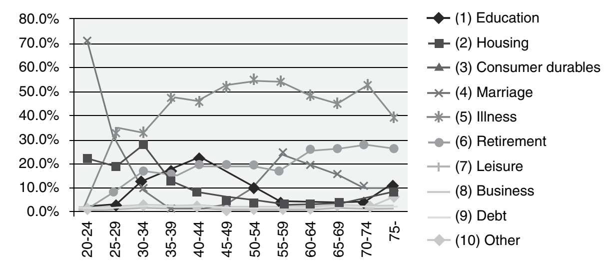
The welfare expenditure level in 2007, just prior to the Lee government, was about 61.4 trillion *won* which accounted for 25.9 percent of total government expenditure. However, welfare expenditure in 2012 will increase to 92.6 trillion *won*—28.5 percent of total government expenditures. The government's third Welfare Task Force forecasts a total minimum of 268 trillion *won* (53.6 trillion *won* per year) will be required to fulfill welfare visions made by both the ruling party and the opposition party before the general election. Since the total government budget in 2012 is 325.4 trillion *won* and the welfare budget in 2012 is 92.6 trillion *won*, the next government would need about 82.4 percent of the total budget in 2012 over the next five-year period. It also implies that the total government budget and the welfare budget need to be increased by 16.5 percent and 57.9 percent respectively, which makes the welfare vision simply unfeasible. The Korea Institute of Public Finance's report on the impact of aging and population reduction on public finance forecasts that the government debt would reach 102 percent of GDP by 2050 even without such a welfare budget increase. The only options available to the incoming government would be to increase welfare taxes or to issue government bonds but both of these options would undermine the economy's long-term potential and increase the likelihood of a euro zone type fiscal crisis in the future.

In a recent report published by the National Pension Research Institute (Pyo, Kim and Lee 2012)[2], we analyzed the national pension system in Korea which was introduced in 1998 and now has over 18 million subscribers. South Korea has become one of the fastest aging nations among OECD countries. The proportion of population age 65 and above was 11.0 percent in 2010, but is estimated to reach 38.2 percent by 2050. During the same period, the elderly dependency ratio which is defined by the age 65 and above population divided by the age 15 to 64 population, is estimated to increase from 15 percent to 72 percent by almost five times. The revised National Pension Act of 2007 stipulates a target to reduce the income substitution ratio by half a percentage point from 50 percent in 2008 to reach 40 percent by 2028. We have recommended three policy options to make the national pension plan self-sustainable: (1) reduce income substitution ratio even after 2028; (2) increase the national pension tax rate and; (3) the government subsidy. Since other social safety net programs are strong—childcare, education and poverty reduction—none of these three options seems politically feasible. However, the only way of ensuring feasible welfare programs in a fast aging society is to increase welfare-related taxes or reduce the coverage and benefits of diverse welfare measures. Another consideration in many discussions is the contingency welfare plan when unification with North Korea occurs. Even though the current welfare standard (welfare expenditure/GDP ratio) of South Korea is relatively low among OECD nations, the speed of aging in South Korea and the potential burden of the contingent unification require more prudent welfare policies in the times ahead. Marcus Noland stated that "standard models of the costs of unification suggest that the amount of investment needed to raise North Korean per capita incomes to 60 percent of the South Korean level, are in excess of $1 trillion, or roughly equal to South Korea's annual national income."[3] Regardless of the estimates, no doubt the cost of reunification will be huge, and South Korea will be unable to absorb the economic cost itself.[4]

Saving Rates and Motives in Korea

I have examined the motives of household savings from the data of Korea Labor Income Panel Study (KLIPS) (1998-2008) in a recent paper (Pyo, 2012).[5] I have found that retirement, education and medical concerns due to illness, are the most significant motives for savings throughout all age groups (See Table 1 and Figure 1). The concern for illness and therefore savings motivation for medical expenses are the largest for those in their 40s and 50s and reflects a precautionary motive. Saving for education was strong during the 30s and 40s. On the other hand, the savings motivation for retirement came on strong rather late, age 60 and above, for household heads.

Figure 1 Proportion of Households Saving for Selected Motives by Age Group of Household Head



Sources: KLIPS Data

This survey data indicates that the high burden of education costs fell on those in their 30s and 40s, which in turn has made them less prepared for their own retirement: the over-investment in education and under-investment in retirement. The high medical cost sits in the middle, inducing households to save little for their retirement. When I estimated returns to schooling and examined the savings rate and motives of households, I found that there is a likelihood of over-investment in education and under-investment in retirement, causing a welfare-related social issue. The estimated marginal returns to years of education using KLIPS (Korea Labor Income Panel Study) data is 0.07 (7 percent) in household income and 0.08-0.09 (8-9 percent) in individual income which is lower

Table 1 The Proportion of Households Saving for Selected Motives by the Age Group of the Household Head

	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60-64	65-69	70-74	75-
(1) Education	0.0	2.7	11.4	16.9	21.9	19.2	9.7	2.2	1.8	3.3	3.7	10.2
(2) Housing	21.4	19.2	26.5	13.4	7.8	4.4	3.3	2.5	2.3	3.3	1.2	8.2
(3) Consumer durables	0.0	0.0	0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(4) Marriage	71.4	31.5	9.0	2.5	1.0	3.9	10.8	24.3	19.8	16.0	11.1	10.2
(5) Illness	0.0	33.6	31.9	46.8	45.2	51.6	54.6	53.6	48.4	45.3	51.9	38.8
(6) Retirement	0.0	8.2	15.8	16.5	20.4	19.5	19.2	15.8	25.3	26.0	28.4	26.5
(7) Leisure	7.1	1.4	0.2	0.2	0.0	0.5	0.0	0.0	0.0	2.7	2.5	0.0
(8) Business	0.0	0.0	0.7	0.4	1.0	0.2	0.8	0.3	0.5	0.7	0.0	0.0
(9) Debt	0.0	0.7	1.2	1.9	1.3	0.5	0.5	0.3	0.5	0.0	0.0	0.0
(10) Other	0.0	2.7	2.7	1.0	1.5	0.2	1.0	0.9	1.4	2.7	1.2	6.1

Sources: KLIPS Data

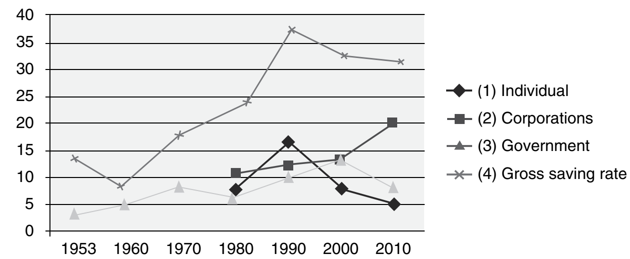
than the world average and the Asian average (0.10, 10 percent). Korea's estimated returns to schooling in earlier studies were 0.09-0.14 for high school graduates. It was mainly due to the baby boom factor, but it calls attention to the role of private versus public education. While Korea's educational attainment is remarkable, the resulting issue of how to support the retirees in a fast-aging society remains as a challenging issue. Estimates of returns to schooling indicate the marginal returns to schooling have started to decline. There was a likelihood of over-investment in education and under-investment in retirement by baby boom parents in Korea. Since there is a strong motive for savings to prepare for large medical expenses, the private pension system needs to be combined with the private medical insurance system.

Trend in Savings Rates and Its Decomposition

I have examined the overall savings rate and its trend in Korea to identify simultaneous effects of education and household savings. As shown in Table 2 and Figure 2, the gross savings rate was only 9 percent in 1960, with a private savings rate of 5 percent and government savings rate of 4 percent. But both gross savings rate and private savings rate increased sharply to reach their peaks of 37.5 percent and 29.2 percent respectively in 1990. The increase in private household savings rate has been instrumental to educational expansion because the role of private education has dominated that of public education in Korea.

According to Horioka (1994)[6], Japan reached a net national savings rate of 23.6 percent in 1990 ranking third among 24 OECD countries, and a net household savings rate of 14.3 percent in 1989 ranking fourth among 18 OECD countries. He concludes that Japan's saving rate would still be higher than average even if all measurement problems such as the treatment of capital consumption allowances could be resolved. Korea seems to have reached Japan's level during the 1980s, earlier than 1990. However, Korea's private household savings rate started to fall rather rapidly after 1990 and returned in 2010 to the same level (5 percent) as it was in 1960. It was substituted by the corporate savings rate (20.2 percent) in 2010. One of the reasons behind Korea's rather rapid household savings rate during the 1980s seems to lie in the need to save for children's education. On the other hand its rather rapid decline during the late 1990s and 2000s seems to reflect high costs of medical expenses and education through the two financial crises of 1997-1998 and 2007-2008.

Figure 2 Trend in Saving Rates in Korea (1953-2010)



Sources: The Bank of Korea, National Accounts, (selected years)

In addition, there are two other factors which have worked jointly to increase households' consumption and decrease their savings. One is the development of financial markets which provided wider choices of payment methods, including credit cards and debit cards, so that households' consumption has been rapidly increasing, including internet banking transactions. The other factor was the cumulative effects of market-opening for foreign goods since joining WTO and OECD in the mid-1990s. The influx of foreign goods through large retail chain stores have opened up consumption opportunities of the households and their conspicuous consumption. The financial crises have also induced firms to retain more savings crowding out household savings.

South Korea and the United States launched a ministerial consultation channel on implementing their bilateral free trade agreement by forming a joint committee on May 17, 2012.

Table 2 Trend in Saving Rates in Korea (1953-2010)

	1953	1960	1970	1980	1990	2000	2010
Gross saving rate	13.1	9.0	19.0	24.4	37.5	33.0	32.0
Private	11.1	5.0	11.9	19.1	29.2	21.4	25.2
(Individual)				(8.3)	(16.7)	(8.6)	(5.0)
(Corporations)				(10.8)	(12.5)	(12.8)	(20.2)
Government	2.0	4.0	7.1	5.2	8.3	11.6	6.8

Sources: The Bank of Korea, National Accounts (selected years)

The joint committee is mandated under the KORUS FTA, which took effect in March 2012. The ministerial mechanism is tasked with supervising the operations of 19 subcommittees and working groups aimed at the smooth implementation of the accord, including solving disputes over interpretations of the terms. South Korea's opposition parties claim this investment safeguard mechanism undermines South Korea's legal independence by allowing U.S. companies to take action against Seoul's policy decisions. They demand Seoul address the concern by altering relevant clauses that they argue unfairly favor American firms with long experience in legal battles against a foreign government. On the investor-state dispute clause in the KORUS FTA, Korean Trade Minister Bark Taeho said it will be handled in the service and investment committee. In early May, South Korea announced the start of FTA talks with China. At a trilateral summit meeting in Beijing, the leaders of South Korea, China, and Japan agreed to launch negotiations on a three-way FTA this year.

Prospect for Sustainable Growth

Economic forecasts for the Korean economy in 2012 by global investment banks (JP Morgan, Deutsche Bank and Nomura) have been adjusted downward from their forecasts of real GDP growth of 3.0-3.6 percent at the end of 2011 to 2.7-3.3 percent in March 2012. This is based on their projections of sluggish export demands due to the continuing European fiscal crisis, higher oil prices and reduced Chinese economic growth. Citigroup forecasts Korean export growth as limited to 6.6 percent and 7.5 percent during the first two quarters of 2012, and Goldman Sachs forecasts a yearly export growth of 5 percent. The most recent forecast by the Asian Development Bank released in April 2012 is 3.3 percent, which is lower than the government's target economic growth rate of 3.7 percent. They also point out that domestic demand including both household consumption and corporate investment will be sluggish due to household debt, as well as the uncertain investment environment in 2012 with both the assembly general election in April and the presidential election in December.

The public has been disappointed by the failed vision by the Lee Government and the net consequence of very minimal increase in their real earnings. It has created room for increasing welfare demands and a progressive agenda for big conglomerate (*Chaebol*) reforms. The result of the general election on April 11 will influence the presidential election in December 2012 and many experts are predicting a very tight presidential race. In addition, if North Korea attempts another nuclear detonation or military adventure, it will also affect the presidential election in South Korea. In this respect, the political economy of South Korea will inevitably depend on the prospect of the new international political order in Northeast Asia.

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DEVELOPING A NEW GROWTH MODEL FOR KOREA

By Randall Jones

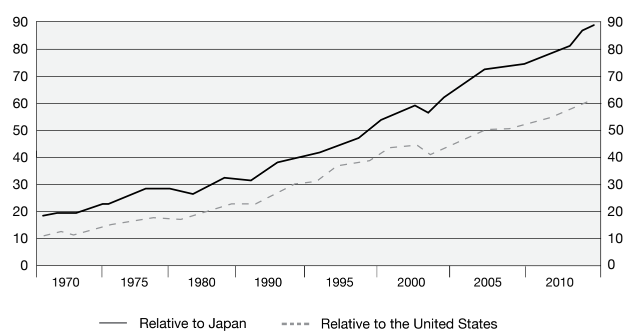
Abstract

Korea's rapid economic development has boosted its per capita income to within two-thirds of the U.S. level. The focus on exports, though, has made Korea vulnerable to external shocks while reducing productivity in the service sector, increasing income inequality and boosting energy intensity. Consequently, Korea's export-led strategy should be balanced by policies to ensure that growth is environmentally and socially sustainable. First, the service sector should be made a second engine of growth by leveling the playing field with the manufacturing sector, strengthening competition in services and expanding openness to foreign competition. Second, market instruments that put a price on carbon, primarily through a cap-and-trade emissions trading scheme, complemented by a carbon tax on small emitters, are needed to achieve the government's vision of "Low Carbon, Green Growth." Third, well-targeted increases in social spending would promote social cohesion, accompanied by reforms in the labor market and education system to address the fundamental causes of inequality. One urgent task is to reduce the share of non-regular workers. Fourth, increasing labor force participation, notably of women, youth and older workers, is essential to mitigate demographic pressures.

The economic development of Korea since 1960 has been among the most rapid ever achieved, transforming it from one of the poorest countries in the world to a major industrial power. Life expectancy has increased from 52 years in 1960 to nearly 80 years, while per capita income rose from 12 percent of the U.S. level in 1970 to 63 percent in 2010 and is now within 10 percent of that of Japan (Figure 1).

Rapid economic development was led by exports, allowing Korea to overcome its lack of natural resources and its small domestic market. Exports increased from less than 5 percent of Korean GDP in 1960 to 32 percent by the time of the 1997 Asian financial crisis. Reforms to develop a more market-oriented economy and increase openness to imports promoted Korea's recovery from the crisis and its further integration in the world economy. Exports were again the key driver of Korea's strong rebound from the 2008 global financial crisis, aided by a sharp depreciation of the won. In sum, net exports (exports minus imports) directly accounted for more than one-quarter of output growth since 1997, while Korea has maintained a current account surplus averaging more than 3 percent of GDP over the past 15 years. Korea is now one of the major producers of ships (first in the world), cars (fifth) and steel (sixth), and has two of the top ten semiconductor firms in the world. By 2010, Korea's share of global exports was 3.1 percent, the seventh largest in the world, and exports as a share of Korean GDP had surpassed one-half.

Figure 1 Korea's Per Capita Income is Converging to the Most Advanced Countries (as a %)



1: Using 2005 purchasing power parity exchange rates.
Source: OECD, *Going for Growth 2012*

While exports will continue to play an important role, Korea must develop new growth engines to ensure that growth is sustainable and reduce vulnerability to external shocks. This article begins by exploring some of the side effects associated with export-led growth. It then considers the challenge of sustaining Korea's convergence to the high-income countries and then offers strategies aimed at ensuring that growth is socially and environmentally sustainable.

The Negative Side Effects of Export-Led Growth

Some negative aspects of the focus on exports have become apparent in recent years:

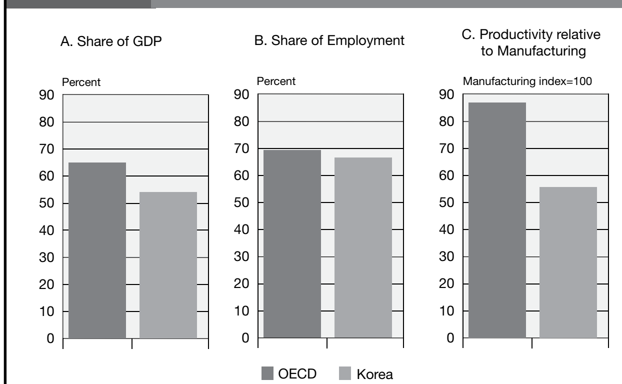
- It has stunted the development of the service sector, which has relatively low productivity.
- It has contributed to the significant rise in income inequality and poverty since 1997.
- It has resulted in a high level of energy intensity and rising greenhouse gas (GHG) emissions.

A Low-Productivity Service Sector

Although the share of the service sector increased from 50 percent of GDP in 1990 to 57 percent in 2008, it is well below the OECD average (Figure 2). Only four of Korea's 30 largest enterprises are in services. The share of employment in services in Korea is closer to the OECD average (Panel B), reflecting the sector's role as a de facto safety net for older workers forced to retire from firms at a relatively young age. However, labor productivity growth in the service sector has consistently lagged behind that in manufacturing, slowing = from an annual rate of 2.6 percent during the 1980s to 1.2 percent between 1997 and 2007, in contrast to nearly 9 percent growth in manufacturing. Consequently, by 2008, service-sector productivity was only about half of that in manufacturing, the largest gap in the OECD area (Panel C).

Korea's economic structure is the legacy of a development strategy that focused on exports and manufacturing, thereby siphoning capital, talent and other resources away from services. For example, R&D investment in services accounts for only 7 percent of total R&D by Korean firms, compared to an average of 25 percent in the G7 economies. Moreover, the government allocates only 3 percent of its R&D budget to services. Manufacturing firms also benefit from a range of policies, including tax benefits and lower electricity charges.

Figure 2 The Service Sector (in 2008, based on 2005 prices for value added)



Source: *2012 OECD Economic Survey of Korea*

Rising Income Inequality and Poverty

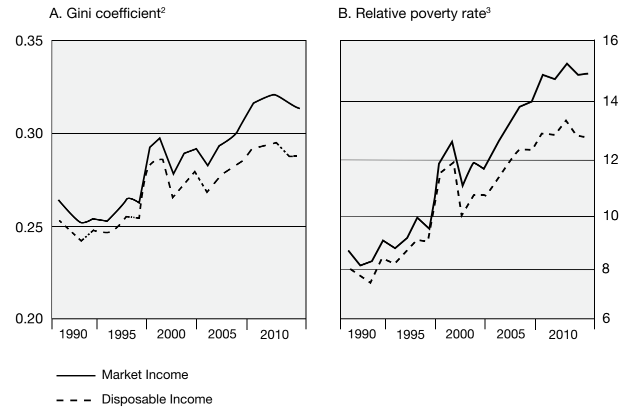
Income inequality has become a major concern in Korea as in many other OECD countries. Until the 1997 Asian financial crisis, Korea's income distribution stood out as one of the most equitable among developing countries. However, income inequality, as measured by the Gini coefficient, increased significantly between 1997 and 2009 (Figure 3), when it reached the OECD average. Moreover, the ratio of the top quintile to the bottom is 5.7, above the OECD average of 5.4. Meanwhile, relative poverty – the share of the population living on less than half of the median income – rose to 15 percent in 2008, the seventh highest in the OECD area.

The rising trend in income inequality and relative poverty is explained in part by the increasing share of services in employment. First, wage dispersion in the service sector is relatively wide, ranging from business services and the financial sector at the high end to hotels and restaurants. Second, the wage gap between services and manufacturing is widening. The average wage in services, which was nearly equal to that in manufacturing in the early 1990, fell to only 54 percent in 2009. Meanwhile, an increasingly capital and technology-intensive manufacturing sector reduced its share of employment from 28 percent to 17 percent over that period. In short, the employment impact of exports is decreasing, reducing its trickle-down effect on the rest of the economy.

The low wages and productivity in the service sector is closely linked to small and medium-sized enterprises (SMEs), which account for 80 percent of output and 90 percent of employment in services. The deteriorating wage performance in services has thus widened the gap between large and small firms. In 1990, workers in firms with 10 to 29 workers earned 24 percent less than workers at companies with 300 or more workers. By 2008, the gap had widened to 43 percent. The incidence of low wages (defined as less than one-half the national median) falls from 39 percent of women employed in firms with less than five workers to 4 percent for companies with more than 1,000. Consequently, the problem of "working poor" is concentrated in small companies.

Other factors besides the problems in the service sector are contributing to widening inequality. First, Korea's dualistic labor market results in high inequality in wage income. Non-regular workers, who account for about one-third of employment, earn only 57 percent as much per hour of work as regular workers. Second, the large share of private spending in education and health increases the impact of socio-economic factors on educational and health outcomes. Third, social spending, which plays an important role in reducing inequality and poverty in most OECD countries, amounted to only 7.6 percent of GDP in Korea in 2007, well below the OECD average of close to 20 percent.[2] Nevertheless, public social

Figure 3 Inequality Has Been Increasing in Korea[1]



1: For urban households with at least two persons.
2: The Gini coefficient can range from 0 (perfect equality) to 1 (perfect inequality).
3: Relative poverty is defined as the share of the population that lives on less than half of the median income.

Source: Statistics Korea

spending has been increasing at a double-digit rate in real terms as the population ages and social insurance systems mature.

A High Level of Energy Intensity

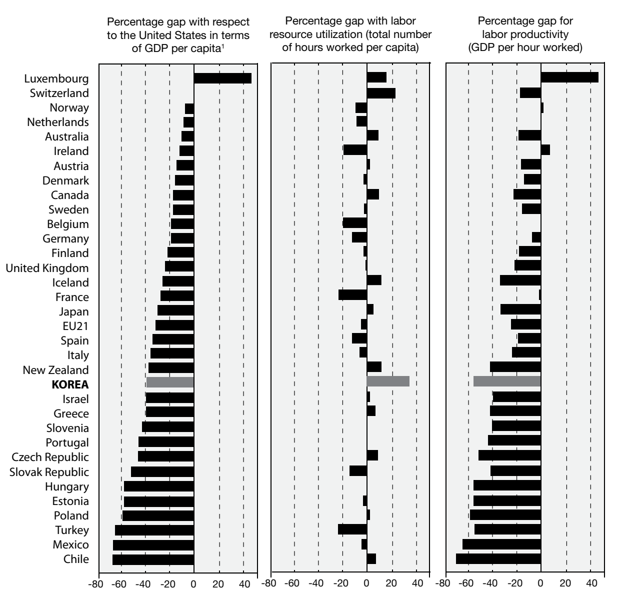
Despite falling since 1997, Korea's energy intensity is about a quarter above the OECD average and the fifth highest in the OECD area, reflecting its concentration in energy-intensive industries. High-energy intensity creates a number of problems. First, Korea is exceptionally dependent on imported energy; net imports accounted for 86 percent of total primary energy supply in 2009. The reliance on imported oil makes Korea vulnerable to external shocks and has contributed to large terms-of-trade losses, averaging 3 percent a year since 1994, thus suppressing national income growth. Second, Korea's greenhouse gas emissions doubled between 1990 and 2008, far outstripping the 24 percent rise in global emissions. Third, the high level of energy consumption in Korea has contributed to environmental problems. The air quality in Korean cities, especially in Seoul, is poor compared to major cities in other OECD countries and absolute levels of air pollutants in Korea are far higher than those of other OECD countries.[3]

Sustaining the Convergence to the High-Income Countries

The per capita income gap with the United States, which was 37 percent in 2010, can be divided into labor inputs (Figure 4, the middle column) and labor productivity (the right-hand column). Labor inputs in Korea, relative to population, are by far the largest in the OECD area, reflecting long working hours that are one-fifth above the OECD average. However, working hours have been declining at a 1.5 percent annual rate since 2000 and are likely to continue falling in line with the government's goal of reducing them to 1,800 hours per year by 2020, close to the OECD average. More importantly, Korea is projected to experience the most rapid population aging among OECD countries. Korea, currently the third-youngest country in the OECD area, is projected to be the second oldest by 2050,[4] reflecting its fertility rate of only 1.2, one of the lowest in the world. The ratio of the working-age population to the elderly will thus fall from six in 2010 to 1.3 in 2050, implying that rising public social spending will pose a heavy burden on a shrinking labor force.

Declining labor inputs will reduce Korea's growth potential and make it harder to narrow the income gap with leading countries. At the same time, there is significant scope for productivity gains, as Korea's labor productivity per hour of work is less than half of the U.S. level (Figure 4, right-hand column). Nevertheless, the Korea Development Institute estimates that the potential growth rate will fall to 1.7 percent during the 2030s. In per capita terms, the fall in potential will be more gradual – from 4.0 percent during the current decade to 2.2 percent in the 2030s – given the decline in population. In sum, increasing labor force participation to mitigate the impact of population aging and raising productivity are the keys so supporting the potential growth rate.

Figure 4 Explaining Differences in Income in 2010



1: Using 2010 PPP exchange rates.
Source: OECD (2012), *Going for Growth 2012*

A New Growth Strategy for Korea

In addition to the negative side effects of focusing on exports, maintaining Korea's convergence to the highest-income countries based on an export-led growth model will become increasingly difficult in the context of expanding globalization and increasing competition from other Asian countries. Korea may face the same challenges as Japan, which has seen its share of world trade drop by half from almost 10 percent in 1993 to around 5 percent in 2010. Meanwhile, China's share rose by a factor of five, from 2 percent to 10 percent over that period. Moreover, the heavy reliance on exports has increased Korea's vulnerability to external shocks. Consequently, Korea's export-led strategy should be balanced by greater emphasis on four priorities:

- Making the service sector a second engine of growth, which would also enhance social cohesion.
- Promoting green growth to make sure that development is environmentally-sustainable.
- Enhancing social cohesion through reforms in the labor market and the education system.
- Increasing labor force participation to mitigate the impact of demographic trends.

Making the Service Sector as a Second Engine of Growth

The service sector's share of GDP is likely to continue rising toward the OECD average (Figure 2). The large and increasing weight of services and its impact as an input in other parts of the economy make it a key determinant of economic growth. Over the past 25 years, nearly 85 percent of GDP growth in high-income countries has come from services.[5] Developing the service sector would also create more high-quality jobs that would better utilize Korea's large supply of tertiary graduates. As noted above, low service-sector productivity is the legacy of an export led growth strategy that attracted the most productive resources into manufacturing. The top priority, therefore, is to level the playing field by removing preferences granted to manufacturing based on a comprehensive quantification of the various forms of explicit and implicit support. In addition, a stronger *won* would promote the development of non-tradable services by boosting domestic demand. In early 2012, the won was still a quarter below its 2007 level in real, trade-weighted terms.

Policies to strengthen competition in services are particularly important, given that "overly strict regulations are obstructing investment and competition," according to the government.[6] The keys to stronger competition include eliminating domestic entry barriers, accelerating regulatory reform, upgrading competition policy and reducing barriers to trade and inflows of foreign direct investment (FDI). The government has reduced entry barriers, as reflected in the improvement in Korea's ranking in the "cost of starting a new business" from 126th in the world in 2008 to 24th in 2011,[7] although there is scope for further reform. In addition, competition policy should be further strengthened. First, even though financial penalties have risen, their deterrent effect is still weaker than in most other OECD countries, indicating a need for further increases. In addition, criminal penalties, which are rarely applied, should be used more frequently. Second, the investigative powers of the competition authority, the Korea Fair Trade Commission, need to be expanded. Third, the number of exemptions from the competition law, including for SMEs, should be further scaled back.

Greater openness to the world economy is another priority to boost productivity in services. The stock of FDI in Korea, at 13 percent of GDP, was the third lowest in the OECD area in 2010 and the share of inward FDI in services was less than half. Consequently, the stock of FDI in services in Korea was only 6 percent of GDP, compared to an OECD average of 37 percent. Strengthening international competition requires reducing barriers to FDI, including foreign ownership ceilings, and liberalizing product market regulations. In addition, it is important to foster a foreign investment-friendly environment, thereby encouraging more cross-border M&As, enhance the transparency of tax and regulatory policies, and reform the labor market.

As noted above, the problems in services are closely linked to those of SMEs. While the major business groups, known as chaebol, were forced to restructure aggressively in the wake of the 1997 crisis, the government essentially bailed out SMEs through increased public subsidies and guarantees, which were not fully scaled back once the crisis had passed. Consequently, the SMEs have not been as aggressive in reforming their business model and their performance has lagged behind that of large firms.[8] In 2009, the government further increased assistance to SMEs by: i) sharply raising guarantees by public financial institutions for lending to SMEs; ii) advising banks to automatically roll over loans to SMEs; iii) creating two initiatives to aid SMEs in distress; and iv) doubling government spending to assist SMEs. While expanded financial support to SMEs prevented some bankruptcies and job losses, it has also exacerbated moral hazard problems by increasing the reliance of SMEs and banks on public assistance. Supporting non-viable SMEs poses a drag on Korea's growth potential.

Achieving the Vision of "Low Carbon, Green Growth"

In 2008, President Lee Myong-bak proclaimed "Low Carbon, Green Growth" as the vision to guide Korea's development over the next 50 years. One of the goals of the Green Growth Strategy is to "attain energy independence," which implies a fundamental transition in Korea's economic structure, given the large share of imports in its energy supply. While such a shift would have great potential for creating new industries, it would also impose heavy transition costs. In addition, Korea set a target to reduce its GHG emissions by 30 percent relative to a business-as-usual baseline by 2020, which implies a 4 percent cut from the 2005 level. Achieving the transition to a low carbon economy and reducing GHG emissions requires a policy framework that provides appropriate incentives to induce the necessary restructuring in a cost-effective way.

The Five-Year Plan for Green Growth

The Five-Year Plan (2009-13) contains about 600 projects and a total budget of 108.7 trillion *won* (10 percent of 2009 GDP), of which public R&D accounts for 13 percent. In 2009, private firms were involved in nearly two-thirds of the nearly 5,000 R&D projects in the Plan, although their financial contributions amounted to only 8 percent of total outlays. Greater involvement by business enterprises is needed to advance green research and make it a driver of private-sector innovation.

The government is pursuing various approaches to supply funds and overcome financial constraints. Bank loans to green industries amounted to 2 percent of their corporate lending during the first half of the Five-Year Plan, with state-owned banks accounting for three-quarters of the loans. Such lending was encouraged by large credit guarantees provided by public institutions. Meanwhile, investment in green industries through the venture capital market nearly doubled between 2009 and 2011, rising to around half of total venture capital investment. Public funds were invested in 83 venture businesses. Such efforts should be pursued cautiously to limit the risks inherent in "picking winners," which could lock Korea into inferior technologies. Korea should channel more of these funds through existing market-based systems and commercial institutions, thereby reducing the role of state-owned banks and public funds.[9]

Introducing Market Instruments to Promote Green Growth

The most important tool to promote green innovation is a market instrument that puts a price on carbon, primarily through a cap-and-trade emissions trading scheme (ETS), complemented by a carbon tax on small emitters. In May 2012, the National Assembly approved a bill to launch an ETS in 2015, which will cover about 500 firms that account for around 60 percent of total emissions. Less than 5 percent of the permits may be auctioned, with the allocation of the remainder yet to be decided. Grandfathering permits would be problematic as it would provide scope for windfall profits for existing firms, potentially resulting in unfair competition for new entrants. The ETS should include a timetable for shifting to an auction system, which would generate revenue that could be used inter alia to offset the impact of the ETS on firms and consumers, reduce more-distorting taxes or achieve fiscal consolidation. While the ETS will control the emissions of large emitters, a carbon tax is needed to cover smaller and more diffuse sources of pollution, such as households and small firms. It is important, though, to minimize overlap and complicated interactions between an ETS and a carbon tax, which would raise costs and uncertainty about the overall outcome.

Another priority is to reform electricity pricing, as Korea's low price increases energy use and GHG emissions. Indeed, electricity consumption per unit of GDP in Korea in 2009 was 1.7 times higher than the OECD average. Moreover, prices vary significantly between sectors, creating significant distortions. Electricity prices should fully reflect their production costs in each sector.

Promoting Social Cohesion through Reforms in the Labor Market and Education System

It is important to address the fundamental causes of inequality and poverty, notably labor market dualism. Given the lower wages paid to non-regular workers, more than a quarter of full-time workers in Korea earn less than two-thirds of the median wage, the highest in the OECD area, thus fueling inequality. In addition, only about 40 percent of non-regular workers are covered by the social insurance system, including unemployment insurance. Firms hire non-regular workers because of the lower labor costs and to enhance employment flexibility. However, labor market dualism creates serious equity problems as a significant portion of the labor force works in precarious jobs at relatively low wages and with less protection from social insurance. It is important to adopt a comprehensive approach to break down dualism, including reduced employment protection for regular workers and improved social insurance coverage and expanded training for non-regular workers.

Several aspects of education–low investment in pre-primary education, heavy reliance on private tutoring, particularly in hagwons, and the high cost of university education–raise equity issues. In particular, the proportion of 15-year-olds participating in after-school lessons in Korea is more than double the OECD average, in part to help students gain admission to prestigious universities. The severe competition to enter the top universities is driven by academic credentialism–the emphasis on where a person studied rather than on their abilities, accomplishments and potential. However, the reliance on private tutoring places heavy financial burdens on families and is cited by families as a key factor explaining Korea's extremely low birth rate. Moreover, the amount of spending is positively correlated with family income, as is the quality of the university attended, thus perpetuating inequality. Private tutoring has a number of other negative impacts. First, it competes and overlaps with public education, thus raising total expenditures on education unnecessarily. Second, it reduces the effectiveness of schools, which have to cope with students of widely differing educational levels. Third, it makes for very long days for children, thus hindering their development. To reduce the role of private tutoring, further measures are needed to improve the quality and diversity of schools and de-emphasize the role of the standardized exam in the university admission process.

There is also a role for well-targeted increases in social spending. The government should move cautiously and incrementally in developing social welfare programs that are carefully designed to achieve their intended objectives, while avoiding wasteful spending and negative externalities. One priority should be the elderly, given that nearly one-half of the over-65 age group lives in relative poverty. However, there is a need for caution as public social spending is already increasing at the fastest rate in the OECD area. Under current policies, population aging alone is projected to boost public social spending from 7.6 percent of GDP to around 20 percent, the average of OECD countries, by 2050. Rising social spending should be financed by tax increases that limit the negative impact on economic growth. This suggests limiting the increase in labor taxes to maintain work incentives, while relying primarily on the VAT and environmental taxes as the primary sources of additional revenue. Keeping Korea's sound fiscal position and low level of government debt is a priority, given the country's rapid aging and the uncertainty about the eventual costs of economic rapprochement with North Korea.

Increasing Labor Force Participation to Mitigate the Impact of Population Aging

Rapid population aging implies a substantial fall in Korea's labor force. If participation rates were to remain at their current levels for each age group and gender, the labor force would peak at 27.2 million in 2022 and then fall by one-fifth, to around 21.5 million, by mid-century. By that point, there would be only 1.2 persons in the labor force per elderly person, compared with 4.5 in 2010, imposing a heavy burden on workers to finance social spending. One option is to increase immigration. At present, Korea has around 0.7 million foreign workers, accounting for only about 3 percent of the labor force, well below the shares in most other OECD countries.

The most important strategy to mitigate demographic change would be to increase the female labor force participation rate. For women between the ages of 25 and 54, the rate was 62 percent in 2010, the third lowest in the OECD area. If the female participation rate in Korea were to converge to the current level for males for each age group by 2050, the labor force would only decline to around 25.6 million, almost 19 percent higher than in the case of unchanged participation rates. Raising the female participation rate requires a comprehensive approach. First, the gender wage gap, the highest in the OECD area, should be narrowed by reducing the high share of non-regular employment and making greater use of performance-based pay. Second, the availability of affordable, high-quality childcare should be increased. Third, maternity leave should be lengthened from 90 days and the take-up of maternity and parental leave increased. Fourth, expanded flexibility in working time would make it easier to combine paid employment with family responsibilities, given that total working hours in Korea are the longest in the OECD area.

Korea's participation rate for young people is also one of the lowest in the OECD area. Although this partly reflects the large share in tertiary education, it is also a result of the mismatch between the skills taught in school and those demanded by firms. Upgrading vocational education would boost employment and reduce labor shortages in SMEs. According to a 2011 government survey, 43 percent of small firms said that they currently face a labor shortage and 40 percent expect to face one.

In addition, there is some scope to increase the participation rate for older workers, or at a minimum, prevent a decline as the pension system matures. It is also important to more effectively utilize older workers, who tend to retire from firms by age 55. More than one-third become unemployed. Moreover, one-third of workers over age 50 are self-employed, compared to 13 percent of those under that age, primarily in services with low productivity. Given strict employment protection for regular workers, firms set mandatory retirement ages so that they can dismiss older workers once their seniority-based wages surpass their productivity. Establishing a minimum age at which firms can set mandatory retirement and then gradually raising it would put pressure on firms to adjust wages in line with productivity as workers grow older. The ultimate goal should be to abolish firms' right to set a mandatory retirement age, as has been done in some other OECD countries.

Conclusion

While Korea's economy remains one of the fastest growing among OECD countries, rapid population aging and other challenges will make it difficult to reach the level of the highest-income countries. Changes in economic policy to diversify away from exports are needed to sustain economic growth. Such a strategy should aim not only at the rate of growth, but also at ensuring that it is environmentally and socially sustainable, while maintaining a sound government financial position. Such a policy should include measures to develop the service sector and promote green growth, accompanied by reforms to promote social cohesion and greater labor force participation.

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[1] According to a 2011 OECD study, *Divided We Stand: Why Inequality Keeps Rising*, inequality in the OECD area is at its highest level in the past 50 years.

[2] The causes of income inequality and poverty are discussed in the *2012 OECD Economic Survey of Korea*.

[3] Pollution and other urban issues are analyzed in *Urban Policy Reviews: Korea*, OECD (2012).

[4] Based on the elderly dependency ratio, defined as the number of persons over age 65 as a share of the population aged 20 to 64. Similarly, the total dependency ratio – the number of persons under 20 and over 64 as a share of the working-age population – is projected to double from 52 percent in 2010 to 105 percent in 2050, the third highest in the OECD area.

[5] See "South Korea: Finding Its Place on the World Stage," McKinsey Quarterly, April 2010.

[6] The Ministry of Strategy and Finance, "Detailed Plans to Nurture the Service Sector," Economic Bulletin, May 2009.

[7] This ranking is by the World Bank, *Doing Business 2011*.

[8] The problems of SMEs are discussed in detail in the 2008 OECD Economic Survey of Korea.

[9] The financing of green business is discussed in Kim Hyoung-Tae, *System Architecture for Effective Green Finance in Korea*, Korea's Economy 2011, Korea Economic Institute, Washington, D.C.

THE FUTURE OF KOREAN TRADE POLICY

KOREA'S TRADE STRUCTURE AND ITS POLICY CHALLENGES

By Lee Junkyu

Abstract

In 2011, Korea achieved one trillion dollars in international trade amidst the global crisis, which marked a new page in Korea's history. Korean trade will no doubt continue to strengthen its economy. Only eight countries are ahead of Korea in terms of achieving one trillion dollars in trade, and Korea should no longer be a follower, but instead a country which sets the course of trade policy within the global economy. It cannot be emphasized enough that Korea should be recognized as a model for its past economic accomplishments and to illustrate the beneficial cycle between trade and growth for the future. The following sections will first investigate changes of Korea's trade structure over a longer period, and its recent export structure by product and destination as well as of the import structure. The next section will look further ahead with trajectories of Korea's trade policies and a dramatic policy shift jumping onto the active FTA policy stance as well as with the FTA roadmap. Furthermore, it will review the comprehensive and high-quality FTAs pursued by Korea since the implementation of the FTA roadmap. Finally, it concludes with challenges facing Korea's future trade policy, including an enhancement of the competitiveness of the service sector, and discusses how to support inclusive and sustainable economic growth with an indispensable pillar, which is free trade policy in the Korean economy.

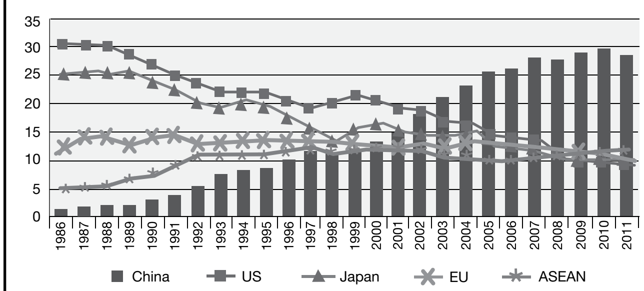
Trade Structure Change

Over the past decades, Korea's trade structure by country has changed greatly. Specifically, as seen in Figure 1, in 1986, the United States took the largest share of 30.8 percent in Korea's total trade, and was followed by Japan with 24.6 percent. The share of China in 1986 was 1.1 percent. But, in 2011, the situation became very different. The largest trade share in Korea's total trade became China with 20.4 percent, followed by ASEAN (11.6 percent), by Japan (10 percent), the EU (9.6 percent) and the United States (9.3 percent). In a nutshell, trade partners became more diverse by country and the rapid rise of the Chinese share is catching attention. Notably, Korea's trade depends much more on China in 2011 than in 1986, but it is not as high as Korea dependence on the United States in 1986. It points out that Korea's efforts to diversify its international trade by country have worked to a certain extent, but that it should not stop its efforts to further reduce excessive concentration of by-country trade.

Moreover, there has been a great deal of change to Korea's regional trade structure with emerging economies receiving bigger shares.

Compared to the trade structure in 1971, in 2011 Korea traded much less with advanced economies and much more with emerging and developing countries. During the past four decades, Korea's trade share with emerging economies rose from 17.5 percent to 67 percent. Since the 2008 global financial crisis, advanced economies continue to face major brakes on growth while emerging economies appear to maintain solid growth momentum. Accordingly, although Korea was not immune to weak recovery with the major advanced economies, Korea's recent high trade share with emerging economies has definitely played an important role in lowering the risks of negative spillovers from the crisis.

Figure 1 Share Changes by Country in Korea's Trade



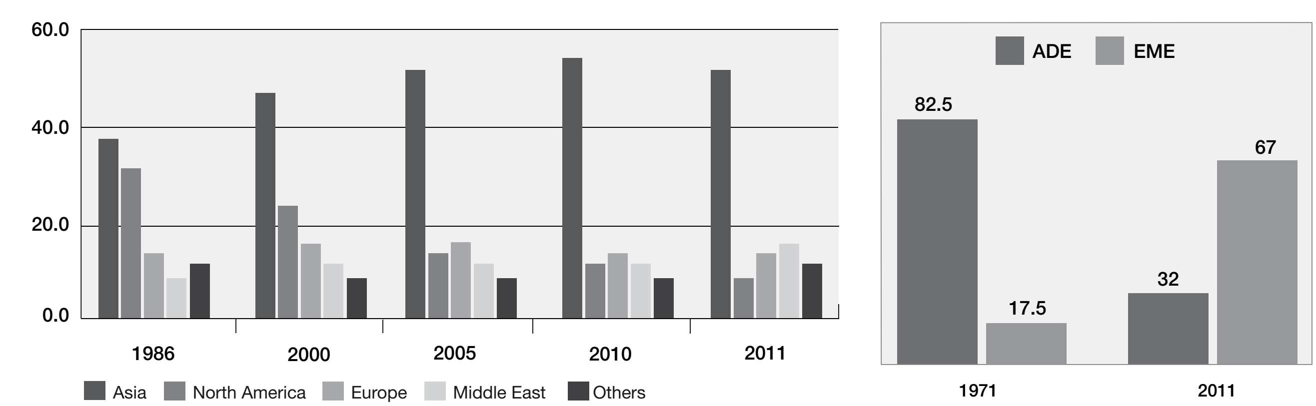
Source: KITA (2012)

Similarly, by region, from 1986 to 2011, Korea traded much more with Asia (37.0 percent→50.8 percent) and the Middle East (7.2 percent→14.1 percent), and much less with North America (33.8 percent→10.4 percent). According to the IMF (WEO, April 2012), in 2011 the United States grew 1.6 percent and developing Asia registered an economic growth rate of 7.8 percent, which is higher than that of any other region in the world. Asian exports have also recovered strongly since the global financial crisis, contrasted with those of developed economies. Notwithstanding continued anemic growth in advanced economies, Korea's high trade share with Asia helped counter the negative impact of the recent Great Recession on its trade performance in 2011, although the latest Korean exports data (April 2012) show moderation in export momentum. Korea is expected to continue its rising trend of intra-regional trade over the next decades.

Product Composition Change of Trade

There has also been a great deal of trend change in Korea's exports by industry over the past decades. In the 1960s, more than 72 percent of Korea's exports were primary industry goods.

Figure 2 Share Changes by Region and Economy



Source: KITA (April 2012)

Table 1	Trend in Product Composition of Korea's Exports

Share (%)	1962	1972	1980	1995	2000	2011
Primary industry goods	72.3	11.1	7.7	4.9	2.8	2.8
Industrial products	27.7	88.9	92.3	95.1	97.2	97.2
Light	NA	67.4	48.4	19.9	16.2	6.2
Heavy	NA	21.5	43.9	75.2	81	91

Source: KITA (April 2012)
Note: NA means not available

As seen in Table 1, since the 1970s, Korea's major exports have been composed of industrial products. For example, in 2011 the share of industrial products was 97.2 percent.

Among them, heavy and chemical products increased greatly from 21.5 percent in 1972 to 91 percent in 2011. In the 1960s, Korea exported labor intensive products like clothes and textiles. In the 1970s, the Korean government strongly pushed the development of heavy and chemical industries, such as steel, shipbuilding, and automobiles. From the 1980s until now, the Korean economy has been exporting a great deal of capital and technology intensive goods. This trend change explains why Korea's top exports include ships, automobiles, semiconductors, displays and mobile communication devices.

Recent Exports Structure

Korea's exports have been a useful indicator and a barometer to gauge Korea's economic vitality and the soundness of global economic growth. The following sections highlight Korea's recent export structure by product and destination.

By Product

Korea's exports in 2011 registered 19.3 percent growth from a year earlier and reached the historic figure of $556.5 billion. While the global economy remained in a heightened state of uncertainty due to the euro zone sovereign debt crisis beginning in the second half of 2011, the Korean economy exported its largest value thanks to the competitiveness of Korea's major exports products and its FTA policies. According to MTI3 digit classification, vessels, articles of petroleum, automobile, and parts of automobiles reached their highest level, while semiconductors, flat display, and wireless communication apparatus declined respectively by 1.1 percent, 4.9 percent, and 1.1 percent year-on-year.

It is worth noting the significant rise in exports such as vessels, automobiles and their parts, and petroleum products. Despite the euro zone debt crisis in the second half of 2011, vessels and ocean structure exports rose significantly in 2011 to $54.5 billion year-on-year. Growth rates of vessel exports were 3.7 percent in 2009, 10 percent in 2010, and the rate rose by 15.2 percent in 2011. The share of vessels was the highest, with 10.2 percent of total exports. In terms of growth rates, petroleum was the highest with 63.7 percent year-on-year and reached $52 billion in 2011 due to high oil prices. Although Korea is not an oil-producer, it exported a large amount of refined oil products—even to OPEC countries, such as Indonesia. In 2011, Korea's petroleum exports equaled $11 billion to China, $8.6 billion to Japan, and $6.5 billion to Indonesia. This momentum is expected to continue due to high oil prices

Table 2	2011 Top Five Major Exports (in U.S. millions)

Export items	2010		2011	
	Value	Growth (%)	Value	Growth (%)
Total	466,384	28.3	555,214	19
Vessel, ocean structure and part of vessel, ocean	49,112	8.8	56,588	15.2
Articles of petroleum	31,531	37.3	51,600	63.7
Semiconductor	50,707	63.4	50,146	-1.1
Automobile	35,411	39.4	45,312	28

Source: Korea International Trade Association (2012) and strong demand for refined products from emerging economies. Automobile exports in 2011 rose by 28 percent year-on-year to the amount of $45.3 billion, which was an 8.2 percent share in total exports. Of Korea's total automobile exports, the United States received the highest (19.7 percent), followed by Russia (7.1 percent), and China (5.2 percent). Exports of automobile parts continued to rise every month and reached $23.1 billion with a growth rate of 21.8 percent in 2011 compared to the previous year. Due to its competitiveness and active FTA policies, an increase in auto parts exports is expected in the following years.

By Destination

In 2011, Korean exports increased by more than two digits to most countries. However, exports to the EU appeared to grow at a weaker pace, by just 4.2 percent, due to the negative impact of the European sovereign debt crisis. While the debt crisis did negatively impact Korea's export performance, the Korean economy was able to withstand the adverse impact due to a larger share of its exports to developing economies. The share of emerging economies to Korea's total exports rose from 65.9 percent in 2007 to 72.5 percent in 2011, which contributed to safeguarding the economy against the debt crisis.

Regarding Korea's 2011 exports to China, they reached their largest value of $134.2 billion with a growth rate of 14.9 percent year-on-year. The share of Korea's exports to China compared to total world exports fell from 25.1 percent in 2010 to 24.2 percent in 2011, but the share has remained above 21 percent since 2005. During 2009, the share rose to 23.9 percent and, during 2010, it jumped to 25.1 percent. Accordingly, even a little hiccup in the Chinese economy would likely produce a major impact on the Korean economy. Except for in 2009, Korean exports to China have remained on an upward trend of two-digit growth rates. From 2002-2011, average annual growth rates of Korea's exports to China registered 21.2 percent.

Korea's exports to the United States reached a level of $56.2 billion in 2011 with a 12.8 percent growth rate year-on-year. In 1971, Korea's export share with the U.S. reached its maximum level of 49.8 percent. Subsequently, it is surprising to observe the rapidly declining share of Korea's exports to the United States in Korea's total exports. As of March 15, 2012, the Korea-U.S. FTA entered into effect, which will likely contribute to a rise of the U.S. share in Korea's exports, thereby reducing a risk of high dependency on trade with China. It is too early to confirm that Korea's exports point to a balance between China and the U.S. However, according to the Customs Office, from January to March 2012, the share of exports China received fell by one percentage point while the share of exports to the U.S. rose by 1.5 percentage points.

With the Korea-EU FTA coming into effect on July 1st, 2011—at the height of the euro zone debt crisis—it is important to gauge the impact of the FTA on Korea's exports in that context. From August-September 2011, Korea's exports to the EU rose, but turned negative in October 2011 due to the deepening concern of the euro zone debt crisis. In sum, Korea's exports to the EU reached $55.7 billion with a just 4.2 percent rise in 2011. However, the rise of only 4.2 percent does not necessarily reflect the full effect of the FTA on Korea's exports to the EU.

According to a report[1] by the Korea International Trade Association (KITA, March 2012), the group showing "an effect of tariff removals," in particular, had a great deal of export performance compared to exports of other countries to the EU over July-November in 2011. The report argued that, over the period, Korea's exports of the group to the EU presented a 14.8 percent rise compared to Chinese exports of a 0.5 percent rise, Japanese exports of a 2.6 percent rise, and the world's exports of a 7.9 percent rise to the EU. Evidently, while there is surely a positive effect of the FTA on the export items of tariff-reduction schedules, there remains an issue of how Korea and the EU can enhance the overall positive effects of the FTA on the economy as a whole regardless of tariff-reduction schedules. Regarding Korea's exports to Japan, Korea achieved $39.7 billion with a rapid rise of 40.9 percent year-on-year and Korea's trade deficit with Japan decreased from $36.1 billion in 2010 to $28.6 billion in 2011 due to the impact of the Japanese earthquake.

Korea's Recent Import Structure

During 2011, Korea's imports reached $524.4 billion with a growth rate of 23.3 percent from a year earlier. The largest value of imports is mainly due to persistently high commodity prices such as crude oil. Recent import statistics point to high growth in raw materials (31.4 percent) and consumer goods (25.6 percent) and slower growth in capital goods year-on-year.

Imports of raw materials during 2011 grew 31.4 percent from the previous year, a share of 62.5 percent in Korea's total exports. The average annual growth rate of imports of raw materials is 14.9 percent, which is almost double the rate of imports of capital goods, 8.0 percent over 2005-2011. The main driver behind the high rate is due to increased volume and prices of crude oil. Compared to 2010, the volume grew 6.6 percent and the unit import price per barrel rose 37.8 percent.

The growth rate of imports of capital goods dropped substantially from 28.2 percent in 2010 to 7.8 percent in 2011. The share of capital goods in Korea's total imports has steadily fallen from 34.7 percent in 2005 to 27.4 percent in 2011. A steady rise of the import share of raw materials and a continuous fall of the share of capital goods are likely becoming a long-term issue to the Korean economy.

Table 3 Korea's Recent Imports by Use (in U.S. billion, as a %)

Export items	2005		2009		2010		2011	
	Value	Share	Value	Share	Value	Share	Value	Share
Total	261.2	100 (16)	323.1	100 (-25.8)	425.2	100 (32)	524.4	100 (23)
Raw materials	142.3	54.5 (20.9)	186.1	57.6 (-31.5)	249.5	58.7 (34.1)	327.8	62.5 (31.4)
Capital goods	90.7	34.7 (11.7)	104.0	32.2 (-15.4)	133.4	31.4 (28.2)	143.8	27.4 (7.8)
Consumer goods	26.4	10.1 (13.3)	32.7	10.1 (-18.4)	41.9	9.8 (27.8)	52.4	10.0 (25.2)

Source: KITA (2012)
Note: ( ) shows growth rates

The share of consumer goods has remained stable at around 10 percent while consumer goods grew 27.8 percent in 2010 and 25.2 percent in 2011 year-on-year. This increase in consumer goods is mainly driven by a rise in imported automobiles, clothes, beef and pork.

Korea's Trade Policies to Date

During the 1950s, the key policies for the Korean economy were import substitution industrialization. The policies helped protect domestic import-substitution industries, but also impeded exports. A big shift from import substitution to export-oriented policy was introduced in the early 1960s by the Korean government. During the 1970s, the government provided much support to the heavy and chemical industries. In the 1980s, the government initiated the Comprehensive Liberalization Policy, including the Import Liberalization Five Year Plan, which was implemented from 1983-1988. The simple average tariff rates were 23.7 percent in 1983 which fell to 18.1 percent in 1988. The ratio of import liberalization in 1983 was 80.3 percent and it rose to 95.2 percent in 1988. In 1995, it rose to 99 percent. During the 1980s, the government transformed its trade and industrial policy from government led to liberalization and competition led policy. During the early 1990s and the beginning of the WTO, Korea further strengthened its policy direction of market openness, deregulation, and free trade. During the early 2000s, building on its continued policy stance of openness and competition promotion policy, Korea expedited its trade liberalization in pursuing Free Trade Agreements with developing and advanced economies around the world. From the early 2000s until now, Korea's trade policy, being in line with the GATT/WTO, has been centered on pursuing active FTA policies more than any other country in the world.

A Policy Shift Towards FTA Policies

The proliferation of the regional trade agreements since the 1980s has been an important factor for encouraging free trade and liberalization in the world trade order. Before the 1997 Asian financial crisis, Korea had put more policy weight on the multilateral trade front. Since the 1997 crisis, Korea had no choice but to push forward complete structural reforms across the economy and to promote trade liberalization. Accordingly, the crisis made Korea well-poised to benefit from taking free trade agreements, which would impact the whole economy by revamping its economic health and structure.

With the proliferation of regional trade agreements, if Korea did not jump on the wagon of free trade agreements during the 2000s, it would be in a difficult situation. In the short-run, Korea would have a relative disadvantage in the global market and in the long-run, it would hamper the country's economic growth potential. The Korean government, mainly thanks to its determination to survive in the global market, turned FTA promotion into critical policy tools and measures to enhance its industrial and national competitiveness.

The FTA Roadmap and its Step Forward

Korea concluded an FTA negotiation with Chile in October 2002. Following that effort, in September 2003, the Korean government announced "the FTA Roadmap" as its national economic development agenda. The FTA Roadmap marked a dramatic policy shift as it changed the country's passive FTA stance to an active one.

The Roadmap reflects two important policy principles. First, if Korea can conclude as many FTAs as possible in a short period of time, it can recover its competitiveness in the global market and reduce opportunity costs for Korean companies, which have observed rising disadvantages in the markets where Korea did not conclude FTAs. Second, the Roadmap pursues multi-track and simultaneous FTA negotiations with large economies. The main reason is to maximize whole economic benefits while minimizing negative costs from FTA negotiations. Building on those two principles, the Roadmap heavily pursues comprehensive and high-quality FTAs in terms of sectors and commitments.

In 2010, the share of Korea's trade with its FTA partners versus Korea's total trade was just 14.6 percent, which is much lower than that of the world average, 49.2 percent according to KITA's estimates (April 2011). The U.S. had a 34.1 percent share with FTA partners, and the EU had more than a 70 percent share. However, during 2011, Korea's trade share with its FTA partners rose to 27.4 percent due to the Korea-EU and Korea-Peru FTA. Over this period, Korea's exports to its FTA partners increased 18.4 percent ($166.8 billion) and the imports from them increased 20.6 percent ($129.4 billion).

The KORUS FTA entered into effect on March 15, 2012. Although it is too early to present an accurate analysis from the KORUS FTA, according to the Korea Customs Service (May 2012), in its initial two months Korea's exports to the United States rose by 11.3 percent and the imports from the United States rose by 2.0 percent. This increase occurred despite weakening Chinese economic growth and the deepening euro zone crisis. Korea's trade with the United State appears to have grown more stable due to the FTA.

In analyzing the FTAs Korea has concluded to date, it is reasonable to say that Korea established a global FTA network and became a hub country in the region. It made itself well-poised to benefit from the FTAs by liberalizing the market and enhancing the investment environment.

Comprehensive and High Quality FTAs Pursued

As argued, Korea has pursued comprehensive and high-quality commitments, that is to say, the NAFTA style, complemented with the South-South style. From the eight FTAs in force, Korea's average concession rate is 97.5 percent with due consideration of sensitive sectors, such as the agricultural sector in the KORUS FTA.

By sector coverage, the KORUS FTA comprehensively includes all sectors, for example, from goods to services and investment, MRA, competition, IPR, Investor-State Dispute Settlement, e-commerce, labor and environment.

Trade Policy Challenges Facing Korea

In 1966, Korea's total trade was about $1 billion and within a half century it topped $1 trillion. Membership in the $1 trillion dollar club is all the more important because the Korean economy achieved such a surprising performance amidst the heightened global economic crisis. Korea's effective economic policy demonstrated that an economy could grow through trade. Despite its eye-popping trade performance, there are challenges and opportunities facing Korea's trade policy for the future. Specifically, Korea faces the challenge of evaluating its trade performance not only by quantity, but also

Table 4 Korea's FTA Progress

Status	FTA partner	Dates in force
FTAs in force (8 FTAs, 45 countries)	Chile	Apr 2004
	Singapore	Mar 2006
	EFTA	Sept 2006
	ASEAN	Jun 2006 (goods)
		May 2009 (service)
		Sept 2009 (investment)
	India	Jan 2010
	EU	Jul 2011
	Peru	Aug 2011
	US	Mar 2012
FTAs, signed recently	Turkey	Mar 2012
FTAs, under negotiation	Canada, Mexico, GCC, Australia, New Zealand, Colombia, China	
FTAs, under examination	Japan, Korea-China-Japan, Mercosur, Israel, Vietnam, Central America, Indonesia, Malaysia	

Source: Ministry of Foreign Affairs and Trade (as of April 2012)

Table 5 Korea's Concession Rates in the FTAs

FTA	Korea's concession rates (%)
Korea-Chile	99.8
Korea-Singapore	91.6
Korea-EFTA	99.1
Korea-ASEAN	99.2
Korea-India	93.2
Korea-US	99.8
Korea-EU	99.6

Source: MOFAT, KIEP, and author calculation

by quality. Accordingly, Korea should look at what should be done to sustain economic growth and to continue its high performance in international trade.

First, the Korean economy should continue to diversify its trading partners and products to reduce the risks of external shocks. If the crisis does not subside, it will impact the Korean economy through trade channels as well as financial channels. As seen in Figure 1 and Figure 2, the Korean economy has been making a great deal of effort to minimize its risk of too much dependence on a small number of trading partners. The effort to lower its excessive exposure has worked, but the economy should not become complacent.

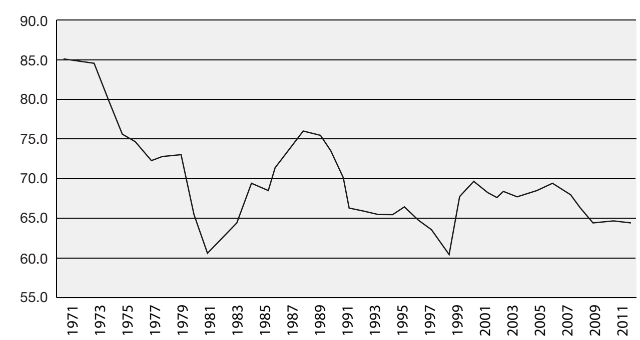
Furthermore, while the export share of China-US-Japan-EU-ASEAN in Korea's total exports has been in a falling trend as indicated in Figure 3, the 2007-2011 share appears to stay at around 65 percent. This means that Korea has yet to run away from its high-trade dependency on its big five trading partners.

In 2011, according to the MTI 3 digit, Korea's top ten export products had a share of 60.3 percent, which shows much greater product concentration compared to the numbers of other economies. According to a KITA report,[2] in average, from 2008 to 2010, the share of top ten export products was 27.1 percent for the U.S., 28.8 percent for China, 24.2 percent for Germany, and 34.7 percent for the UK. The shares of these countries were much lower than that of Korea, which was 51.1 percent in the report. Accordingly, it is desirable for SMEs to enhance their competitiveness and reduce concentration by exporting a variety of goods and services. This is easier said than done, requiring a longer term effort and continued commitment by the government and SMEs.

Second, the Korean economy needs to enhance the competitiveness of its services sector and increase the share of its service exports in the world.

As seen in Table 6, the share of Korea's service exports in the world rose from 2.1 percent in 2007 to 2.3 percent in 2011, while China rose from 3.6 percent to 4.4 percent over the same period. Specifically, during the last decade (2001-2011), according to the WTO (2012), the share of Korea's merchandise exports rose from 2.4 percent to 3.0 percent while the share of Korea's service exports rose from only 2.0 percent to 2.3 percent. Moreover, the annual average growth rate of

Figure 3 Exports Share of China-US-Japan-EU-ASEAN (as a %)



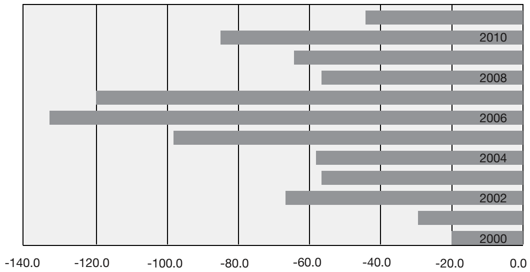
Source: KITA (2012)

Table 6 Export Shares in Commercial Services by Country

Share (%)	2007	2008	2009	2010	2011
United States	13.7	13.4	14.1	13.9	13.9
UK	8.4	7.3	7.1	6.6	6.6
Germany	6.3	6.5	6.7	6.2	6.1
China	3.6	3.8	3.8	4.5	4.4
Japan	3.7	3.8	3.7	3.7	3.4
Korea	2.1	2.3	2.1	2.3	2.3

Source: WTO (2012)

Figure 4 Korea's Service Trade Balance (in U.S. 100 million)



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Service balance	-20.4	-29.7	-64.4	-57.9	-59.6	-99.5	-133.3	-119.7	-57.3	-66.4	-86.3	-43.8

Source: Bank of Korea (2012)

Korea's merchandise exports is 13.9 percent, which is higher than that of its service exports, 12.3 percent.[3]

However, while Korea's ranking in merchandise exports rose from 13th to 7th from 2001-2011, Korea's ranking in the services exports fell from 13th to 15th. According to the Bank of Korea, in regards to Korea's services' balance between 2000- 2006, it has continued to widen the trade deficit. As seen in figure 4, while reaching its peak deficit in 2006, Korea still maintained a substantial amount of the service trade deficit. Economic evidence builds that the service sector helps promote job-creation and economic growth. Yet, Korea's trade policy thus far has been centered on strengthening the manufacturing sector, leading up to an inevitable rising gap between goods and services in terms of trade balance.

Imperatively, the Korean economy will not be able to sustain itself or promote more balanced growth in the mid-to-long term without enhancing the competitiveness of the service sector.

Third, Korea must implement policy measures to further enhance the effectiveness of its FTAs. There should be domestic reform measures commensurate with free trade agreements. For example, domestic reform measures in distribution services should be implemented to make consumers feel price cuts through tariff reductions. Should consumers not reap the benefits of price reductions, static welfare effect will not be materialized, and thereby the non-competitive market structure will eventually erode the support of consumers for further trade liberalization. Domestically, it is imperative to make the market more competitive to benefit from the FTAs and to raise the utilization rates in those FTAs in force. According to a recent KIEP[4] report, except for the Korea-Chile FTA which has around 95 percent utilization, most of the existing FTAs have low utilization rates. For example, the Korea-India FTA maintained just a 25 percent rate for exports.

Last but not least, Korea has to continue gathering internal constituent support for FTA policies. It must also enhance policy communications with a variety of groups and sectors across the economy, including opponents to its FTA policies. As trade liberalization moves forward, it is natural to see some sectors win and other sectors lose, while achieving a net positive gain for the whole economy. Frequently, widening income gap between winners and losers would cause conflicts among the sectors or the groups in the economy, which can play a negative role by impeding economic growth and stalling consumer benefits.

Therefore, it is important to prepare a compensation mechanism as well as promote competitiveness in the specific sector which is adversely affected by free trade policy. Legitimate concerns of the sector should be properly addressed by the government and a mutual consensus should be pursued among the members of the society. Conclusively, free trade policy has been an indispensable pillar of support for economic growth in Korea. Building on free trade agreements already concluded, Korea should pursue an inclusive and sustainable growth trajectory with strong support of its citizens for future FTAs. It must also continue to figure out a new growth opportunity by implementing measures such as promoting R&D, expanding the FTA network in Asia and other regions, and advancing high valued-added technology.

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[1] *Trade Focus*, Vol.11, No.15, p.8-14. March, 2012, Korea International Trade Association (KITA-IIT)

[2] *Trade Focus*, Vol.10 No.55, November 2011, KITA: The data comes from the UN Comtrade by HS 4 digit.

[3] According to the calculation based on the WTO (2012), the annual average growth rate of world merchandise exports was 11.4 percent and that of the world services exports was 10.8 percent from 2001 to 2011.

[4] *Korea's FTA Networks and its Global Leadership*, Young gui Kim, May 8, 2012, KIEP.

IMPACTS AND MAIN ISSUES OF THE KOREA-CHINA FTA

By Choi Nakgyoon

Abstract

In May of this year, after Korea finalized all necessary domestic measures, Korea and China officially launched bilateral FTA negotiations. This paper looks at the FTA from the Korean perspective. The FTA talks will be conducted in two stages. In the first stage, they will finalize the modalities for trade in goods, services, investment and other areas. In the second stage, they will discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. For its part, Korea needs to protect sensitive sectors including agriculture and fishery, among others. The FTA will be beneficial for the sustainable growth of Korean economy and the service and investment liberalization will be no less important than the tariff reductions for the impact of the FTA. The FTA will also benefit Korea as China has shifted its policy directions in favor of domestic demand rather than exports. However, the agreement is expected to have negative effects on the Korean agricultural and fishery sectors. Beyond economic benefits, the Korea-China FTA is expected to contribute to stabilizing the diplomatic and geo-political relationship between Korea and China. It can also be seen as a first step in accomplishing Northeast Asian regional integration.

In January 2012, Korean President Lee Myung-bak had a summit meeting with Chinese counterpart Hu Jintao and announced that Korea would initiate steps domestically to officially launch Free Trade Agreement (FTA) negotiations between Korea and China. The two countries decided to officially launch bilateral FTA negotiations in May after Korea finalized all necessary domestic measures regarding a public hearing and the ministerial meeting for international economic affairs.

In retrospect, there was more than seven years since the two countries agreed to begin joint research on a Korea-China FTA by private institutions in 2004. The joint study investigated the macroeconomic benefits expected from the bilateral FTA. From 2007 to 2010, the joint research of industry, government and academia on Korea-China FTA focused on impacts to industrial sectors, such as agriculture and manufacturing industries, discussing how to deal with sensitive products.

Until recently, China strongly hoped to launch Korea-China FTA negotiations as soon as possible. For its part, Korea needs to protect sensitive sectors including agriculture and fishery, among others. In order to facilitate the negotiations, the two countries will take the following two-stage approach. In the first stage, they will finalize the modalities for trade in goods, services, investment and other areas. They are expected to focus on the share and composition of the tariff lines placed in the sensitive as well as highly sensitive list. In the second stage, they will discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. That means nothing is considered final until everything is actually agreed upon.

This paper deals with the Korea-China FTA from the Korean perspective. It reviews the current status of economic relations between Korea and China, dealing with the benefits and potential costs of a Korea-China FTA. It also touches upon the main issues of the bilateral FTA, comparing it to the proposed Korea-China-Japan FTA.

Economic Relations between Korea and China

The interdependency between Korea and China has rapidly increased in recent years. According to research conducted by KIEP[1], Korean exports to China will increase by about 2 percent and real GDP will increase by about 0.22-0.38 percent, if the Chinese real GDP increases by 1 percent. China has become the biggest exporting and importing country for Korea since 2004 and 2007, respectively. Currently, Korea is China's number four trading partner after the U.S., Hong Kong and Japan.

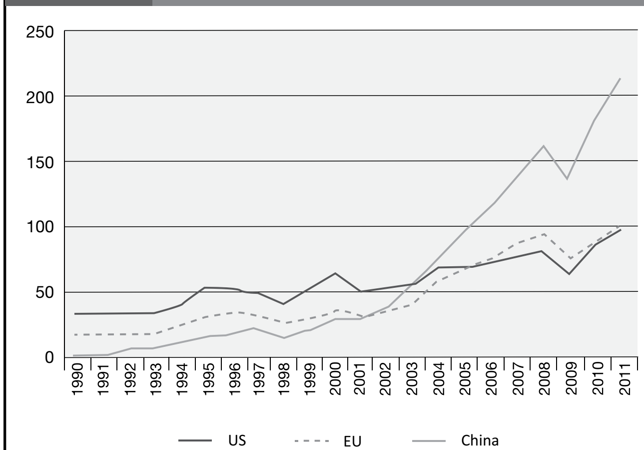
Korean exports to China amounted to $134.2 billion in 2011, occupying 24.1 percent of total Korean trade, followed by the U.S. (10.1 percent), Japan (7.1 percent), Hong Kong (5.6 percent), and Singapore (3.7 percent). Korea imported $86.4 billion from China, occupying 16.5 percent of total Korean imports, followed by Japan (13.0 percent), the U.S. (8.5 percent), Saudi Arabia (7.1 percent), and Australia (5.0 percent).

A breakdown of Korean exports to China by final usage shows that the majority are products for re-exports, such as parts and material. According to a Korea International Trade Association (KITA) report[2], Korean exports for domestic use to China in 2011 were 34.4 percent, which was very low compared to Japan (51.7 percent), Hong Kong = (59.5 percent), and the United States (66.7 percent). As we are all aware, the tariffs on exports for use in re-exporting are exempt or re-funded in most countries including China. Therefore, almost two-thirds of Korean exports are not disadvantaged by high levels of Chinese tariffs.

On the other hand, Korea's bilateral trade with China was $220.6 billion, which amounted to 20.4 percent of total trade in 2011, followed by Japan (10.0 percent) and the U.S. (9.3 percent). Korea recorded a bilateral trade surplus of $47.8 billion, which represents 155.2 percent of the total trade surplus in 2011. That means Korea would have recorded a trade deficit of $17 billion without its trade with China. According to the Bank of Korea, the average Korean GDP growth rate from 2008 to the first half of 2010 was 4.2 percent, while the contribution level of exports to China was 2.2 percent, indicating that the contribution of exports to China on the Korean GDP is approximately 52 percent.

China has been one of the most important partners for Korea in terms of inbound as well as outbound FDI. Outbound Korean FDI to China increased rapidly in recent years in order to make the most of China's expanding market[3] and low labor costs.

Figure 1 Korea's Trade with China, the US and the EU (in U.S. billion)



Source: KITA

Table 1 Chinese Contribution to Korean Inbound and Outbound FDI (in U.S. million)

	Before 1990	1991-2000	2001-2011	Total Chinese Contribution	Chinese Share (%)
Foreign Direct Investment	2.8	149.1	3,584.8	3,736.7	2.0
Overseas Investment	22.5	5,369.1	28,718.8	34,110.4	17.7

Source: Ministry of Knowledge Economy and Korea Eximbank

As of 2012, China is second among Korea's overseas investment destinations, surpassed only by the United States (20.4 percent). Korean outbound investment to China amounted to $35.9 billion, or 18.9 percent of total Korean overseas investment, followed by Hong Kong (6.5 percent), the UK (4.6 percent), Vietnam (3.9 percent), Canada (3.4 percent), Netherlands (3.3 percent), Indonesia (3.0 percent), Singapore (2.2 percent), Australia (2.1 percent), and Brazil (2.0 percent).

On the other hand, inbound FDI from China from 1991 to 2000 amounted to $149.1 million, jumping to $3.58 billion from 2001 to 2011, which means that Chinese investment to Korea has been accelerating during the last decade. The total of China's FDI stock in Korea amounted to $3.74 billion from 1962 to 2011, and its share in the total inbound FDI in Korea turned out to be 2.0 percent. This number is relatively small compared to the U.S. (24.6 percent), Japan (15.1 percent), Netherlands (11.2 percent), the UK (6.2 percent), Germany (5.7 percent), Singapore (3.9 percent), Malaysia (3.9 percent), France (3.3 percent), Canada (2.8 percent), and Hong Kong (2.5 percent).

FTA Policies of Korea and China

Korea designated Chile as its first FTA partner because Chile was regarded as being in a strategic position for advancement into other Latin American countries. After completing the negotiations with Chile in 2002, Korea concluded FTA negotiations with Singapore, the European Free Trade Association (EFTA), the Association of Southeast Asian Nations (ASEAN), India, the European Union, Peru, and the United States.

Notably, Korea diversified its FTA partnership among the Americas, Europe, and Asia. As an export-oriented economy, Korea urgently needed to access the major markets and minimize the negative effects from the FTAs of competing countries. Interestingly, Korea finalized FTA negotiations without any hesitation with regional bases such as Chile in America, Singapore in Asia, and the EFTA in Europe.

Upon a review of Korea's FTA policy, we found that Korea uses the FTAs to liberalize its domestic markets, as seen in the FTAs with the United States and the European Union. It also has taken care of its sensitive sectors by providing restructuring programs for the agricultural sector and designing assistance related to trade adjustment.

On the other hand, China shifted its international economic policy in favor of FTAs after joining the WTO in 2001. Specifically, China pursued FTA negotiations with neighboring countries including ASEAN in 2005, Pakistan in 2006, Chile in 2006, and New Zealand in 2008. Currently, it has been negotiating with many countries including Iceland, Norway, the Gulf Cooperation Council (GCC), and the South African Customs Union (SACU).

A review of the Chinese FTA policy reveals that China uses FTAs with neighboring and strategic base countries to support its diplomatic policy, as demonstrated by its designation of ASEAN as its initial FTA partner. China has not shown an interest in FTAs with developed countries such as the United States and the EU because they have not granted China market economy status. Specifically, it concluded FTA negotiations with Pakistan which imports armaments from China. It has been negotiating with Australia and the GCC, in consideration of the importance of energy resources and geo-political interests.

Benefits and Potential Costs

The Korea-China FTA is expected to provide economic and geo-political benefits. First of all, it will be beneficial for the sustainable growth of Korean economy. According to KIEP, the Korea-China FTA is expected to increase Korea's real GDP by about 0.95-1.25 percent in five years and 2.28-3.04 percent in ten years[4]. The KIEP study included only concessions of the tariff schedule in its Computable General Equilibrium (CGE) simulations. It did not consider service and investment liberalization in the model. According to KIEP, the service and investment liberalization will be no less important than the tariff reductions for a FTA feasibility study, which indicates that the potential dynamic effects will be possibly greater than the static effects of tariff reductions.

Specifically, Korea can use the Korea-China FTA to make further advances into the Chinese domestic market, which is being regarded as the market with the biggest potential after the global economic crisis in 2008. China has shifted its policy directions in favor of domestic demand rather than exports. It is currently putting more emphasis on domestic demand than exports, according to the five-year economic development plan released in 2010.

It is noticeable that tariffs on exports for domestic use are neither exempted nor refunded. Thus, the Korea-China FTA will be very conducive to exports for domestic use. This is because China's major trading partners have not negotiated bilateral FTAs with China, with the exception of Taiwan which has finalized the Economic Cooperation Framework Agreement (ECFA) in 2010. The ECFA is reputed to be a preliminary step for China-Taiwan FTA negotiations. Thus Taiwanese products that have been competing with Korean export commodities in the Chinese market were given advantages by the ECFA, specifically in the chemical and electronic sectors. If main negotiations in the various areas such as goods, services, investment, and economic cooperation are concluded, it will have great impact on Korean exports. The Korea-China FTA will be expected to address Korean concerns about the potential increase for Taiwan in Chinese market shares.

On the other hand, the effects from the service and investment liberalization are expected to be substantial because beyond-the-border barriers in China are reputed to be very high. More specifically, a Korea-China FTA will contribute to the market expansion of producer services embodied in the Korean manufacturing exports. It is also expected to provide an impetus for substantial increase in the outbound FDI to China as well as intra-firm exports of services, in light of the rapidly expanding Chinese domestic demand.

In contrast to the benefits for the manufacturing and service sectors, the Korea-China FTA is expected to have negative effects on the Korean agricultural and fishery sectors. China is different from previous Korean FTA partners in that it can export fresh vegetables and live fish for the Korean market because it is geographically closer to South Korea. Therefore, potential costs from the Korea-China FTA are expected to accrue to the agricultural and fishery sectors.

Specifically, the imports of sensitive products from China have been increasing very rapidly in recent years. Korean agricultural exports to China amounted to $556.1 million while its agricultural imports from China reached $3.23 billion. The trade deficit in the agricultural sector amounted to $2.67 billion. Marine products from China also represent a sensitive problem for the Koran economy, as Chinese products have account for more than 30% of Korean fishery imports.

Besides the above-mentioned economic effects, the Korea-China FTA is expected to have geo-political effects in Asia. Above all, it will contribute to stabilizing the diplomatic and geo-political relationship between Korea and China, thereby contributing to the reunification of the Korean peninsula. The Korea-China FTA is expected to result in the expansion of bilateral cooperation and greater interdependency. It will also help the Chinese leadership and private sector to realize the importance of political as well as military security in the Korean peninsula. For its part, Korea can use the Korea-China FTA to develop a strategic and cooperative relationship with China while maintaining the Korea-U.S. alliance.

Main Issues

Korea and China concluded (at the joint research of industry, government and academia) that a Korea-China FTA will lead to positive effects for both economies. However, they did not launch official negotiations because they have reacted sensitively to various products imported from each other. This demonstrates the importance of dealing with sensitive products. The two countries should design concession lists to maximize the expected benefits and maintain the balance of economic interests for both countries. The two countries are planning to negotiate the modality of market access for goods in the first stage of the FTA negotiations.

Specifically, Korea has a keen interest in how to liberalize the agricultural sector in the Korea-China FTA negotiations because most of the negative impacts of the bilateral FTA will be felt in that sector. On the other hand, China recorded huge trade deficits in the manufacturing sector including automobiles, chemical, and electronics among others and has an interest in these areas. In addition, rival companies of the two countries are engaged in competition to increase their market shares in third-country markets. For its part, China is expected to place many manufacturing tariff lines in the sensitive as well as the highly sensitive list.

Regarding rules—including intellectual property rights, anti-dumping, environment and competition policies, and government procurement—Chinese legal institutions substantially improved during the process of WTO accession in 2001. However, there were many complaints from Korean companies about the effective enforcement of Chinese rules. It is highly probable that a compromise on rules will be very difficult to achieve. It would be tough to apply domestic rules differently to member and non-member countries of a FTA.

Notwithstanding the geographic proximity and economic interaction between the providers and consumers of each country, the trade in services between Korea and China has been trivial compared to trade in manufactured goods. Yet the potential for future expansion in services trade is substantial in light of cultural homogeneity and the bilateral trade volume between the two countries.

A review of China's FTAs with New Zealand, Hong Kong, Macao, and Taiwan revealed that China liberalized various services sectors including telecommunication, transportation, government-related services, and business services. However, New Zealand is not noted for being competitive in the above service sectors. On the other hand, Hong Kong, Macao, and Taiwan all belong to the greater China economic area. Thus, it is not surprising to see that China has been reluctant to liberalize the service sectors in the case of the other previous Chinese FTAs. Part of the reason is that the competitiveness of China's own service sectors are lagging and the Chinese government tends to regard domestic regulations as security issues.

In the second stage of Korea-China FTA negotiations, the two countries are scheduled to discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. In previous FTA negotiations, China's position in services and investment liberalization was a decidedly negative one. Thus, enhanced access to Chinese service markets and improvement of the Chinese investment environment are expected to be top priority agendas in the Korea-China FTA negotiations. Specifically, a guarantee of future liberalization, transparency, rational domestic regulation, and mutual recognition will likely be the main issues in negotiations for services and investment.

A Comparison with the Proposed Korea-China-Japan FTA

Discussions about regional economic integration in Asia have not been as enthusiastic as those in other regions. For example, European countries launched an ambitious program for regional integration in the 1950s, and the North American countries concluded North American Free Trade Agreement, or NAFTA, in the 1990s. The Korea-China FTA will have potential effects not only on the two countries, but also on neighboring Asian countries.

A review of recent economic statistics finds that greater interdependency has developed among Korea, China, and Japan in terms of trade, investment, and technology cooperation in recent years. Amidst head-to-head competition among the three countries, there are also many opportunities for them to cooperate with each other to expand mutual economic relations through FDI, strategic alliances, and technology transfers.

For example, as we can see in Table 2, shares of trilateral trade among Korea, China, and Japan increased very rapidly for Korea and Japan. In the case of China, it decreased to 15.78% in 2010 because China diversified its trade partners for its aggressive advance into the global market.

Recognizing the importance of trilateral economic cooperation, discussion of the FTA among Korea, China, and Japan started in 2002. Specifically, the three countries launched a joint study of private institutions to investigate the feasibility of the trilateral FTA from 2003 to 2008. The joint study dealt with a wide range of topics including macroeconomic effects, impacts on industries, and rules of origin, among others. Since 2009, the joint research of industry, government and academia indicates that the trilateral FTA will lead to substantial macroeconomic effects in all three economies, meaning that it will be a win-win strategy to be adopted for regional integration.

Reportedly, China recognizes the importance of Korea's bridging role because of its intermediary position between China and Japan in terms of development level. Currently, both China and Japan are courting Korea to launch FTA talks. For its part, Korea may possibly restart the FTA with Japan and has announced it will launch a trilateral FTA with China and Japan after officially starting FTA negotiations with China. Thus, a Korea-China FTA can be seen as a first step in accomplishing Northeast Asian regional integration. In addition, it will also provide momentum for an East Asian FTA including ASEAN+3 because the three countries all concluded their FTAs with ASEAN. Furthermore, a Korea-China FTA will have international political impact on the discussion of a greater Asian FTA among China, Japan, Korea, ASEAN, India, Australia, and New Zealand.

It is highly probable that politico-economic factors are more important than economic ones in the process of trilateral FTA negotiations. Thus, the three countries need to set up the modality,

Table 2 Bilateral/Trilateral Trade Shares (as a %)

Year	China			Japan			Korea		
	Japan	Korea	C-J-K	China	Korea	C-J-K	China	Japan	C-J-K
2000	16.14	5.63	21.77	8.91	5.79	14.70	8.02	14.95	22.96
2005	12.49	6.72	19.20	15.98	6.27	22.26	17.51	12.77	30.28
2010	9.63	6.14	15.78	19.58	6.14	25.72	20.46	10.06	30.52

Source: Comtrade Database, UN

scope, and framework for the trilateral FTA, considering the template of the Korea-China FTA and the dynamic economic as well as political relations between China and Japan.

Conclusion

The Korea-China FTA is expected to have substantial benefits for the two countries, but they have conflicting views on the main issues. Thus it will take a certain period of time to reach a compromise in goods, rules, and services areas. The Korean government is known to have precluded the possibility of concluding a Korea-China FTA within a pre-specified period.

Specifically, it is very important to negotiate successfully on the modality in market access for goods. If the two countries reach a compromise for a low-level FTA to take gradual concession schedules, then it will not be consistent with Article 24 of GATT 1948. In addition, it will not be the optimum choice in terms of economic benefits for the two countries to liberalize only a limited range of tariff lines.

Thus, one of the acceptable options for the two countries is to consider an 'ASEAN FTA plus' in order to protect the sensitive products of each country. This is because the level of concessions in the goods area of the Korea-ASEAN FTA is higher than that of the Korea-India Comprehensive Economic Partnership Agreement (CEPA), but lower than the FTAs with developed countries including the U.S. and the EU.

To conclude, the Korea-China FTA will provide more benefits for the Korean economy than potential costs, considering that it will strengthen its market competitiveness and upgrade its industrial productivity. If it is successfully concluded, Korea can become a business hub that connects the United States and European countries to Asian economies. In addition, the Korea-China FTA is expected to be an effective catalyst in speeding up the discussion about Asian regional economic integration.

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[1] KIEP, "Recent Trends, Main Issues, and Prospects of Chinese Economy," 2010.

[2] KITA, "Effects of Korea-China FTA on Korean Trade," presented at the public hearing on Korea-China FTA, 2012.

[3] China has emerged as the number one global market in such goods and services as automobile sales (13,640 thousand units), mobile phone (747.38 million persons), and internet usage (380 million persons) in 2009.

[4] KIEP employed the CGE (Computable General Equilibrium) model to investigate the potential economic effects according to the two scenarios of concession. See KIEP, "Macroeconomic Effects of Korea-China FTA," presented at the public hearing on the Korea-China FTA, 2012.

KOREA: BEYOND PREFERENTIAL TRADE DEALS

By Shiro Armstrong

Abstract

Korea has managed to sign free trade agreements (FTAs) with nearly all its major trading partners and the major global economies except for Japan and China. Although it has made some progress in trade liberalization due to FTAs, there is little evidence they have had, or will have, anywhere near the transformative effects on the Korean economy as did the earlier unilateral trade liberalization in the 1980s. Now that it is running out of potential FTA partners, Korea can be a leader in moving forward with untangling the extensive network of its FTAs and supporting the multilateral trading system. That would benefit Korea, its trading partners, regional trade flows and contribute to buttressing the global trading system when that is greatly needed. Preferential tariffs can be mulitilateralized, MFN rates can be reduced to the lowest preferential rates, or reduced to zero. The liberalization in service sectors can be extended with relative ease so that the Korean domestic economy can go beyond giving FTA partner country firms national treatment to allowing entry (and exit) of all foreign and domestic firms. It is in Korea's interest to extend the opening of its market which has been achieved via FTAs to all countries.

The State of Play

Korea[1] owes its rapid growth and economic modernization to its opening up to, and integration into, the global economy. Korea went from being one of the poorest countries in Asia in the 1960s to an economic success story boasting the world's twelfth largest economy with membership in the club of wealthy countries, the OECD.

The export-oriented, but heavily protected Korean economy, really took off as it opened up unilaterally in the 1980s. Unilateral liberalization was underpinned by commitment to the multilateral trading system and supported through concerted liberalization through APEC. Concerted unilateral liberalization within the framework of GATT negotiations helped Korea and many of the East Asian economies to open up their economies and led to increasing trade shares and rapid economic modernization.

Korea has developed into a significant middle economic power and an active contributor to the global economic system. President Lee showed strong leadership during the global financial crisis to ensure no backsliding into protectionism. Korea hosted the G20 summit in 2010 and is playing an active role in keeping the global trade and economic system open.[2]

More recently Korea has been an aggressive participant in trade liberalization mostly in the form of signing free trade agreements (FTAs).[3] Korea has been very successful in its strategy of signing FTAs with large and important trading partners and given this success (despite the political difficulties in ratifying KORUS with the United States), it is now time to think about the next stage of Korea's trade policy strategies and economic diplomacy.

Taking Stock of Korea's FTAs

At the turn of the century, Korea was one of the few East Asian economies not to have any FTAs and was still flying the multilateral flag. That changed when the Chile-Korea FTA was signed in 2003 and came into force in 2004. In less than a decade following its first venture into preferential trade, Korea has managed to sign agreements with nearly all its principal trading partners and the major global economies except for Japan and China. Nor has it yet signed an FTA with Australia, one of its key resource and food suppliers.

The Korea-US FTA (KORUS) came into effect in March 2012 giving Korea eight concluded FTAs with a further seven under negotiation and nine under consideration. While those numbers are not particularly high compared to its neighbors (Japan with twelve and Singapore with eleven, for example) what is significant is the partners of those FTAs. Of the completed FTAs, the economically and politically significant ones in addition to KORUS are with the European Union (KOREU), India and ASEAN. Among the countries with which Korea currently has FTAs under negotiation are Australia, Canada, Mexico, the Gulf Cooperation Council, New Zealand, and in the consideration stage are agreements with Japan, China, Japan and China together (CJK), Indonesia, Vietnam and MERCOSUR. If those were all completed, Korea will have trade agreements with its largest trading partners and political allies.

The economic effects of FTAs are usually quite limited with sensitive sectors exempted and difficult protection measures avoided, but for Korea, KOREU and KORUS have played an important role in liberalizing Korea's heavily protected automobile and agriculture sectors. There has also been success in opening up some service sectors to U.S. and European firms. KORUS and KOREU have managed to include the phase-out of protection of sensitive sectors in Korea including pork, dairy and other agricultural goods (except for rice). Although the tariff phase-out varies and is quite lengthy for some sensitive sectors (up to fifteen or twenty years for some products), they will eventually move to duty free.[4]

Although Korea has made some progress in trade liberalization due to FTAs, there is little evidence they have had, or will have, anywhere near the transformative effects on the Korean economy as the earlier liberalization in the 1980s. Earlier unilateral liberalization was undertaken in concert with other APEC economies so that the economic benefits to opening up were multiplied. Unlike liberalization through FTAs, unilateral liberalization does not distort trade towards preferred partners and allows for a more efficient allocation of resources determined by market forces.

The other major trade agreement in the region that could involve Korea is the Trans-Pacific Partnership (TPP) which is a trade deal being negotiated by nine countries including the United States, Chile, Peru and Singapore—with whom Korea already has FTAs—and with Australia, New Zealand, Vietnam, and Malaysia—with whom Korea has FTAs under negotiation or consideration. Mexico and Canada are set to join the TPP negotiations and Japan has shown interest in joining. All three and are also currently undergoing talks with Korea for signing FTAs.

There is a chance that Korea will find it congenial to join the TPP given that it has, or will have, deals with all the members, and importantly the United States. But given it already has deals with those members, and the political difficulties it had in passing KORUS, it is unlikely that Korea can or will attempt to join TPP talks in the near future. Korea has less incentive than Japan to join TPP negotiations, for example, because Japan does not have an FTA with the United States.

The trade agreement talks with China and Japan (Korea's two largest import sources and largest and third largest export markets, respectively) have recently been given a boost from the progress of the TPP, given that it is highly unlikely China can join the TPP any time soon.[5] As the world's second largest economy and the largest trading partner for most of the East Asian economies, China is an important element in Korean, Japanese and East Asian trade. The TPP has also given impetus for other broader regional arrangements such as an ASEAN+3 FTA and the ASEAN+6 FTA, in both of which Korea would be involved.

Historical baggage and differences in political systems could mean that any FTA signed with Japan, China or both together could be either full of exemptions and lack liberalization or take a long time to conclude. The three countries should work at making a clean (fewer exemptions), multilateral friendly (lack of discrimination) agreement even if that requires longer phase-in periods.

While Korea has made significant progress in signing FTAs, and that may be the end point for trade negotiators, trade liberalization should not stop with the conclusion of these trade agreements.

Distortions and Inefficiencies

The problems with bilateral or regional preferential agreements are well known. Preferential trade agreements are a policy tool used to discriminate among trading partners and they divert trade away from third party countries regardless of whether they are members of the WTO and should have most favored nation (MFN) treatment in trade.

Korean trade is regulated by eight different preferential arrangements (in addition to the global rules and norms of the trading system) and potentially up to twenty-four if all those under negotiation and consideration come to fruition. Given the loss of political face for both sides of FTA negotiating countries, it is likely that the FTAs currently under negotiation will conclude at some stage, in some form, albeit with exclusions and potentially very little liberalization.

The proliferation of FTAs in the region has led to cumbersome rules of origin (RoOs) for trade across borders that involve different duties charged on different components or parts based on the country where value was added. Trade between two or more countries can come under different rules depending on which agreement or regulatory regime the trader chooses.

The gains in market share that Korea has achieved through FTAs will be eroded as its trading partners conclude more FTAs and divert trade from Korea. But that is not a main issue.

FTAs can inhibit competition, rather than encourage it. Preferential trade deals create interest groups around new preferences, or preferential access to investment or service delivery, that can make it harder to liberalize further. With European and U.S. beef enjoying preferential access to the Korean market, there now exists strong U.S. and European interest in protecting that preference from other suppliers, such as Australia and New Zealand.

FTAs have yet to demonstrate that they complement and promote multilateral liberalization, as their protagonists argue. For FTAs to be building blocks towards multilateral liberalization, and for this 'competitive liberalization' to work, the messy web of overlapping FTAs (noodles in the Asian noodle or spaghetti bowl) that have introduced distortions to business needs untangling. There also needs to be multilateralization or elimination of the preferences so that they add to the openness of the global trading system, not detract from it.

The problems that FTAs raise are compounded by the fragmentation of production and division of labor across countries in international production networks. Trade within production networks, and in other contexts, extends beyond bilateral trade but often, preferential trade deals are bilateral. Even when trade agreements involve more than two countries, they inevitably raise trade barriers relative to those outside the agreements. Each FTA that is brought into force in the region adds restrictions to trade, in the form of RoOs or a new set of discriminatory measures.

The proliferation of Korea's FTA can be argued as successful competitive regionalism, where countries sign FTAs to offset the discrimination they face in the Korean market. Some see KOREU as a response to KORUS,[6] although KOREU ultimately came into effect earlier than KORUS, and now there appears to be a big incentive for Japan to sign an FTA with Korea to offset the discrimination Japanese auto manufacturers face in Korean markets, for example.

What should Korea do once it has signed deals with Japan and China? It will have no important trade partners left to negotiate FTAs. The bicycle theory of trade suggests that a country should continue to liberalize otherwise they will backtrack into protectionism or liberalization will become stalled. Korea has been pedaling very fast but is it toward a dead end with too strong a focus on FTAs? Negotiating trade deals consumes a lot of resources and bureaucratic energy but is it worth it to sign more deals with smaller countries? Would pedaling in a different gear or different direction move Korea forward more effectively?

Liberalization through FTAs can be phased in but, unlike non-discriminatory framework agreements or agreements based on granting of MFN status, this liberalization has a tendency to stop there making them a somewhat static instrument for liberalizing trade. Interests privileged in participating partners have motivation to protect that privilege and frustrate more general liberalization. In addition, once a bilateral agreement is completed, for all practical purposes, that is the end for trade negotiators. Renegotiation or further liberalization in an FTA framework does not happen automatically even when review arrangements are built into the outcome, and is in fact very rare. Trade liberalization is an ongoing process of removing barriers to efficiently allocate resources towards their most productive use and to further the division of labor for a freer, flexible and more open economy.

Liberalization that occurs through negotiating FTAs, it is argued, may engage export interest groups that directly benefit from foreign market opening in overcoming resistance to trade reform. Yet by far the largest gains in trade liberalization accrue from what you give up, not what you extract from others in a negotiating framework, so it would appear that more productive catalyst might be found through mobilizing the interest of consumers and end-users on importable goods and services in trade reform and liberalization.

Korea has the opportunity to show leadership in untangling the FTA noodles given that it has signed FTAs with so many of its important trading partners; its record as a positive force in active middle power economic diplomacy; its location in the world between three economic giants; its secure trade agreement with the EU and its ally the United States; and its place in a dynamic, integrated region.

Asian, Trans-Pacific or Global Trade Policy?

The choice of a bilateral, regional, trans-Pacific or global trade policy is a false choice in that if those options are seen as mutually exclusive, the global edifice into which they are built will be corroded. Bilateral and regional initiatives should be consistent with Korea's global outlook and be designed to foster open trade arrangements generally.

The failure of the Doha round in the WTO was used as an excuse to pursue FTAs but it has locked in preferences and meant that this second best (or even third best) FTA solution has become the enemy of the first best, non-discriminatory multilateral solution. Now that the Doha round has collapsed, it is a dangerous time to further weaken the multilateral system. Rather, there is need to show leadership in reversing some of the damage that bilateral deals have done to the non-discriminatory multilateral trading system.

The GATT was created to avoid a repeat of the retreat into preferentialism of the interwar period, where trade declined by seventy percent as preferential trade proliferated.[7] The interwar collapse in trade extended the Great Depression and exacerbated political tensions with the 'Dissatisfied Powers.' The global trading system has played a significant role in dampening political tensions. One prime example in Korea's neighborhood is the way in which it has underpinned growth of the economic relationship between Japan and China where that relationship has prospered despite the political tensions between the two countries. The unilateral liberalization that China undertook as part of its accession bid for entry to the WTO demonstrated commitment to the global trading system's rules and norms. This commitment to further reforms and marketization gave Japanese (and other international) investors and traders confidence in economic engagement with China even when political differences arose.[8]

Korea can be an active agent, or better, a leader in moving forward with untangling the extensive network of its FTAs and supporting the multilateral trading system. That would benefit Korea, its trading partners, regional trade flows and contribute to buttressing the global trading system when that is greatly needed. It would hurt narrow interests that currently have preferential access to Korean markets but those preferences are at the expense of Korean consumers and third party country trading partners. It is in Korea's interest to extend the opening up of its market which has been achieved via FTAs to all countries.

Digesting the Noodles

Korea can be a leader in untangling the noodle bowl to make it more digestible. There are at least three ways forward in dealing with FTAs.[9] The first, which proponents of FTAs as stepping-stones towards regional trade agreements and then onto multilateralization might favor, is the consolidation approach. That would involve bilateral preferential deals being consolidated into regional deals. The second is to dilute the distortionary effects of FTAs by multilateralizing the preferences and other accords or by reducing the MFN rates. The third involves pushing deregulation and structural reform to level the playing field in the Korean domestic market and developing a regional and international agenda of regulatory reform and integration.

While the idea of consolidating, or joining up, FTAs may sound attractive, it is in practice unlikely to succeed in a way that will not be damaging to the global trading system. Where regional trade agreements have been brought into effect involving existing FTA partners, bilateral deals have not disappeared or become less important. The outcome is another layer or set of trade rules and restrictions within that region. If the consolidation approach did succeed, however, it is likely to further fragment global trade. Consolidation of intraregional FTAs is difficult enough[10] but consolidation of interregional FTAs is close to impossible. For example, if Korea succeeds in its FTA negotiations with Mexico and Canada, this will not qualify Korea to join NAFTA nor can those agreements join up in any easy way. And KOREU will not lead to Korea enjoying equal treatment among EU members.

Although Korea has FTAs with the United States and ASEAN, there is little chance that Korea could connect those two FTAs as the United States would have to extend KORUS preferences to ASEAN. But for Korea, there is powerful incentive to level the playing field between the U.S., Southeast Asia and other firms in the Korean economy.

The TPP was originally cast in terms of being the solution to overlapping FTAs and the related restrictions, such as RoOs, by consolidating FTAs in the region and providing a pathway towards a broader regional agreement encompassing all APEC members (a Free Trade Agreement of Asia and the Pacific). The goal of having a consolidated text with common market access schedules for all members and no exemptions is at risk. Instead of a truly clean regional FTA that liberalizes, albeit preferentially, a U.S.-led compromise made in Brunei in 2009 has led to market access offers on a bilateral basis or to the TPP as a whole.[11] There are signs that the TPP will end up as a series of bilateral deals which adds to the problems of overlapping FTAs instead of solving them,[12] in which case Korea should not join.

Diluting Tariff Preferences

In order to reduce and eventually eliminate the distortions in Korea's FTAs, different aspects of the FTAs have to be dealt with in different ways. Preferential tariffs, for example, can be mulitilateralized, and MFN rates can be reduced to the lowest preferential rates, or reduced to zero. ASEAN has managed to multilateralize most of the preferences in the ASEAN Free Trade Area.

Korea has achieved opening up some sensitive sectors, such as agriculture and automobiles, in KORUS and KOREU (albeit with varying phase-in periods and safeguard measures in the event of import surges to protect domestic producers) that are arguably more difficult to achieve multilaterally. Some negotiations may be easier with only two parties but once those protected sectors are opened up to foreign competition, liberalizations can more readily be extended on an MFN basis.

Korea will completely remove its tariff on U.S. automobiles by 2016, from the pre-KORUS level of eight percent (they dropped to four percent as soon as KORUS came into force). Under KOREU, tariffs towards European automobiles will be eliminated roughly around the same time as with KORUS, with tariffs on light trucks eliminated a year or two earlier. Korean consumers will be paying more for Japanese automobiles which will incur eight percent tariffs and hence be at a disadvantage in competing in the Korean market. But given that Korea will have opened up to U.S. and European automobile companies, it should be relatively easy to eliminate tariffs towards Japanese automobiles, and all other auto-mobile suppliers, so that the Korean automobile market is more open, competitive and prepared to improve Korean consumer welfare. There is no justification for making any potential innovative or cheaper cars from Japan, China or elsewhere relatively more expensive in favor of U.S. or European cars.

The same applies for other sectors. Australia and Korea do not need an FTA for Korea to extend the tariff reductions to Australian beef and other agricultural goods that have already been extended to the United States and Europe. If Korean consumers can access cheap American and European agricultural goods, that access should be extended to Australian and Brazilian agricultural producers. Korean consumers can benefit from a more competitive market, including more product varieties, cheaper goods and more liberal trade with producers in the Southern Hemisphere with different climates.

Another way to dilute tariff preferences is to reduce MFN rates so that the margin of preference shrinks. Korea is already a relatively open economy with average tariffs at around nine percent, and now that it has succeeded in liberalizing some sensitive sectors for the first time, could work towards eliminating the remaining tariffs. Korea would then no longer be contributing to the RoO problem.

There is no justification for preferential treatment under other non-tariff barriers to trade that have been identified and liberalized through bilateral trade agreements.

A Level Playing Field for Korean and Foreign Firms

But FTAs are not only about preferential treatment of goods at the border in terms of tariffs. They include services trade and often cover labor and environmental standards, intellectual property rights, competition policy, rules on investment, e-commerce, government procurement and other issues. Most of those are domestic economic policy issues to do with making the market more efficient and contestable.

There is little evidence[13] that preferential services commitments deliver much in terms of liberalization outside of Europe, but Korea has opened up its legal, financial, and telecommunications sectors in varying degrees for U.S. and European service delivery. Healthcare and education services are still protected sectors in Korea and have been excluded from all its FTAs. What gains in service trade liberalization Korea has achieved through its FTAs can be multilateralized relatively easily from the preferential accords that are in place.[14] Some of the services trade liberalization measures mean American and European law firms are now allowed to open offices in Korea. The forty-nine percent foreign voting share limit for telecom providers was removed for U.S. and European telecommunication service providers, European and American financial firms had data transfer restrictions lifted, and American and European accounting and taxation service providers are allowed to enter the Korean market.

Those hard fought trade "concessions" can be extended with relative ease so that the Korean domestic economy can go beyond giving U.S., European and other FTA partner country firms national treatment to allowing entry (and exit) of all foreign and domestic firms. As with many barriers to entry for firms, it is a domestic issue more than a trade issue and more about creating a level playing field for Korean and foreign firms in Korea. Barriers to entry that exist for domestic firms are just as important an issue as barriers to entry to foreign competition.

The aim for Korea is to have well-regulated and competitive markets, not markets with barriers to entry and national treatment for preferred country firms. As one of Asia's most developed economies, Korea should focus on adopting regulatory best practice and using its membership of the OECD, for example, to co-opt the most advanced benchmarks for new regulatory challenges.[15] Such regulatory leadership will not only help the Korean economy, but can contribute to the global and regional regulatory standards and the provision of this public good can be championed at APEC and the OECD.

With investment accords, instead of having different rules protecting foreign investors depending on their country of origin, Korean interests are much better served with a set of robust, transparent investment rules and regulations that afford all foreign investors protection in order to attract foreign capital and technology, as well balancing that with protecting Korean interests.

Other provisions or chapters labeled "WTO-plus" in FTAs such as labor and environment standards, as well as strengthened IPR, are measures usually included in FTAs to level the playing field between countries. They are usually measures introduced from more developed countries so that countries cannot gain competitive advantages when the cost of environmental degradation is not factored into the cost of production and wages are artificially low due to unregulated labor markets. The argument for IPR chapters is for protection of IPR in order to encourage innovation. Such measures can be seen as protectionist measures that do not recognize different stages of economic development and try to erode some of the comparative advantages in lower cost production, especially in developing countries.

Korea has a mature economy and does not have many of the problems that other developing countries might in meeting U.S. or EU standards for WTO-plus provisions. The one area where this is an issue in KORUS and KOREU, but not in most of Korea's other FTAs, is in relation to goods produced in the Kaesong Industrial Complex located in North Korea. Preferential treatment for products originating from Kaesong being traded between Korea and the United States or Europe will require further negotiation. Problems would arise if Korea demanded similar WTO-plus standards from its other trading partners, especially developing countries, before it engages in trade deals with them.

A New Trade Paradigm: Beyond FTAs

Korea needs a new trade liberalization paradigm and strategy that takes it beyond FTAs.

Korea does not need negotiated trade agreements based on tit-for-tat trading of preferences and discrimination in order to liberalize trade. The domestic sell should move from opening up certain sensitive sectors like beef and automobiles to global powers bilaterally to opening up for a more efficient, open and contestable market and strengthening Korea's global role.

In APEC and the G20, Korea has the platform to show leadership in unilateral initiatives that dilute the effects of the discrimination in its trade agreements. Korea can make clear commitments to the multilateralization of preferences over time as well as commitments to multilateralizing special treatment in services trade or delivery. As the Korean economy moves towards a new economic model based on green growth, there is an opportunity to frame its commitments to trade globally in a manner consistent with its moves to free trade in green technologies.

The dilution or multilateralization of the adverse effects of FTAs will provide a regional and even a global public good, which can be supported and emulated at APEC, for example. Leading a concerted approach to untangling noodles will compound the benefits.

Korea sits between two economic giants in Japan and China, with both of whom it has large economic relations; is part of the production networks in a deeply integrated region; and has a major FTA with its important political ally in the United States. Korean interests are best served by eliminating the discriminatory and distortionary features in its trade arrangements and by being a leader in keeping the global trading system open and strong.

The debate must move to making Korea more competitive internationally and to continuing its economic development success story, and away from picking trading partners and leading the world in riding the FTA bicycle.

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[1] This paper refers to the Republic of Korea, or South Korea, simply as Korea, distinguishing it from North Korea.

[2] For instance, Korea is leading by example with free and open trade in green goods (those goods embodying environmentally friendly technologies).

[3] This paper uses FTAs to cover preferential trade agreements (PTAs), economic partnership agreements (EPAs) and any other bilateral or regional trade agreement that has preferential tariff and other features.

[4] For a detailed comparison of KORUS and KOREU, see Song, Y. "KORUS FTA vs. Korea-EU FTA: Why the Differences," Korea Economic Institute Academic Paper Series, Vol. 6 Issue 5, May 2011.

[5] Armstrong, S. "China's Participation in the Trans-Pacific Partnership," East Asia Forum, December 11, 2011. http://www.eastasiaforum.org/2011/12/11/china-participation-in-the-trans-pacific-partnership/.

[6] See Schott, J. "Free Trade Agreements and the Future of U.S.-Korea Trade Relations," *Navigating Turbulence in Northeast Asia: The Future of the US-ROK Alliance*, Korea Economic Institute, http://www.keia.org/publication/free-trade-agreements-and-future-us-korean-trade-relations.

[7] Cho, S. "Is a Free Trade Agreement a Royal Road to Prosperity? Demystifying Trade Regionalism," in Static and Dynamic Consequences of a KORUS FTA, The Korea Economic Institute, 2007.

[8] See Armstrong, S, "The Politics of Japan-China Trade and the Role of the World Trade System," in *The World Economy*, forthcoming 2012.

[9] For detailed discussion of dealing with FTAs in the Asian region and beyond, see Menon, J. 2009, "Dealing with the Proliferation of Bilateral Free Trade Agreements," *The World Economy*, Vol. 32, Issue 10, pp. 1381-1407.

[10] Again, see Menon (2009) for discussion of South Asia.

[11] See Barfield, C. "The Trans-Pacific Partnership: A Model for Twenty-first-Century Trade Agreements," American Enterprise Institute, *International Economic Outlook*, No. 2, June 2011.

[12] See Armstrong, S. "The TPP, APEC and East Asian Trade Strategies," East Asia Forum November 14, 2011, http://www.eastasiaforum.org/2011/11/14/the-tpp-apec-and-east-asian-trade-strategies/.

[13] See Francois, J. and B. Hoekman, "Services Trade and Policy," *Journal of Economic Literature*, 2010, Volume 48, pp. 642-92

[14] Hoekman, B. and L. A. Winters. "Multilateralizing 'Deep Regional Integration': A Developing Country Perspective." Paper presented at the Conference on Multilateralizing Regionalism, WTO and CEPR, September, Geneva, 2007.

[15] Cho, S. "Is a free trade agreement a royal road to prosperity? Demystifying trade regionalism," in *Static and Dynamic Consequences of a KORUS FTA*, The Korean Economic Institute, 2007.

KOREA'S ROLE IN ECONOMIC DEVELOPMENT

THE SECRET SUCCESS OF U.S. AID TO SOUTH KOREA

By Andrew S. Natsios

In the 1950s South Korea was one of the poorest countries in the world, and yet today it is one of the richest with the 13th largest economy and a functioning parliamentary democracy. Between 1961 and 1979 per capita income rose eight fold, and its economic growth rate exceeded 1400 percent. How did this economic miracle take place? What role did the United States aid program play in this transformation?

In the 1950s the Korean people were hungry, impoverished, and in poor health. The U.S. aid program imported massive amounts of food aid to feed the population, but focused on increasing agricultural development to produce food for Japanese markets. Dr. Syngman Rhee, President of the Republic of Korea between 1948 and 1961, also pursued a policy of import substitution based on what is called dependency theory. Under this theory the government created (and still continue to own) local businesses that produced products for domestic consumption to reduce the need for imports. This approach has consistently failed to produce sustained rates of growth in nearly every country it has been attempted, including in South Korea in the 1950s. Typically, the government-run businesses created by import substitution become inefficient monopolies that try to protect their exclusive control over domestic markets, avoid risk, innovation, and improvements in productivity. Thus import substitution policies impeded rather than increased economic growth.

General Park Chung-hee's assumption of the presidency in 1961 coincided with the arrival of a new USAID mission director (Bernstein) who proposed to Park that Korea shift focus from producing agricultural to industrial products for export. This appealed to Park who adopted the strategy and approached the effort as a military commander. He held regular staff meetings of his cabinet and business leaders at which he demanded accountability and results, established market-based export quotas of industrial goods the business community had to meet based on market demand, and created heavy incentives for those businesses which met the goals, and withdrew incentives when businesses failed to meet them. The industrialization effort was done through what were called the chaebol business elite who Park had earlier put in jail for corruption, but later released to lead his export-led growth strategy.

The Park strategy was part Korean and part American, and was partly based on a book called the Stages of Economic Growth by Walter Rostow, which had just come out on development economics. The author was a senior advisor to both President Kennedy and later President Johnson. Rostow argued that foreign aid could be used to accelerate growth at certain stages of economic development in poor countries using economists and other technocrats to guide the implementation. USAID provided both the funding and the economists to the South Korean government. Michael Pillsbury is currently writing an important new book, based on recently declassified CIA cables, called The Secret Successes of USAID which describes the aggressive nature of U.S. efforts in Korea to ensure that the growth strategy was successful. At times Park complained to the CIA that these USAID economists were running the country—though he continued to support the recommended policies.

The Korean economic model did not enjoy universal support among development professionals even as late as the 1970s when some questioned whether this was the right strategy. It was not until the 1980s that it became indisputably obvious that the Park strategy was a remarkable success.

What lessons can we draw from the Korean experience? Firstly, growth strategies required a long time horizon—two decades. It could not produce immediate, visible, and quantifiable results which policy makers in Washington often demand of aid programs. In fact none of the Asian economic success stories—Taiwan, Hong Kong, Singapore, Thailand, China, or South Korea—produced quick results.

Secondly, to be successful the strategy required President Park's strong and aggressive support over the entire period—without local leadership the strategy would have failed. This also meant donors—in this case the United States—had to provide consistent support for the strategy over a long period of time. The U.S. economic aid program was not phased out until 1982. Without country leadership the strategy would have failed.

Thirdly, the strategy would not have succeeded if there had been a civil war or widespread political instability in South Korea because "capital is a coward" as Colin Powell has often said. Investors avoid putting private capital at risk in an unstable country with an internal conflict raging.

Fourthly, the fear of a looming North Korea on the other side of the border with the South backed by the Communist Chinese and Soviet governments motivated President Park and the South Korean political and economic elite to make their strategy work. They took risks, avoided using aid money to reward friends and loyal supporters with unproductive government jobs and crony protection schemes (a problem in many developing countries), and avoided making unproductive but politically popular economic investments. The abiding external threat over two decades created the motivation for leaders to ensure the strategy worked.

What worked in South Korea is not necessarily a model for every country. Each country has its own unique set of local challenges, its own historical narrative, and its culture and values which influence its development trajectory. But the Korean growth strategy, which the U.S. government aid program, according to the CIA declassified cables, played a major role in helping the South Korean government formulate and implement, produced the jobs and prosperity that created a South Korean middle class which later demanded political reform, democracy, and free institutions. Those skeptics who argue that foreign aid does not work should examine the shining example of South Korea. Other developing countries could benefit from learning how South Korea achieved its economic and political miracle.

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AID BY KOREA: PROGRESS AND CHALLENGES

By Lee Kye Woo

Abstract

This paper aims to evaluate the progress made in Korea's official development assistance (ODA) since 2008, when the country applied for accession to the OECD's Development Assistance Committee (DAC) and established its Medium-term Aid Plan (2008-2010). Using empirical statistical data, it assesses the performance of Korea's ODA against the norms and practices of DAC member countries. In particular, this study analyzes the Korean government's achievement in addressing the 2008 concerns of the OECD's Special Review Team about Korea's aid allocation to developing countries and coordination of the policies and programs of its numerous aid agencies.

Introduction

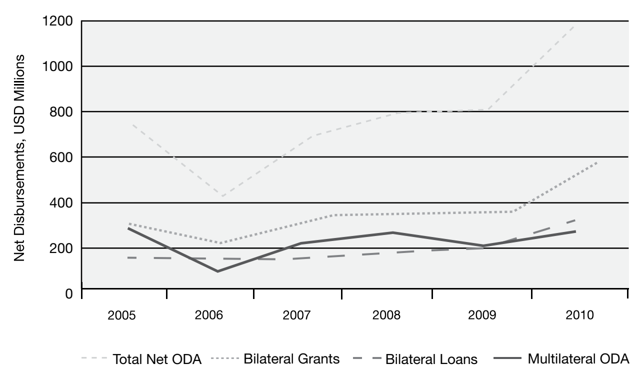
2012 marks a special year for Korea's official development assistance (ODA). A year after Korea hosted the Busan International Conference on Aid Effectiveness (HLF-4) in 2011, the country's aid is to be evaluated by the Organization for Economic Cooperation and Development (OECD) peer review team for the first time since Korea joined the Development Assistance Committee (DAC) in 2010. The DAC, which discusses and coordinates member donor governments' foreign aid policies, is composed of the European Union and twenty-three of thirty-four OECD member countries.

The DAC conducts a peer review of its member states' ODA policies and practices every two to three years, and publishes the results. The review will analyze changes in Korea's ODA since it applied for DAC membership in 2008 and offer recommendations for future improvement. The baseline reference will most likely be the OECD's 2008 Special Review Report, which provided data for evaluating Korea's DAC membership application. Although the review's recommendations are not binding, all DAC members agreed to follow Committee policies and regulations when they joined.

Accordingly, as a way of analyzing Korea's aid policies and practices, this paper is intended to evaluate any changes (or lack of changes) in Korean aid since the OECD's 2008 report. In particular, it analyzes issues and concerns raised by that report and compares Korean ODA policies and practices during the period 2008-10 with those that prevailed before the report was issued, i.e., the period 2005-07.

The Special Review Report urged changes to the scale and terms of Korean aid, and highlighted two additional concerns. One was that Korean ODA was ineffective mainly due to fragmentation: aid was administered by many ministries and other public agencies without a coherent legal and policy framework. Korea's bilateral ODA was divided between grants offered by KOICA (Korea International Cooperation Agency) under the policy guidance and supervision of the MOFAT (Ministry of Foreign Affairs and Trade) and concessional loans offered by the EDCF (Economic Development Cooperation Fund) under the guidance and supervision of the MOSF (Ministry of Strategy and Finance). In addition, some 25% of total bilateral grants were offered by more than thirty central and provincial governments and independent public organizations. Multilateral ODA was offered by more than twenty agencies to more than eighty intergovernmental organizations. Coordination and cooperation between the major grant and loan agencies, KOICA/MOFAT on the one hand and EDCF/MOSF on the other, and their programs was ineffective. Moreover, coordination was lacking between these agencies/programs and more than thirty other grant-giving agencies.

Figure 1 Korea's Net ODA



Source: Korea Eximbank, KOICA

The other concern was the unclear criteria for selecting ODA recipient countries and allocating aid. The ODA allocated to recipient countries by income level was inconsistent with the ODA objectives generally agreed upon by all DAC members. A similar concern was expressed with respect to aid allocated to recipient countries classified by region, sector, and project.

Therefore, in addition to reviewing changes in the scale and terms of Korea's ODA since 2008, this paper will review shifts in legal and policy coherence, as well as selection and allocation criteria, as aimed in the Mid-term ODA Plan (2008-10). This paper will also empirically analyze Korea's aid allocation practices in comparison with other DAC member states. Finally, this paper will highlight conclusions and future challenges for Korean ODA.

The Scale and Terms of Aid

The Special Review Report (OECD 2008) expressed satisfaction with Korea's plan to increase ODA and encouraged a strong commitment. The incoming Lee Myung-bak government in 2008 promised to follow through with the plan, which was set up by the exiting Roh Moo-hyun government. The Mid-term ODA Plan 2008-10 stipulated that the volume of aid would increase from 0.06% of gross national income (GNI) in 2006 to 0.25 percent by 2015.

Since 2008, Korea has pursued the goal with vigor. During the period 2006-10, whereas Korea's total fiscal expenditure increased at 7 percent per year, its ODA expenditure rose at 29 percent per year. In 2010, the net ODA disbursed increased sharply, reaching $1.174 billion, the equivalent of 0.12 percent of GNI. The size of ODA has scaled up by 0.03 percentage points every two years, i.e., 0.06 percent of GDP in 2006, 0.09 percent in 2008, and 0.12 percent in 2010. If this trend continues, the size of ODA will reach 0.27 percent of GNI in 2015, exceeding the 0.25 percent goal.

The Special Review Report (2008) also encouraged Korea to soften its ODA terms. A 1978 DAC agreement on improving ODA terms includes three standards. First, 86% of annual ODA commitments should be a grant element. Second, annual ODA commitments should be above the ODA members' average (0.28 percent of GNI in 2010). Third, ODA commitments for all least developing countries (LDCs) should contain a grant element above 90 percent annually, or ODA commitments for each LDC should contain a grant element above 86 percent on a three-year average basis.

Korea satisfied the first and third standards in 2010. The aid commitments contained a 93.6 percent grant element; annual aid commitments to all LDCs reached 94.5 percent, and the three-year average aid commitment to each LDC also exceeded 86 percent. This was made possible not by reducing the share of loans in total bilateral ODA, as recommended by the DAC; in fact, the share of loans in total bilateral aid rose steadily from 27 percent in 2007 to 36 percent in 2010. Instead, Korea achieved these goals mainly by softening concessional loan terms via reductions in interest rates (up to 0.01 percent) and extensions of the grace and repayment periods (up to forty years), especially for those loans directed to LDCs, green growth, and climatic change preparedness.

Regarding the DAC's second standard for ODA commitments at 0.28 percent of GNI, Korea's 2010 ODA commitments reached only 0.20 percent of GNI. However, Korea's ODA commitment would approach the second standard by 2015 if it attains the net ODA disbursement goal of 0.25 percent of GNI by 2015, and would nearly meet it if its loan commitment continues to increase as it has in recent years. Even if Korea's ODA does not attain the second standard, DAC members would likely understand: currently France fails to reach the first standard; Portugal falls short of the second standard; and Greece (0.17 percent), Italy (0.16 percent), and the United States (0.25 percent), like Korea, fail to reach the third standard.

Integrated Legal and Policy Frameworks

The integrated or coherent legal and policy frameworks for Korean ODA can be discussed at two levels: at all recipient countries level and at each individual recipient country level. First, at the level of all recipient countries, Korea has continuously pursued a coherent legal and policy framework since 2005. This effort finally came to fruition at the end of the Mid-term ODA Plan, when the government promulgated the Basic Law on International Development Cooperation in early 2010. Second, at the individual recipient country level, Korea decided to prepare Country Partnership Strategy (CPS) papers to coordinate all Korean aid agencies' programs and projects.

Basic Law and Related Mechanisms

The 2008 OECD Special Review Report recommended a single integrated legal framework to encompass all aid types and agencies, and a single integrated aid controller to guide and supervise all aid agencies and programs.

Basic Law

The government of Korea decided not to establish such an integrated aid agency, which may require a major reorganization of the rights and responsibilities of many ministries and a sharp increase in government officials. Instead, the government attempted to promote coordination and cooperation of numerous aid agencies through the Basic Law on International Development Cooperation of 2010. This law requires the government to designate controlling aid agencies for grants and loans, respectively, for a coherent legal and policy framework, and prepare a mid-term aid plan and annual implementation programs, for coordinated and cooperated aid implementation programs and projects.

The Basic Law designated MOFAT (Ministry of Foreign Affairs and Trade) as the controlling agency for all grant aid agencies, and MOSF (Ministry of Strategy and Finance) for loan aid agencies. The controlling agencies are responsible for coordination, monitoring and supervision, and support of other aid agencies, especially the thirty-plus grant agencies. In addition, the Basic Law elevates the existing Committee on International Development Cooperation as the apex agency for deliberation and coordination of all aid agencies and programs.

At present, there is no consensus on whether the OECD's 2008 recommendation as implemented in the Basic Law was appropriate for Korea. A single, overarching ODA law was not universally adopted by DAC member countries. At that time, only twelve of twenty-two members adopted such legislation; the other ten used only fundamental policy documents for managing ODA. Seven of those twelve members having such legislation also prepared and used a fundamental policy document (Sohn 2009).

While it is clear that the Basic Law has contributed to the coordination and regulation of Korean ODA efforts, the legislation also has a potential downside. Prior to 2010, Korea had several laws on ODA activities, including the organic laws for EDCF (1987), KOICA (1991), and KOFIH (Korea Foundation for International Health: 2005), which together provided legal authority and responsibility to handle about 80 percent of total bilateral ODA in Korea. These laws outlined two simple and clear ODA objectives: economic development of recipient countries and mutual exchanges. However, the Basic Law lists eight, adding such objectives as: resolution of global development issues; promotion of human rights for women and children; gender equality; achievement of humanitarianism; improvement of developing countries' institutions and systems; and contribution to global peace and prosperity. Therefore, one risk that the Basic Law poses is that it may provide a legal basis for the proliferation of new agencies to specialize in some of the six additional aid objectives, potentially complicating rather than easing Korea's efforts to reduce proliferation of aid agencies and coordinate their ODA initiatives. Another problem with the law is that it does not give any sense of priority among the diversified objectives for aid resource allocation and execution.

Coordination and Cooperation Mechanisms

In accordance with the Basic Law, the controlling and other aid agencies collaborated to prepare the Aid Modernization Strategy Paper (Office of Prime Minister 2010) and Five-Year Aid Plan: 2011-15 (Office of Prime Minister 2011). This plan provided a basis for preparing annual aid implementation programs, the country assistance strategy for priority recipient countries, and the volume and grant elements of total ODA. Therefore, it indirectly enhanced aid predictability for all stakeholders and aid coordination among domestic aid agencies, goals that were emphasized in the Paris Declaration for Aid Effectiveness (OECD 2005), Accra Agenda for Action (OECD 2008), and the Busan Outcome Document on Aid Effectiveness (OECD 2011).

While the Five-Year Aid Plan improves aid predictability, the Annual Aid Implementation Program (AAIP) tries to ensure coordination and cooperation among all aid agencies and programs, and consistency between the Five-Year Plan and the annual aid budget. Before 2008, there was no planning and management instrument to ascertain coordination and coherence among programs of almost forty aid agencies, and monitor and evaluate their implementation.

The AAIP is similar to the International Assistance Envelope System in Canada, under which all aid related agencies and the budget authority work together to determine priorities and annual budget proposals for all aid agencies within the budget envelope given by the Ministry of Finance (OECD 2009).

However, Korea's AAIP does not function like Canada's system since it is put into effect in several sequential steps by aid implementing agencies, the controlling agencies, and the Committee on International Development Cooperation. Moreover, the program has no binding effects on the Ministry of Finance since it is prepared only by aid-related agencies without an aid budget envelope. To enhance aid predictability and consistency with the Five-Year Plan, Korea should try to include in the AAIP at least an indicative aid amount for the next two years, as has been done by more than half the DAC member states in their annual budgets (OECD 2009).

Country Partnership Strategies

For each priority aid recipient country, Korea is committed to prepare a Country Partnership Strategy (CPS) and update it every three years. Currently there are twenty-six priority countries. By the end of 2011, strategies for three countries had been completed, with half of the remaining scheduled for completion in 2012 and the other half in 2013.

Preparation of the CPS is a great stride forward for recipients' aid predictability and coordination among diverse Korean aid agencies. Before 2008, there were numerous cases of overlapping or conflicting aid programs or projects among numerous Korean aid agencies in each recipient country. There were also unbalanced or inequitable aid programs between recipient countries since each of the two major aid agencies (KOICA and EDCF) prepared their own country assistance strategy, and aid programs operated without any strategy documents for many recipient countries. Although there had been efforts to prepare a single assistance strategy paper for a particular recipient country before 2008, these simply combined KOICA and EDCF documents without a coherent assistance strategy or program, as pointed out by the 2008 OECD Special Review Report.

Currently, the CPS documents are flawed in that they contain only strategy and lack any implementation program over a three-year period. Therefore, the documents do not provide as much aid predictability to stakeholders as they could. Nor do they provide any guidance for the preparation of the Annual Aid Implementation Program or annual budgets. Moreover, the CPS system does not solve the problem of aid coordination and cooperation among aid agencies, especially Korea's numerous grant aid agencies, since the document does not discuss or include any implementation programs or projects at a recipient country level. Although the Five-Year Aid Plan provides a broad guide to the emphasis of EDCF's loan aid programs (e.g. infrastructure, green growth, climatic change preparedness), no guidelines have yet been provided for the division of labor or specialization among more than thirty grant aid agencies.

Selection of Recipients and Aid Allocation Criteria

The Special Review Report (OECD 2008) recommended that Korea should pay more attention to aid for the least developed (LDCs) and other low income developing countries (LICs), and should clarify the criteria for selecting recipient countries, allocating aid transparently among countries. To assess the progress made since the OECD report, it is useful to review Korea's aid allocations by recipient's income level, region, and sector.

Aid Allocation by Income Level

One of the most critically reviewed issues by the OECD team in 2008 was Korea's aid allocation by recipient's income level.

The review criticized Korea's allocation of grants and loans, which went against generally agreed upon international aid policies, such as poverty reduction or achievement of the Millennium Development Goals (MDG). The criticism is summarized as follows, using the KOICA and EDCF aid only, which accounted for about 80 percent of total bilateral ODA during 2005-07.

First, KOICA and EDCF allocated only 35 percent of total bilateral aid to the least developed (LDCs) and other low income countries (LICs), well below the DAC average of 44 percent. At the same time, the agencies allocated 56 percent of total bilateral aid to middle income countries (MICs).

Second, while EDCF—the loan agency—allocated loans mostly to LDCs (63 percent; and including LICs 54 percent), KOICA—the grant agency—allocated grants mostly to lower middle income countries (LMICs 68 percent). In other words, Korea allocated grants to LMICs, which have relatively greater capacities to repay debts, but provided loans to LDCs and LICs, which generally have weaker capacities to service debts. Such aid allocation policies were not only inequitable, but also would jeopardize debt sustainability in LDCs and LICs, and would risk the achievement of the MDGs. Such aid allocation practices were indicative of Korea's lack of a coherent or integrated aid framework and policies at a national level.

However, during the period 2008-10, Korea has shown starkly clear changes in aid allocation practices, reflecting the OECD's recommendations. First, of the total bilateral aid by KOICA and EDCF, aid to LDCs and LICs increased from 35 percent during 2005-07 to 43 percent during 2008-10, which is nearly the same level as the DAC average. Aid to MICs decreased from 56 percent to 49 percent, with aid to LMICs in particular seeing a drop. Second, of the total KOICA and EDCF aid given to LDCs, the share of loans decreased from 63 percent to 45 percent, and the share of grants rose from 37 percent to 55 percent, a change that likely contributed to poverty reduction and achievement of the MDGs. Such changes are due to policy shifts by the KOICA and EDCF, as well as coordination efforts made by the Prime Minister's office and the Committee on International Development Cooperation.

Aid Allocation by Region

During 2005-07, the bilateral ODA by KOICA and EDCF focused on Asia by allocating 35 percent of total aid. The OECD's Special Review Report (2008) called the practice understandable, which is to be expected since the DAC recommended a focus and concentration in aid allocations. During 2008-10, the bilateral ODA by KOICA and EDCF allocated 55 percent of aid to Asia. KOICA's aid to Asia (47 percent) almost attained the Mid-term ODA Plan (2008-10) goal for grant aid of 50 percent.

Korea also increased its aid to high-poverty-rate Africa, from 13 percent to 15 percent of total bilateral aid. KOICA's aid (17 percent) almost attained the grant aid goal of 20% set in the Mid-term ODA Plan. Korea's aid to Africa was expected to increase sharply since the country announced its Initiative for Africa Development in 2006 with the aim of tripling aid to that continent by 2008. Although the goal was not quite attained, aid to Africa nearly doubled from a total of $154 million to $278 million during the two periods compared.

Table 1 Korea and DAC: Aid Allocation by Recipients' Income Level, 2005-07 (net ODA)

Countries	Korean ODA Average (2005-2007)						DAC average (2005-2007)	
	KOICA (grant)		EDCF (loan)		Total			
	$ (million)	%	$ (million)	%	$ (million)	%	$ (million)	%
Least Developed	39	17.2	65	39.3	103	26.6	28,962	27.1
		37		*63*		*100*		
Other Low Income	25	11.1	9	5.4	34	8.7	17,543	16.4
		74		*26*		*100*		
Lower Middle Income	127	56.5	59	35.7	186	47.7	31,903	30
		68		*32*		*100*		
Upper Middle Income	5	2.2	26	15.8	31	8.0	4,220	4
		16		*84*		*100*		
Unallocated	29	13.0	6	3.8	36	9.1	24,091	22.5
Total	*225*	*100.0*	*165.0*	*100.0*	*390*	*100.0*	*106,680*	*100.0*

Table 2 Korea and DAC: Aid Allocation by Recipients' Income Level, 2008-10 (net ODA)

Countries	Korean ODA Average (2008-2010)*						DAC average (2008-2010)*	
	KOICA		EDCF		Total			
	$ (million)	%	$ (million)	%	$ (million)	%	$ (million)	%
Least Developed	112	33.4	90	32.3	202	32.9	41,398	32.2
		55		*45*		*100*		
Other Low Income	54	16.2	8	2.8	62	10.1	13,753	10.7
		87		*13*		*100*		
Lower Middle Income	118	34.9	135	48.2	252	41.0	28,028	21.8
		47		*53*		*100*		
Upper Middle Income	6	1.7	42	15.0	48	7.7	7,832	6.1
		12		*88*				
Unallocated	47	13.9	5	1.7	51	8.3	37,646	29.2
Total	*336*	*100.0*	*279*	*100.0*	*616*	*100.0*	*128,657*	*100.0*

The OECD Special Review Report recommended that Korea give adequate consideration to the aid policies and practices of other numerous and active donors in Africa and to the relatively high income level and low poverty rates in Latin America. In fact, Korean aid to Latin America increased from 6.5 percent to 10 percent of total bilateral aid during the two periods compared. However, KOICA provided only 11 percent of its total aid to Latin America, which is much lower than the goal for grant aid to the region (15 percent) set in the Mid-term ODA Plan. This means that the increase in aid to Latin America, the relatively high income region, was made mainly by EDCF loans and was consistent with the OECD recommendation.

Korean aid in the Middle East did not meet its goals. KOICA and EDCF were tasked with providing $100 million each in grant and loan aid to Iraq under the Mid-term ODA Plan. However, the two agencies fell far short of this target.

Aid Allocation by Sector

The OECD Special Review Report (2008) recommended that Korea's aid should focus on two-to-three sectors in each recipient country, taking into account the aid provided by other donors in the same country and the comparative advantage of Korean aid in those sectors. The special report pointed out that Korea tended to spread its relatively small amount of total aid too thinly across many countries and sectors.

However, during 2008-10, Korea's aid allocation by sector failed to make progress. Korea offered aid to all countries and sectors covered by other DAC member states. For example, on the one hand, KOICA offered grant aid for seven sectors on average in each of some sixty ordinary partner countries and for the multi-sector at a rate much higher than the DAC average (18 percent versus 9 percent). On the other hand, it offered no aid for the program sectors (sector or budget supports) and reduced humanitarian sector aid from 7 percent to 4 percent, which is much smaller than the 8 percent DAC average.

During 2008-10, social-administrative infrastructure sector aid made up 42 percent of total Korean ODA, which is somewhat higher than the DAC average (39 percent). However, during the same period, economic infrastructure sector aid made up 32 percent of total Korean ODA, which is much higher than the DAC average (17 percent). These results may be due in part to the peculiar aid policies in Korea. EDCF loans, which share a greater part of total bilateral aid relative to other DAC member states, focus on economic infrastructure. However, KOICA's grant aid also covers economic infrastructure at 18 percent of its total. Likewise, EDCF's loans also allocate a high share to social-administrative infrastructure at 40 percent of its total.

Aid for economic infrastructure contributes more effectively to economic growth in a shorter period, while aid for social-administrative services contributes to economic growth over a relatively longer period of time, but more effectively improves welfare of the poor in the short-run (Radelet et al 2005). Therefore, loans may focus more on aid for economic infrastructure to generate funds to be used for repaying the loans in a shorter period, while grants may concentrate on aid for social-administrative infrastructure and services.

Table 3 Korea and DAC: Aid Allocation by Region, 2005-07 (net ODA)

Region	Korean ODA Average (2005-2007)						DAC average (2005-2007)	
	KOICA		EDCF		Total			
	$ (million)	%	$ (million)	%	$ (million)	%	$ (million)	%
Africa	27	12.1	24	14.6	51	13.1	39,257	36.8
		53		*47*		*100*		
Asia	76	33.7	97	58.9	173	44.6	20,275	19
		44		*56*		*100*		
Latin America	21	9.1	11	7.0	32	8.2	6,885	6.5
		66		*34*		*100*		
Middle East	64	28.4	11	6.6	75	19.2	17,713	16.6
		85		*15*		*100*		
Oceania	1	0.3	-	-	1	0.2	1,217	1.1
		100.0		*-*	*100*	*100*		
Europe	8	3.5	15	9.2	23	5.9	4,418	4.1
		35		*65*		*100*		
Unallocated	29	12.8	6	3.8	35	9.0	16,915	15.9
Total	*225*	*100.0*	*165*	*100.0*	*390*	*100.0*	*106,680*	*100.0*

Table 4 Korea and DAC: Aid Allocation by Region, 2008-10 (net ODA)

Region	Korean ODA Average (2008-2010)						DAC average (2008-2010)	
	KOICA		EDCF		Total			
	$ (million)	%	$ (million)	%	$ (million)	%	$ (million)	%
Africa	59	17.4	34	12.2	93	15.0	46,971	36.5
		63		*37*		*100*		
Asia	157	46.6	183	65.4	339	55.1	26,437	20.5
		46		*54*		*100*		
Latin America	36	10.8	24	8.7	61	9.8	9,707	7.5
		59		*41*		*100*		
Middle East	19	5.8	5	1.9	25	4.0	13,263	10.3
		23		*77*		*100*		
Oceania	-	-	-	-	-	-	1,704	1.3
Europe	19	5.6	28	10.1	47	7.7	5,608	4.5
		40		*60*		*100*		
Unallocated	47	13.8	5	1.7	51	8.3	24,967	19.4
Total	*336*	*100.0*	*279*	*100.0*	*616*	*100.0*	*128,657*	*100.0*

By allocating their aid according to recipients' income level, KOICA's grants and EDCF's loans made progress in improving their division of labor and specialization. Likewise, these aid agencies need to work more on allocating their aid by sector as well. In particular, the numerous aid agencies offering grants should develop a clear division of labor and specialization among themselves. The Committee on International Development Cooperation and MOFAT, the controlling and coordinating agencies for grant aid, should take up the challenge rigorously.

An Econometric Analysis of Aid Allocation Criteria

The OECD Special Review Report (2008) argued that Korea's aid recipients were too numerous and that the criteria for selecting recipients and allocating aid were unclear. In 2008, the number of recipients reached 129 countries, which were divided among three groups: priority, ordinary, and other recipients. The priority recipients included nineteen countries in the KOICA list and eleven countries in the EDCF list. However, seven priority countries were common to both lists, and therefore there were a total of twenty-three priority countries. Both the criteria for selecting those countries and the criteria for allocating aid to those three groups of countries were unclear. Although the Mid-term ODA Plan indicates that priority countries were those with Korean embassies, the list included some priority recipient countries without a Korean ambassador. The Basic Law of 2010 indicates that the priority countries are basically the LDCs, but there are many non-LDCs on the list. The difference between the ordinary and other recipients is also unclear.

During the period 2008-10, there was little progress in reducing the number of recipients and clarifying the criteria for electing countries and allocating aid to them. However, few DAC member countries have clarified the country selection or aid distribution criteria (except perhaps the Millennium Challenge Corporation of the U.S.). Even when some member countries declared their policies or criteria, there were substantial gaps between the announced policies and actual practice (Alesina and Dollar 2000, Alesina and Weder 2002, Easterly and Pfutze 2008).

Some recent empirical studies of the data during the 1990s (and through 2003) indicate that DAC members increasingly selected recipient countries and allocated aid to them in accordance with the aid objective of poverty reduction (Dollar and Levin 2004;

Table 5 Korea and DAC: Aid Allocation by Sector, 2005-07 (net bilateral ODA)

Sector	Korean ODA Average (2005-2007)						DAC average (2005-2007)	
	KOICA		EDCF		Total			
	$ (million)	%	$ (million)	%	$ (million)	%	$ (million)	%
Social-Administrative Infrastructure	111	49.5	61	36.9	172	44.2	37,764	35.4
		65		*35*		*100*		
Economic Infrastructure	51	22.5	84	50.9	135	34.5	12,374	11.6
		38		*62*		*100*		
Production	11	4.7	12	7.1	22	5.7	5,654	5.3
		50		*50*		*100*		
Multi-sector	33	14.9	1	0.4	34	8.8	6,934	6.5
		97		*3*		*100*		
Program	-	-	-	-	-	-	3,520	3.3
Humanitarian	16	6.9	-	-	16	4.0	8,644	8.1
		100				*100*		
Others (debt service, adm., other)	3	1.5	8	4.6	11	2.8	31,790	29.8
		27		*73*		*100*		
Total	*225*	*100.0*	*165*	*100.0*	*390*	*100.0*	*106,680*	*100.0*

Table 6	Korea and DAC: Aid Allocation by Sector, 2008-10 (net bilateral ODA)							
Sector	**Korean ODA Average (2008-2010)***						**DAC average (2008-2010)***	
	KOICA		EDCF		Total			
	$ (million)	%	$ (million)	%	$ (million)	%	$ (million)	%
Social-Administrative Infrastructure	147	43.8	110	39.5	258	41.9	49,469	38.45
		57		*43*		*100*		
Economic Infrastructure	60	17.9	136	48.5	196	31.8	21,550	16.75
		31		*69*		*100*		
Production	30	9.1	27	9.5	57	9.3	9,135	7.1
		53		*47*		*100*		
Multi-sector	60	17.9	2	0.6	62	10.1	11,836	9.2
		97		*3*		*100*		
Program	-	-		-	-	-	5,403	4.2
Humanitarian	14	4.0	-	-	14	2.2	10,679	8.3
		100				*100*		
Others (debt service, adm., other)	24	7.2	5	1.9	30	4.8	20,585	16
		80		*20*		*100*		
Total	*336*	*100.0*	*279*	*100.0*	*616*	*100.0*	*128,657*	*100.0*

Berthelemy and Ticher 2004; Claessens, et al 2007; Bandyopadhyay and Wall 2007). That is, DAC members increasingly allocated more aid to those developing countries with lower per-capita income, greater needs for human capital development, sounder political and economic policies and institutions, and a larger number of poor people. However, the studies did not reveal consistent results, and the estimation models were fraught with defects or weaknesses. Therefore, this paper makes an empirical analysis, overcoming the defects of the past estimation models, and using data on 157 recipient countries and twenty-three donor countries during the period 2005-10 (Annex 1). The analysis aims to confirm whether DAC member states, including Korea, provided ODA in a manner consistent with the optimum aid allocation model for poverty reduction (Collier and Dollar 2002).

The generalized least square model with heteroskedasticity to estimate the aid allocation practice of DAC member states can be expressed as follows:

$A_{ijt}= a_0+b_i+c_t+d_j+fX_{ijt}+e_{ijt}$ (1)

A_{ijt} : bilateral ODA from each donor country (j) to each recipient country (i) over the sample period (t)

a_0 : common intercept

b_i : recipient country dummy, specific to each recipient but fixed over the period

c_t : year dummy, common to all countries in the sample but varies over the period

d_j : donor country dummy, specific to each donor but fixed over the period

X_{ijt} : independent variables including all variables explaining recipient countries' developmental needs and donor countries' economic interests in offering aid to recipients (i.e., per capita income and its squared value, infant mortality rate and its squared value, index of civil rights/participation rights, index of government effectiveness, size of population and its squared number, imports from the donor and its squared value, exports to the donor and its squared value, foreign direct investment from the donor and its squared value).

Estimation of DAC Members' Aid Allocation Criteria

The results of the analysis conducted for twenty-two DAC member states excluding Korea can be summarized as follows (Lee 2011). First, DAC member states did provide more aid to those countries with lower per-capita real income and a larger population. However, the aid level was in a negative relationship with the civil rights and government effectiveness levels. Moreover, the need for human capital development, reflected in such measures as the infant mortality rate, was not seriously considered. Such practice contravenes the optimum aid allocation model. On the other hand, DAC member states also seriously considered their own economic interests in actual aid allocation practice. More aid went to those countries that import more from and export more to the donor country, although investment in the aid recipient countries (FDI) did not show a relationship at a statistically significant level.

Estimation of Korea's Aid Allocation Criteria

The same model was applied to the total aid by KOICA and EDCF during the periods 2005-07 and 2008-10, respectively, to ascertain any progress made toward the optimum aid allocation model for poverty reduction.

The results indicate that the total aid allocation by Korea made statistically significant progress toward the optimum aid allocation model between the two periods compared (Annex 2). During the Mid-term ODA plan period (2008-10), Korea provided more aid to countries with lower per-capita real income, higher infant mortality rates, and a larger number of the population. Moreover, more aid was provided to countries with higher levels of government effectiveness. However, total aid allocation by Korea during this period did not consider the civil rights level, which was well considered in the previous 2005-07 period.

On the other hand, Korea's total aid allocation in 2008-10 did not consider national interests, as was the case in the previous period. Imports from the recipient countries and exports to the recipients did not have any statistically significant influence on aid amount to recipients. This situation goes well for the modernization of Korea's aid system. However, it contravenes the domestic mandates given to KOICA and EDCF, since their organic laws, as well as the Basic Law on International Development Cooperation, stipulate that they should pursue the economic development of recipient countries and "mutual exchanges and friendships" at the same time.

On average, other DAC member states significantly follow their national mandates, which are often specified as their aid aim in either their laws or basic policy documents, such as "mutual benefits" (e.g. Netherlands), "national security" or "foreign policy objectives" (e.g. U.S.). These examples point to the difference between development assistance by the private sector (corporations, NGOs, philanthropic organizations, etc.) and official development assistance by governments and governmental organizations. Korea should strive to strike a balance between the competing objectives of ODA, as other advanced DAC member governments have done.

Multilateral Aid Allocation

Korea maintained about 30 percent of its total ODA for multilateral aid, i.e., non-earmarked contributions to intergovernmental organizations, as other DAC member states did. While this share was only 17 percent in 2006; it rose sharply to about 30 percent on average during 2007-10, although the share declined to 23 percent in 2010. Korea even joined the Multilateral Organizations Performance Assessment Network (MOPAN) with other DAC members in 2008.

As in bilateral ODA, the most critical issue in multilateral aid for Korea is a lack of a coherent allocation mechanism. During 2005-07, more than twenty government ministries, including the MOFAT, allocated aid to some eighty inter-governmental organizations. Korea has contemplated establishing a guideline for cooperating with international organizations, since ministries and government agencies were aiding numerous international organizations with overlapping small contributions and programs. However, the government has not yet developed any overarching and coherent strategy document to set priorities among competing objectives and international organizations.

Conclusions and Future Challenges

This paper aims to assess the progress made in ODA management by Korea since it expressed its interest in joining the DAC in 2008. Since the topic to be covered is so broad, this paper focuses on those issues and problems most critically reviewed by the OECD Special Review Report of 2008. They can be summarized as the scale and terms of aid, and a lack of a coherent aid management framework and aid allocation criteria.

Regarding the scale and terms of aid, Korea has made satisfactory progress since 2008. While total government expenditure rose by 7 percent per year, total aid increased by 29 percent per year. Based on this trend, it is expected that Korea will most likely attain its promised net ODA goal of 0.25 percent of GNI by 2015 and terms of ODA commitments comparable to those of other DAC member states.

As to the need for a unified and coherent aid framework encompassing all aid agencies and programs, substantial progress has been made since 2008. The Basic Law on International Development Cooperation (2010) mandated that Korea formulate an integrated Five-Year Aid Plan and the Annual Aid Implementation Plan. The Committee on International Development Cooperation, led by the Prime Minister, was designated as the apex agency for deliberation and coordination of all ODA related matters, and the MOFAT and MOSF assumed the responsibilities for monitoring, coordinating, and supporting all grant and loan aid agencies and programs, respectively. A new list of twenty-six priority aid recipients, which is common to both grant and loan aid programs, was drawn up, and an integrated country partnership strategy document was prepared for each of three priority recipients in consultation with all stakeholders. However, the documents contain only strategy; an integrated implementation program covering three-year aid activities of all grant and loan programs per country has yet to be prepared and included in each of the strategy document. Moreover, the linkage between this country partnership strategy document and the Annual Aid Implementation Program as well as the annual budget proposal should be established and strengthened over time.

Although clear policies and criteria for selecting aid recipient countries and allocating aid have not been announced yet, grant/loan coordination in allocating aid by recipient countries' per capita income and region has substantially improved during the 2008-10 period. Contrary to the earlier period of 2005-07, grant aid tends to focus on the least developed or lower income countries, while loan aid focuses more on middle income countries. However, a coordination challenge still remains in allocating aid by country and sector. The challenge of clarifying the criteria for division of labor or specialization by sector at each recipient country level still remains between grant and loan aid agencies, in particular among more than thirty grant aid agencies. Moreover, Korea still tries to spread a small amount of total aid too thinly across some 130 developing countries. The total number of recipient countries may not be easily reduced. However, the major aid agencies like KOICA and EDCF should concentrate mainly on delivering aid to priority and ordinary recipient countries, and aid for the rest of the countries should be relegated to other numerous public aid agencies and private sector aid agencies like corporations and NGOs. Even for the priority and ordinary recipient countries, a challenge remains in reflecting the "Busan Partnership for Effective Development Cooperation" with other public aid agencies and the private sector organizations (OECD 2011).

To estimate the actual criteria for selecting recipient countries and allocating aid, an econometric analysis was conducted with an improved estimation model and the most recently available data. Although Korea's aid allocation does not quite reach the level of other DAC member states, the country has made progress toward selective (or modernized) aid allocation. Since 2008, it has allocated more aid to countries with lower per-capita income, greater needs for human development, a larger number of poor people, and a more effective government. However, Korea has not taken into account policies and political institutions, such as the promotion of civil rights/participation, and national economic interests simultaneously.

The Five-Year Aid Plan (2011-15) emphasizes the need to tackle these remaining issues and challenges, but does not provide specific policies or programs. The Committee on International Development Cooperation and monitoring agencies, such as the MOFAT and MOSF, should show leadership and work harder with other stakeholders to fill that void.

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Annex 1 Sources of Data

Variable	Source	URL
ODA- DAC member	OECD	http://stats.oecd.org/index.aspx?r=427326
ODA- Korea	KOICA	http://stat.koica.go.kr:8077/komis/jsptemp/ps/stat_index.jsp
GDP Deflator	World Bank	http://databank.worldbank.org/ddp/home.do?Step=2&id=4&DisplayAggregation=N&SdmxSupported=Y&CNO=2&SET_BRANDING=YES
GDP per capita	World Bank	http://databank.worldbank.org/ddp/home.do?Step=2&id=4&DisplayAggregation=N&SdmxSupported=Y&CNO=2&SET_BRANDING=YES
Infant Mortality	World Bank	http://databank.worldbank.org/ddp/home.do?Step=2&id=4&DisplayAggregation=N&SdmxSupported=Y&CNO=2&SET_BRANDING=YES
Civil Liberty & Political Rights	Freedom House	http://www.freedomhouse.org/templatecfm?page=25&year=2010
Govt. Effectiveness	World Bank	http://databank.worldbank.org/ddp/home.do?Step=2&id=4&DisplayAggregation=N&SdmxSupported=N&CNO=1181&SET_BRANDING=YES
Population	World Bank	http://databank.worldbank.org/ddp/home.do?Step=2&id=4&DisplayAggregation=N&SdmxSupported=Y&CNO=2&SET_BRANDING=YES
Export to the Donor	UNCTAD	http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx
Import from the Donor	UNCTAD	http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx
FDI from the Donor	OECD	http://stats.oecd.org/index.aspx?r=427326
FDI from Korea	Korea Eximbank	http://odisis.koreaexim.go.kr/fv/fvweb/login.jsp

Annex 2 Korea and DAC: Regression Analysis of Aid Allocation (net bilateral ODA)

Dependent Variable: Aid Amount ($ in constant 2005 price)	**DAC Members (2005-09)**	**KOICA+EDCF (2008-10)**	**KOICA+ EDCF (2005-07)**
Recipient Fixed Effects	Y	Y	Y
Time Dummy	Y	Y	Y
Donor Dummy	Y	Y	Y
Common Intercept	57.81821* (18.80)	52.67486* (3.07)	2.683334 (0.88)
Real GDP per capita	-1.812406* (-5.13)	0.027868* (-24.71)	(dropped)
Real GDP per capita squared	0.0775636* (4.70)	1.29E-06* (34.96)	-1.14E-06* (-52.96)
Infant Mortality	-0.0593616 (-0.47)	0.2771697* (5.09)	0.0318128 (0.77)
Infant Mortality squared	-0.001732* (-2.21)	-0.002664* (-5.17)	-0.000306 (-1.04)
Civil Liberty & Political Rights	-0.490909* (-3.12)	0.0021943 (0.09)	0.2347748* (3.8)
Govt. Effectiveness	-1.984915* (-2.89)	1.597834* (2.51)	0.0871865 (0.38)
Population	0.3969686* (2.89)	0.0011204* (31.25)	(dropped)
Population squared	-0.000157 (-1.79)	-2.94E-10*(-30.71)	1.33E-12* (6.20)
Real Export to the Donor	4.32E-07*(2.45)	2.14E-07 (1.23)	-3.71E-07 (-1.79)
Real Export to the Donor Squared	-3.90E-15* (-5.20)	5.81E-15 (0.57)	1.03E-14 (0.43)
Real Import from the Donor	1.30E-06* (4.20)	-3.54E-08 (-0.2)	4.62E-07 (1.85)
Real Import from the Donor wSquared	3.77E-14* (2.46)	-1.28E-15 (-0.93)	-3.55E-14 (-1.26)
Real FDI from the Donor	0.0015829 (1.88)	7.94E-07 (0.19)	9.70E-07 (0.35)
Real FDI from the Donor Squared	-5.84E-09 (-0.03)	-8.64E-13 (-0.24)	2.22E-12* (2.29)
No. of Observations	5,540	336	366
Overall Specification Test	Wald chi^2 (170)=30882 Prob>chi^2=0	Wald chi^2(124)=58859.21 Prob>chi^2=0	Wald chi^2(131)=6000.33 Prob>chi^2=0

KOREA'S ROLE AND THE ACHIEVEMENTS OF THE FOURTH HIGH LEVEL FORUM ON AID EFFECTIVENESS IN BUSAN

By Enna Park

Abstract

On 29 November 2011, over 3,000 participants gathered in the bustling city of Busan to seek a new consensus on aid and development. The Busan Forum on Aid Effectiveness (HLF-4) represents a turning point in global development by shifting the paradigm from aid to development effectiveness and forging a new global partnership for development. The promise of the Busan Partnership will be met when the political momentum and active participation by all development stakeholders continue.

Background

Three years ago, in March 2009, the decision was made in Paris that Korea would host the last High Level Forum on Aid Effectiveness (HLF-4) with the unanimous support of all the members of the Working Party on Aid Effectiveness (WP-EFF). Korea's hosting the global development event holds special meaning in the history of development cooperation.

Despite the remarkable economic progress in emerging and developing countries, poverty remains a global challenge. In addition, recurring global crises such as climate change, food insecurity, and financial instability have posed a great threat to both developed and developing countries.

The donor community has made significant efforts in terms of expanding the assistance to developing countries through Official Development Assistance (ODA) and enhancing the quality of aid with a series of OECD-led high level forums on aid effectiveness starting in Rome in 2003. Yet, the results of development cooperation have been not fully satisfactory.

With the target year of the Millennium Development Goals (MDGs) approaching in less than four years, the Busan Forum was uniquely positioned to take stock of progress and challenges in the past and to define new directions in development cooperation. In this context, Korea, as an exemplary case of showcasing the power of effective aid, offered an inspiriting setting to discuss aid effectiveness and to look beyond the horizon of aid toward effective development cooperation.

Lessons Learned

Five years of implementing the Paris Declaration and a global reflection on the changing development landscape have left invaluable lessons, putting the Busan Forum in a different context from previous forums.

As evidenced in the three-time monitoring surveys and independent evaluations, aid effectiveness matters for development results. Yet, political will, especially from the donor, is critical to bring further progress. The call for moving from the process-oriented, technical talks to more focus on sustainable development results has been increasing throughout the years.

At the same time, the global community needs to adapt to a series of changes in the global development landscape. While North-South cooperation remains the mainstream of development cooperation, developing countries are increasingly becoming vital sources of trade, investment, knowledge, and development cooperation. Moreover, NGOs, global programs, private funds and businesses are actively engaging in development, providing innovative thinking and approaches to development. The diversity of development players and the expansion of development resources beyond aid are reshaping the global development architecture. This means that the development agenda set and led by donor countries alone will no longer be relevant and effective. This change calls for more inclusive development partnership.

In addition, as an Organization for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC) Chair previously noted, the global development community is now moving from "a transactional aid relationship" to a "transformational development relationship." Aid is an important, but limited, resource for development. It is time to deepen the understanding of development in a broader context. As development is increasingly intertwined with other policy issues—such as trade, investment, the environment, security, etc.—promoting greater coherence among these policies is essential to producing better development results.

Key Achievements in Busan

Against this backdrop, the Busan Forum marked a turning point in development cooperation by making an important step forward in several ways.

Political Discussion on Aid and Development

The Busan Forum brought together the broadest range of stakeholders in development. Several heads of states, over 100 ministers from 160 countries, 30 heads of international organizations, around 90 parliamentarians, 300 partners from civil society organizations, and more than 100 representatives from the private sector and academia attended the meeting.

Most notably, there were high-profile political leaders in Busan including President Lee Myung-bak, President Paul Kagame of Rwanda, Prime Minister Meles Zenawi of Ethiopia, Secretary of State Hillary Clinton, UN Secretary General Ban Ki-Moon, and OECD Secretary General Angél Gurría.

The unprecedented high level of participation reflected the gravity of responsibility and enthusiasm for the work they are undertaking in Busan. All development actors represented in Busan were tasked with responding to the increasing call for more effectiveness, accountability and, most importantly, results of their efforts.

Truly Multi-Stakeholder Partnership: Busan's Contribution to MDG 8

Unlike previous forums, the Busan Forum was attended by a large number of diverse development actors beyond governments and international organizations. With Korea's leadership, several multi-stakeholders events were organized including the Parliamentarian Forum, the Private Sector Forum, and the Youth Forum. Also, prior to the main event, the Civil Society Forum was organized with over 500 participants.

The Busan Forum recognized these development actors as true partners in development and facilitated their substantive contributions to the Busan agenda and the outcome document, contributing to realizing the MDG goal of global partnership for development.

From Aid to Development Effectiveness

It was well noted that there was much “unfinished business” in the aid effectiveness journey as only one of thirteen indicators of the Paris Declaration had been met. In response, the participants in Busan agreed to keep the promise on aid effectiveness by renewing core commitments including transparency, predictability, accountability and agreeing to monitor progress.

However, deepening the aid effectiveness agenda would not suffice to promote sustainable growth and development, and to respond to the rapidly changing world. To make development happen and enhance the impact of cooperation, there is a need to take a broader approach to development. Some critics argued that Busan was facing the risk of being “a lowest-common denominator without bite or focus by becoming more general and inclusive” and diluting the level of commitment by donors. However, sticking to the previous aid effectiveness agenda would make Busan even less significant.

To large extent, Korea’s vision for development effectiveness was largely based on its own development experience. And it was well supported by African countries through the Tunis Consensus. Aid should be used as a catalyst to leverage other development financing including trade, private investment, and domestic resources. By doing so, it can create the enabling environment to realize the country’s own potential for growth and development.

OECD-UN Joint Partnership

Another initiative proposed by Korea was to forge more systematic cooperation among global development fora, calling for a synergic partnership between the OECD and the United Nations (UN) for the first time in the history of global development cooperation. This proposal was well received by the participants and incorporated into the outcome document.

Departing from the previous process led by donor countries, the Busan Forum demonstrated that developing countries can and should take the lead in setting the development agenda. The participants also recognized the role of the UN in enhancing effective development cooperation and invited the United Nations Development Programme (UNDP) along with the OECD to work together in supporting the effective functioning of the Busan Partnership. Given the UN’s universal convening power and the UNDP’s field presence in developing countries, inviting the UNDP as a core partner is expected to provide greater legitimacy and political clout to the new partnership.

Issues and Breakthroughs

The outcome document, Busan Partnership for Effective Development Cooperation, was the result of an inclusive year-long process of consultation with a broad range of governmental, civil society, and private actors in development.

A small group of sherpas representing each constituency were responsible for negotiating the document. Like any other international negotiation processes, the Busan outcome document was finalized after a great deal of political nudge and compromise. Korea, as host country, played brokering roles and exerted diplomatic leadership to bridge the gap of differences and bring key issues into the consensus.

South-South Cooperation Providers

The Busan Forum marked a significant progress in engaging South-South cooperation partners by recognizing their complementary roles and creating a space for them under the principle of “common but differential commitments” and “voluntary participation” in the partnership.

The outcome’s second paragraph clearly states, “The principles, commitments and actions agreed in the outcome document in Busan shall be the reference for South-South partners on a voluntary basis.”

Arguably, the paragraph lessened the overall ambition of Busan commitments. However, it is neither legitimate nor realistic to apply the same standards to South-South Cooperation providers as traditional donors. South-South partners have a relatively short history of development cooperation as providers. Also, they remain developing countries and face poverty at home. As the Mexican sherpa articulately explained during the negotiation, the engagement of South-South cooperation partners should be approached with a progressive manner. The so-called “twin-track” deal, thus, was an optimal option grounded on the careful political calibration of changing realities.

Korea’s Gender Initiative

Korea’s proposal to include gender equality in the Busan agenda was not enthusiastically received at the initial stage. However, Korea, in close cooperation with the United States, the UN Women, and the GENDERNET, successfully placed the issue high on the effectiveness agenda.

The political support rendered by the UN Women and Secretary of State Clinton was also instrumental to highlighting the significance of gender equality and women’s empowerment for development effectiveness. As a result, a special session on Gender Equality was organized as the main event of the Busan Forum and a Joint Action Plan for Gender Equality and Development was adopted. More than twenty countries and organizations rendered support to this voluntary action plan.

The Role of Private Sector

Another notable aspect of Busan was the active involvement of the private sector. For the first time, over 100 representatives from the private sector participated in the Busan Forum as full members of the broader effectiveness partnership, including large and small firms from both developed and developing countries.

Korea was among the leaders like the United States to advocate the role of private sector in development. A strong private sector and well-functioning market has been the key driver of poverty reduction, job creation, and sustainable growth in Korea. However, the private sector's contribution should not be confined to funding only, but involve market-driven technical input as well as training and capacity building. For this, a model where a profit objective meets with a development objective should be adequately explored.

The notion that development and the emergence of new markets can benefit the business's long-term profits was addressed in A Joint Statement on Expanding and Enhancing Public and Private Co-operation for Broad-based, Inclusive and Sustainable Growth at the Private Sector Forum. This statement was endorsed for the first time by both representatives from the public and the private sector in Busan.

Effective Institutions

Effective institutions are important to deliver development results in a sustainable and holistic manner. This issue was broadly recognized at the Busan Forum where thirty organizations and countries endorsed a New Consensus on Effective Institutions.

Strengthening effective institutions covers the issues beyond the existing work on the use of country system and procurement, and addresses the importance of political economy of reform, capacity building, and institutional changes.

Busan Follow-up

The outcome document has left the details of the Busan Partnership to be determined after the Busan Forum. The mandate of the Working Party on Aid Effectiveness has been extended to prepare for this transition period. Making maximum use of the existing group of sherpas who successfully negotiated the Busan outcome document, the members of the Working Party agreed to form a Post-Busan Interim Group (PBIG) to prepare detailed transition plans and lead consultative processes. The members of the PBIG have been extended from the existing sherpas to ensure a broader inclusiveness of stakeholders. After broad consultations, the final proposals of the working arrangements and the global monitoring framework of the Busan Partnership will be submitted to the last Working Party on Aid Effectiveness meeting in June for endorsement.

Closing

Busan represents the high aspirations of the global development community for effective development cooperation. The impact of the new Global Partnership largely depends on support by all development stakeholders. In particular, the voluntary and proactive participation of emerging economies is essential to drive the new global partnership forward. Building trust through policy dialogues and knowledge sharing should be the starting point to work with the new partners. However daunting a task this may be, the Busan Forum demonstrated that with right spirit and strong political will, progress can be made. The Republic of Korea will remain fully committed to working closely with the global community to make the Busan spirit alive throughout the progressive transformation of the new global partnership.

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KOREAN PUBLIC OPINION ABOUT DEVELOPMENT AID

By Kwon Yul and Park Sukyung

Abstract

Since joining the OECD Development Assistance Committee (DAC) in 2009, Korea as a new donor has been actively carrying out reforms to improve its development aid system. This article provides recent trends of public opinion in Korea on issues of aid and development cooperation by presenting the survey results. It introduces the background of past opinion polls and presents public attitudes and perceptions in Korea on foreign aid. It identifies the level of public support, awareness, motives for aid giving, priorities in development aid, as well as the assessment of the contribution of Korea's official development assistance (ODA). Finally, it examines how the Korean government could respond to challenges to improve the effectiveness of development cooperation and to convince its citizenry to pursue its ambitious aid policy.

Introduction

Korea's history as an official donor country and an OECD DAC member is short, but this new donor country has been proactive in setting a foundation for development cooperation since it accession to the DAC in November 2009. Followed by the first ODA reform plan in November 2005, the International Development Cooperation Act was enacted in early 2010 and the ODA Advancement Plan was also prepared in October 2010.

Despite the achievements and progress it made, Korea still has a long way to go in order to improve the quantity and quality of its aid. Korea pledged to the international development community to expand its aid volume to achieve an ODA/GNI ratio of 0.25 percent by 2015, which requires doubling of the current level of ODA budget. Besides this challenge, Korea has been facing several aid effectiveness issues such as fragmentation in aid implementation, a bifurcated aid delivery system and lack of coordination.

As Korea is scheduled to have its first official DAC peer review in 2012, it would be timely and meaningful to review the achievements of and changes in Korea's development cooperation for the past two years since its accession to DAC through the eyes of the Korean public. As the discussion on the reform of aid policy and management system is ongoing, Korea needs to closely monitor how the public's perception of global development, poverty issues and international development cooperation policies has been shaped.

This paper reviews how Korean citizens perceive the relatively new issue of development cooperation and how the Korean government could pursue its policy objectives based on public awareness and opinion. Particularly, it analyzes the level of public support, awareness, preference and participation about foreign aid in Korea to see how it has evolved over time and how it relates to Korea's ODA policy and practice. Furthermore, we will also make comparisons with other countries' public survey results where relevant to find out unique or common characteristics of Korean public opinion in a broader context.

Trends in Public Opinion on Development Aid in Korea

Background of Surveys on Development Aid in Korea

Facing a downturn in the level of ODA spending after the Asian financial crisis in the late 1990s, public surveys on foreign aid in Korea began. The first survey was initiated by KOICA in 1999 and MOFAT[1] conducted another survey in 2002 for the targeted group of 'opinion leaders' who are more engaged in ODA policy, in addition to the general public. In 2003, *Dong-A Daily*, one of the major newspapers in Korea, launched a joint survey with KOICA. The earlier surveys were designed mainly for the purpose of public relations about ODA. The questions focused on the level of attention on ODA, and the awareness on Korean government's ODA and its implementing agencies.

As its ODA level began to increase noticeably from $423.3 million in 2004 to $752.3 million in 2005, securing public support for the expansion of ODA was posited as one of the Korean government's policy priorities. In this regard, the Korea Information Agency conducted a survey in 2005 and MOFAT also initiated surveys in 2008 and 2010 respectively. These surveys added questions closely related to decision-making issues such as opinions about the expansion of ODA volume, priority regions and sectors to provide assistance, and ODA's contribution to poverty reduction or national interest.

This section of the paper presents the result of the most recent public survey on development cooperation conducted in 2011 by Gallup Korea on behalf of the Korea Institute for International Economic Policy (KIEP) through a face-to face survey involving 1,000 respondents. The detailed demographic char-

Box 1 Demographic Characteristics of KIEP Survey 2011

* Total number of respondents: 1,000 (100%)

* Gender | male (49.3%), female (50.7%)

* Age | 19-29 (18.9%), 30-39 (21.0%), 40-49 (21.9%), 50-59 (18.4%), 60 and above (19.8%)

* Region | Seoul (21.2%), Busan (7.4%), Daegu (5.0%), Incheon (5.5%), Gwangju (2.7%), Daejeon (2.9%), Ulsan (2.1%), Gyunggi (22.7%), Gangwon (3.0%), Chungbuk (3.1%), Chungnam (4.1%), Jeonbuk (3.7%), Jeonnam (3.8%), Gyungbuk (5.4%), Geyungnam (6.4%), Jeju (1.0%)

* Occupation | self-employed (19.8%), blue collar (24.6%), white collar (26.1%), housewife (19.5%), students (6.5%), others (3.5%)

* Level of education | below primary school (6.3%), junior-high (9.0%), high school (38.7%), college/university (43.5%), graduate school (2.4%)

* Level of monthly household income (KRW)| below 1 million (2.9%), 1-2 million (14.0%), 2-3 million (26.9%), 3-4 million (28.0%), 4-5 million (12.4%), above 5 million (15.2%)

acteristics of the respondents in this survey are summarized in Box 1. The composition of respondents by gender was 50 percent each for male and female. The age group was divided into five categories of 19-29, 30-39, 40-49, 50-59 and above 60 and the ratio in each group was set at approximately 20 percent. In terms of region, the survey followed the administrative district of the country and the number of sample was proportionately distributed according to the regional population; Seoul and Gyunggi area had the largest number of respondents over 20 percent each and the rest of the 14 regions had 1.0 to 7.4 percent of respondents depending on the size of the regional population.

The survey questions include various aspects of foreign aid such as motives for aid giving, level of support for aid, priorities in aid policy, effectiveness of aid as well as access to relevant information. It also reviewed the results of past surveys conducted in Korea as well as in other donor countries such as the EU[2] to gain a more comprehensive understanding of the Korean public's opinion on aid within various time series and country context.

Comparing the results with the previous surveys, three data sets are reviewed to compare the trend of public perceptions and attitudes toward foreign aid in Korea.[3] Additionally, the survey results of other donor countries will be introduced to compare the similarities and differences vis-à-vis Korea despite limitations imposed on the direct comparison among donor countries due to variations in the design, methodology and the respondent sample of each survey limit.

The following section introduces the level of support and awareness of the Korean public in general. More specific responses to various policy related issues such as motivation of aid, volume of aid, priority regions and areas as well as the assessment of aid effectiveness will be presented in the next part of the paper with corresponding policy initiatives and changes in Korea.

Public Support

The Korean public appears highly supportive of ODA as more than 90 percent of respondents strongly acknowledged the importance of development aid. The support level increased by more than 30 percent compared to the 2005 survey. This level of support in Korea is on par with the ones of other donors such as Sweden (93 percent), Denmark (92 percent), Ireland (92 percent) or EU (90 percent) according to the 2010 survey. Given that two thirds of (62.7 percent) of people in the 2011 survey still regard Korea as a developing country, it is interesting to know that the recognition of national status did not much affect the level of support for foreign aid.

While Koreans are largely supportive of development aid, survey results indicate that they tend to be less enthusiastic when it comes to scaling up the aid volume. Though Koreans are more generous than before regarding the level of aid, the majority still prefer to preserve the status quo. Such limited support for the expansion of the ODA budget despite the higher level of support for the principle of development assistance could be best explained by the concerns over the current state of the economy, according to previous survey results. Particularly, among those who are opposed to the provision of aid, the majority (70.7 percent) of respondents were concerned with the country's economic

Table 1 Overview of Public Surveys on Foreign Aid in Korea

	Korea Information Agency	MOFAT	MOFAT	KIEP
Target group (age)	20+ years	19+ years	20+ years	20+ years
Sample size	1,000	500	1,002	1,000
Sampling method	proportional sampling	proportional sampling	proportional stratified / systematic sampling	multi-stage stratified random sampling
Survey mode	Telephone	Face to face	Telephone	Face to face
Duration of survey	2005.8	2008.8	2010.10	2011.15
Number of questions	12	25	12	22
Sampling error	±3.1%p (95% C.L.)	±4.38%p (95% C.L.)	±3.8%p (95% C.L.)	±3.1%p (95% C.L.)
Survey agency	TNS	Gallup	InfoMaster	Gallup

MOFAT: Ministry of Foreign Affairs and Trade; KIEP: Korea Institute for International Economic Policy; C.L: Confidence Level; this table only list surveys conducted after 2005.

Table 2 Public Attitude Toward the Volume of Aid (as a %)

	2008	2011	Change
Too big	33.6	26.7	-6.9
Too small	13.6	10.0	+3.6
Adequate	44.0	63.3	+19.3

Source: MOFAT (2008), KIEP (2011)

situation and this is consistent with the 2005 survey result that showed two thirds of people think that "Korea is not rich enough to provide aid."

Public Awareness

Almost half of the Korean public is aware that the Korean government is providing aid. This ratio has been constantly increasing; from 37 percent in 2005 to about 50 percent in 2008 and 2011. According to socio-demographic analysis, the younger generation in their 20s showed the lowest level of awareness. Similar to the case of support level, better-educated respondents knew more about the fact that Korea is providing aid to developing countries.

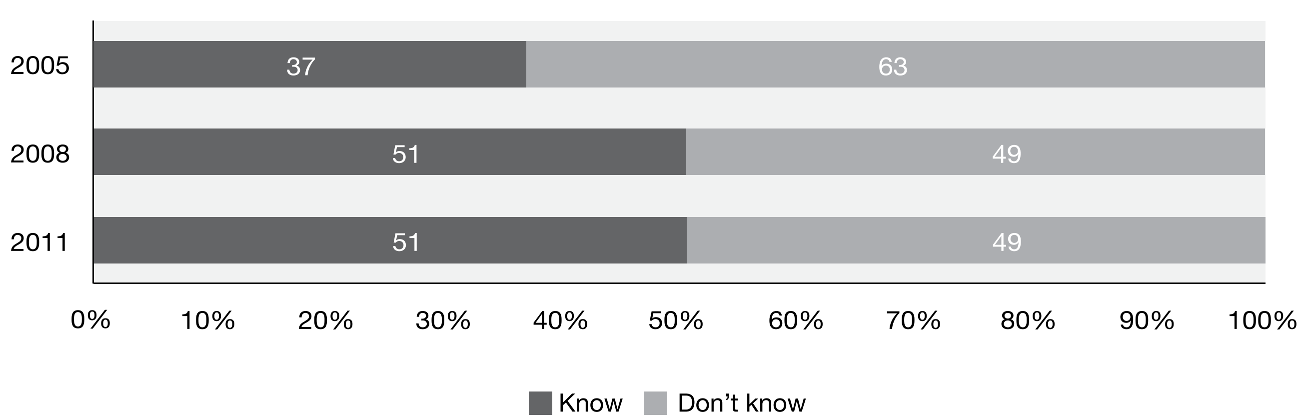
In terms of awareness of global development agenda items, such as MDGs (Millennium Development Goals), more than half (59.1 percent) have "never heard of" MDGs. The relatively low level of awareness of global agendas has remained largely unchanged in comparison with a previous survey in 2008. Interestingly, those who "have heard of it without knowing in detail" represent almost a third of the respondents. This group would be the priority target of development education to boost the level of interest and awareness on foreign aid in the future. Analysis of the demographic determinants of public opinion shows that the younger generation in their 20s was, again, the least informed about MDGs.

There was correlation between the level of support and awareness. Those who know better about MDGs tend to strongly support foreign aid. Out of those respondents who are well aware of MDGs, 42.6 percent "strongly support" and another 54.1 percent "support" development aid. This group is more enthusiastic about the expansion of ODA budgets, as almost one third of the respondents think that Korea should increase its ODA above the committed level. This result confirms the previous research outcomes that no effective action is taken without sufficient prior awareness.[4]

Motives of Aid Giving

The unique characteristic of Korea as a former-recipient-to-donor inevitably influences its motivation for aid giving. In 2011, 13.4 percent of people think that "Korea should give aid to give back what it had received from other countries"

Figure 1 Level of Awareness on Korea's ODA Provision



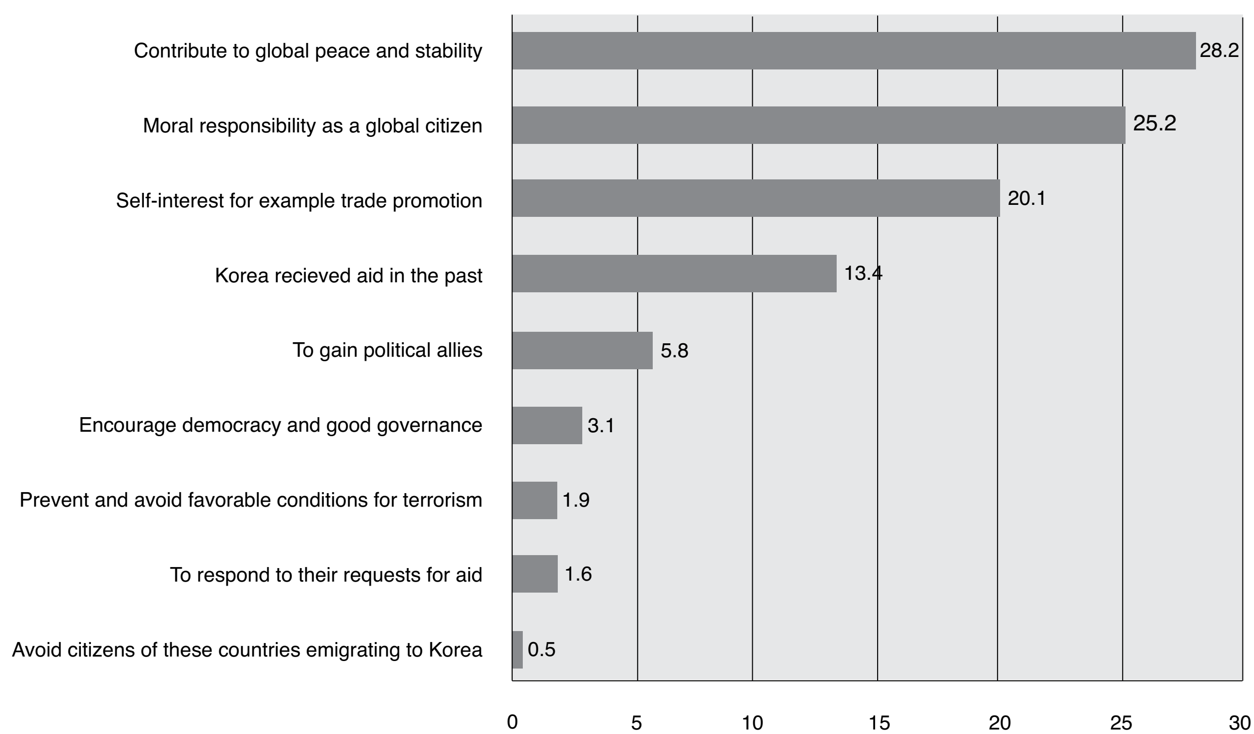
Note: "know" includes both "know very well" and "know." "Don't know" includes both "have heard of it without knowing in detail" and "don't know at all."

Table 3 Correlation Between the Level of Awareness and Support (as a %)

		Awareness about MDGs					
		Know very well		Heard about it without knowing in detail		Never heard of it	
Support for foreign aid	**Strongly support**	42.6	96.7	**17.2**	94.2	**12.7**	85.1
	Support	54.1		**77.0**		**72.4**	
	Oppose	3.3		**4.9**	5.8	**13.0**	**14.9**
	Strongly oppose	-		**0.9**		**1.9**	
Current ODA volume	Too large	19.7		21.6		**30.5**	
	Too little	11.5		10.6		9.5	
	Adequate	68.9		67.8		60.1	
Expansion of ODA volume	More commitment needed	**29.5**		17.8		15.4	
	Maintain commitment level	54.1		58.0		54.7	
	Don't expand	9.8		12.9		**16.8**	
	Reduce the volume	6.6		10.9		**12.7**	

Source: KIEP (2011)

Figure 2 Motives of Aid: Why Should Korea Give Aid to Developing Countries? (as a %)



Source: KIEP (2011)

according to the survey by KIEP. This tendency is also found in the 2008 survey, where the response ratio was higher, at 30 percent. Among other donor countries, Poland shows similar survey results regarding motives for giving aid. Almost half of the people in Poland think that it is their turn to help poor people since they benefitted from foreign aid from affluent countries; the ratio for this response rose to 50 percent from 33 percent in 2004.[5]

Aside from this particular consideration for Korea's past international status as an aid recipient, the Korean public seems to be driven more by humanitarian and egalitarian reasons. According to a 2011 survey, almost a third of the respondents replied that Korea should give aid to "contribute to global peace and stability" (28.2 percent), followed by "moral responsibility as a global citizen" (25.2 percent). The percentage of those who defend the aid for reasons of economic and self-interest was relatively low, at 20.1 percent.

Looking at examples from other donor countries, a 2009 EU survey shows that two out of three Europeans responded with reasons based on self-interest for giving aid (64 percent), namely to facilitate trade, to deter terrorism, to prevent migration and maintain positive political relations with developing countries. This tendency is particularly strong in Greece, France and Belgium.

The motive for giving aid also differs by age and level of education. Respondents over the age of 60 who have had direct experience as aid recipients in their lifetime tend to find the reasons of aid giving based on their personal events. A large number of better-educated respondents regard moral responsibility as the foremost reason for giving aid (41.8 percent) while a less-educated group tends to define Korea's past experience as a recipient country as the primary motivational factor.

The International Development Cooperation Act enacted in 2010 specifies the objectives of Korea's ODA as follows: "to reduce poverty and enhance sustainable development in developing countries based on humanitarianism; to promote economic cooperation with partner countries and to pursue global peace and prosperity."[6] The debate over what the motive for foreign aid should be is not new and Korea is not the only country that has had difficulty answering the question.

It is natural for Korea as a new donor to struggle to define its aid philosophy and ethics among contending norms and values. In Korea, what the objective of aid should be has been long debated. Should ODA proceed primarily for economic and humanitarian reasons, or should national interest play a part as well? Korea's strong inclination to assimilate into the group of traditional donors who are often referred to as advanced donors by the Korean government strongly implies to what direction the country is headed.[7] This sentiment is also emulated in Korea's aid philosophy and the de jure principle of Korean aid leans towards international values.

Priorities

According to 2011 survey results, almost 40 percent of Korean people consider sub-Saharan Africa as the most important destination for Korean aid while attention to Asia also remained strong as a substantial percentage of respondents stated Southeast Asia (33.8 percent) and South Asia (14.9 percent) as next in the list of priorities. The growing interest in Africa as a destination for ODA was also observed in the 2005 survey; almost half of respondents indicate Africa as the priority region followed by Asia-Pacific (24.4 percent).[8]

The share of Asian countries among Korea's top ten recipients such as Vietnam, Bangladesh, Sri Lanka and Mongolia is notable, representing 65.2 percent of total bilateral aid. But the figure has tended to fluctuate wildly; it reached 72.6 percent in 2001, down to 52.2 percent in 2008, decreased further to 38.5 percent in 2009, until soaring again in 2010. While maintaining a strong regional focus on Asia, Korea tries to balance its regional ODA allocation by providing more aid to Africa; the amount of aid going to the region more than tripled from $39.1 million in 2001 to $134.9 million in 2010. Sub-Saharan countries received most of the aid; top recipients in Africa include Tanzania ($21.46 million), Angola (18.83), Senegal (14.85) and Ethiopia (10.2) in 2010.

The expansion of focus on Africa is partly reflected in some of the high-level initiatives such as President Lee Myung-bak's recent visit to African countries (Ethiopia and DR Congo) in July 2011, and also the 2006 visit of the late President Roh Moo-hyun to Egypt, Nigeria and Algeria. During Roh's visit to Africa, he announced the Initiative for Development in Africa and pledged to increase the ODA level for Africa by three-fold by 2008 and expand cooperation through sharing of development knowledge and increasing the number of volunteers and medical teams to Africa.

For priority sectors, the 2011 survey results show that the majority of Koreans think Korea can most effectively provide assistance in social and economic infrastructure and services such as health, education, transport or energy. Actually, Korea provided a total of $1,279.01 million in these sectors, which is 88.1 percent of total bilateral ODA in 2009. Beside these sectors, agricultural development was regarded as the potential sector that Korea can help out effectively: 24.5 percent of respondents think Korea has a competitive edge in agricultural development and this reaction stands out among respondents in their 50s and 60s, with less education or lower income.

By sector, social and economic infrastructure and services have traditionally received the largest portion amounting to approximately 60 to 80 percentage of total bilateral ODA and it has increased significantly since 2007. Particularly, support in such sectors as education and government/civil society was outstanding in 2010 compared to previous years and this change has meant a doubling in the amount of aid disbursed to the social sectors.

Assessment on the Contribution of Korea's ODA

The attitude of the Korean public is mostly positive toward Korea's ODA contributions: 79.4 percent think that "Korea's ODA contributes to the economic development and poverty reduction in developing countries." Those who are more supportive and aware of Korea's experience as an aid recipient tend to be even more positive concerning Korea's contribution to developing countries through aid. Attitudes on Korean ODA have grown even more positive since 2005, when slightly more than half of respondents thought that Korea's ODA contributes toward tackling global issues. This ratio jumped significantly to 76.8 percent in 2008.

Among skeptics of Korea's contribution to developing countries are those who are concerned with problems prevalent in developing countries. "Weak aid management capacity" (28.4 percent) and "lack of self-help" (17.2 percent) are the two main reasons when citing aid ineffectiveness. Others pointed out some domestic issues such as "lack of specialization of aid agencies" (15.6 percent), "lack of transparency in aid management" (15.4 percent)', "small aid volume" (13.6 percent), and an "inefficient aid system" (13.5 percent). In the 2008 survey which asked the same questions, a third of the respondents were concerned about "corruption in developing countries" as well as "poor management of aid in developing countries" (22.4 percent).[9] As survey questions and response options were not identical for the two surveys, it is hard to track down the trends of response over time. However, it is still worth noting that the Korean public recognizes issues of developing countries as the main reasons that hamper aid effectiveness.

The strong emphasis on efficiency and effectiveness of aid among the Korean public can also be observed in other aspects. The majority of the Korean public is most interested in whether the aid project has actually helped developing countries (56.4 percent) and if the aid budget was used efficiently (50.8 percent).[10] About a third (36.9 percent) of respondents think that post-project follow-up and maintenance is important. The 2008 survey shows a similar tendency to focus on effectiveness and efficiency as the majority of respondents were interested whether aid was properly used by the government of the developing country (40.4 percent) and to what extent the aid project contributes to poverty reduction in the recipient country (33.4 percent).

In terms of aid agency, Koreans demonstrate almost the same level of confidence toward government agencies and NGOs: 68 percent of respondents said that NGOs are best placed to deliver effective aid and another 64.8 percent expected that aid through government agencies would be more effective.[11] An interesting difference according to the level of education appeared: the more educated the respondents are, the more they trusted NGOs than government agencies. Also, students and high-income groups also showed a high level of confidence with NGOs.

Public Participation and Information

Slightly over two thirds of Koreans describe themselves as being in favor of helping developing countries, without being a volunteer or giving donations. The ratio of people who are actively engaged in activities, such as giving donations or volunteering, was 23%. Nine out of ten Koreans believe that it is important to help developing countries, however, the level of participation and involvement remains relatively low. Very few Koreans are opposed to development cooperation in general but one in ten Koreans seems to be indifferent to voluntary activities or donations as they simply mention that "they are not interested." This result exhibits a discrepancy between the perceived importance of development cooperation and actual participation.

Socio-demographic analysis shows that high-income groups are more active in donations due to the natural reason of financial affordability. However, the level of participation as volunteers is not necessarily related to income levels, as some lower-income level groups showed an even higher participation rate. Those who have visited developing countries appeared to be more willing to give donations (30.3 percent) or work as a volunteer (9.6 percent). It can be seen as evidence of direct learning experience about situations in developing countries affecting the level of engagement to help developing countries.

In terms of exposure to media coverage on foreign aid and Korea's ODA activities, over half of respondents (52.4 percent) acquired information through various media sources. However, a greater percentage of younger people in their 20s stated that they were not familiar with information on development aid. This is consistent with the result that this group is the least aware of the fact that Korea received aid in the past. In addition, students, among other occupations, are the least acquainted with stories on foreign aid.

Knowledge and information on development aid obtained from various media sources seem to increase the level of awareness: more informed groups showed higher levels of awareness on MDGs by nearly fourfold (9.5 percent)[12] and on Korea's provision of development aid by a factor of two (66.6 percent). In terms of support level, those who are familiar with information on foreign aid tend to show a slightly higher level of support. They tend to recognize to a greater degree the importance of aid in helping developing countries and expressed a higher level of support for providing aid. In addition, informed respondents were more positive on their assessment of the level of contribution of Korea's ODA. However, the support level in terms of current ODA volume or expansion of future aid budget does not seem to reflect these trends.

Policy Challenges for Korea

Korea, as a new DAC member, pledged the international development community to expand its aid volume and has pursued various institutional arrangements to enhance the quality of its aid. For the Korean government to achieve its ambitious aid policy goals, one of the critical factors is to gain public support and to create a society-wide consensus on the need for better and more aid. Conducting surveys to gauge public opinion on development cooperation is one convenient way to assess the trend. Despite its relatively short history as a donor, the support for foreign aid in Korea is stronger now than in the past, as the survey results reveal. There definitely exists a positive environment to advance the Korean government's ODA policy in the long term.

However, Korea still faces several challenges despite these advances. According to survey results, immediate improvement is needed with respect to enhancing transparency of aid policy and dissemination of information on aid as well as post-completion management of aid projects. In terms of transparency, the Korean government needs to pay attention to the fact that the general public is more interested in efficiency and effectiveness of aid policy and their implementation than before. It needs to regard the general public as one of the key stakeholders in development cooperation, as they pay taxes which fund aid programs in other part of the world. The nature of development aid, where the policies do not directly influence the well-being of its own citizens but rather anonymous people beyond its borders, there exists a large discrepancy between the opacity vis-à-vis the public and their concerns about global issues.[13]

Similarly, a large number of respondents pointed out the importance of post-completion management for aid projects, and strengthening feasibility studies and ex-ante evaluation. Focus on the substance and result-based management of aid projects has been growing as the Korean public has better access through media and press coverage to monitor the aid effectiveness.

Table 4 Correlation Between the Exposure to Media and Level of Support/Awareness (as a %)

		Exposure to media coverage on foreign aid			
		Yes		No	
Aware of MDGs	Know very well Heard of it without knowing in detail Never heard of it	9.5 38.7 51.8		2.3 30.5 **67.2**	
Aware of Korea's ODA	Know very well Know it	7.6 59.0	66.6	3.6 31.2	**34.8**
	Heard of it without knowing in detail Never heard of it	27.2 6.1		35.8 **29.5**	
Current ODA volume	Too large Too little Adequate	23.0 11.2 65.7		**30.7** 8.6 60.6	
Contribution of Korea's aid in developing countries	Contributing Not contributing	**83.8** 16.2		74.5 25.5	
Importance of helping developing countries	Very important Fairly important	32.0 61.9	**93.9**	26.1 61.5	87.6
	Not so important Not important	5.9 0.2	6.1	11.8 0.6	12.4
Support for providing aid	Strongly support Tend to support	20.2 71.7	**91.2**	11.8 74.7	86.5
	Tend to not support Not support	7.8 1.0	8.8	11.6 1.9	13.5

In addition, other issues related to the aid system should not be ignored: (1) fragmentation of aid implementation bodies where more than a hundred government agencies take part in aid delivery based on their priorities has been pointed out as a major detriment to aid effectiveness and coherence; and (2) the lack of specialists who understand sectors, regions and situations in the field is a major hurdle Korea must overcome.

Lastly, the Korean government could take a more systematic approach to enhance the level of awareness on aid and development cooperation, particularly by forming target groups and strategies according to their stance on aid, age groups and personal background such as level of education. When the Korean public is well informed of issues related to development cooperation, they are more likely to act or express their support for aid.

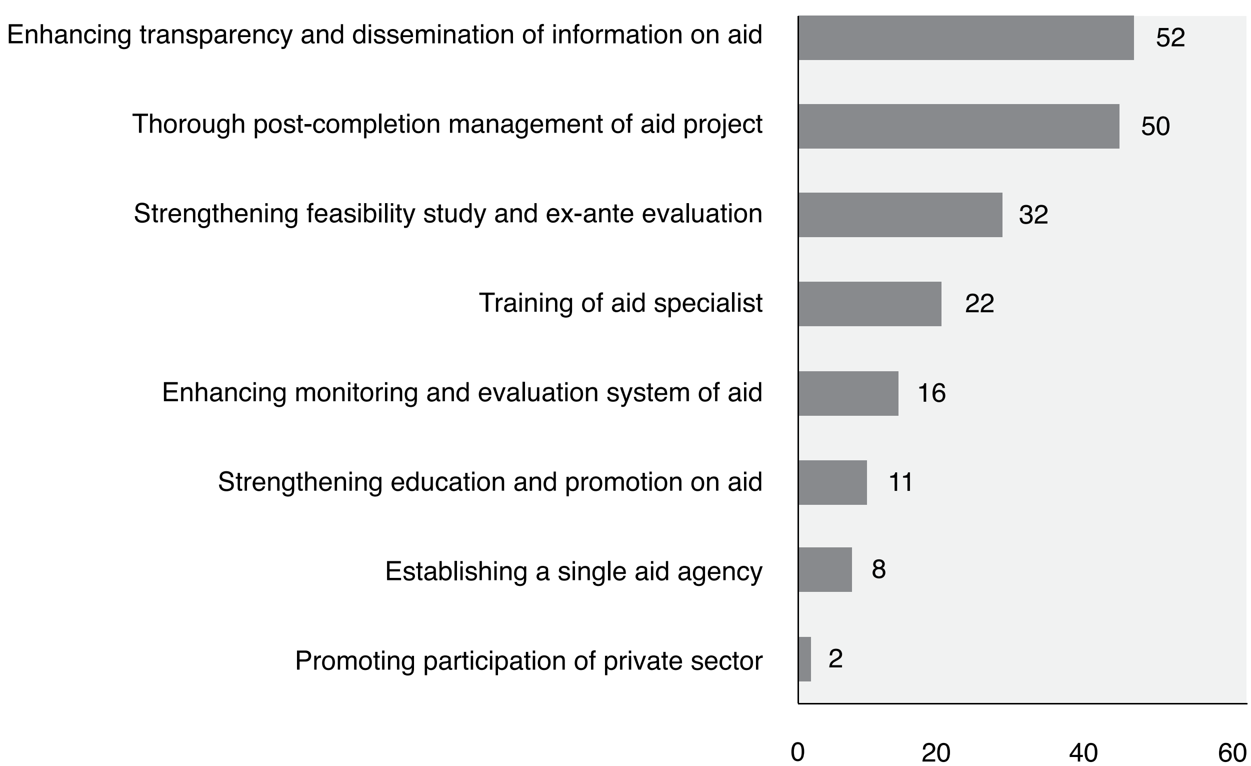
Conclusion

As a new DAC member, Korea has set ambitious aid policy goals and pursued various initiatives for providing more and better aid. One of the critical factors for the Korean government in justifying its policy drives and investments is to gain public support and to form a broad social consensus. With the changes and reforms in its aid system to improve the quality of aid, the country has continuously striven to develop its ODA policy as well as to gain public support. In response to efforts to increase the volume of aid and to improve the aid system, public concerns about foreign aid policy have significantly increased as well. Public support towards the expansion of the ODA budget is essential to maintain the promise Korea made with the international community on increasing aid volume.

Most DAC members conduct public opinion surveys periodically in order to analyze and assess the public's perception and awareness of development assistance. This is because the majority of citizens are taxpayers who pay close attention to the effective spending of financial resources based on the appropriate aid policy. Moreover, survey results provide important background information to set up effective public engagement and development education programs in the country, which positively influence the support and understanding of the donor's foreign aid.

Public opinion surveys prove to be meaningful with respect to recommending effective ODA policy agendas and directions to the Korean government. It also provides useful findings about important factors that affect the general public's attitude towards development aid in Korea, such as the respondent's

Figure 3 The Most Urgent Policy Issues in Korea's ODA



Source: KIEP (2011)

socio-demographic profiles, personal experiences, perception of poverty, recognition of Korea's national status (a developed or developing country), awareness of foreign aid projects, as well as experience of visiting developing countries.

In conclusion, the Korean government must gain full understanding of public opinion towards foreign aid and implementation of its ODA policy in order to establish greater public support as a new and small donor. The public poll on development cooperation may be one useful way to see how Korea's aid policy and practice are being accepted by its people. Despite its relatively short history as a donor, the support for development aid in Korea is stronger now as the survey results reveal. This is definitely a positive factor in advancing Korea's ODA policy in the long term, and Korea needs to sustain the course.

Dr. Park Sukyung is a Senior Researcher at the Korea Institute for International Economic Policy. Dr. Kwon Yul is a Research Fellow for the Korea Institute for International Economic Policy.

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[1] Ministry of Foreign Affairs and Trade (MOFAT). 2008. Public opinion poll on development aid and policy research on Korean government's development cooperation policy. (Korean)

[2] Refer to European Commission surveys. Attitudes towards development aid (2005); Europeans and Development Aid (2007); Development Aid in times of economic turmoil (2009); Europeans, Development Aid and the Millennium Development Goals (2010).

[3] (1) The 2010 survey was conducted by Infomaster on behalf of MOFAT, (2) the 2008 survey was carried out by Gallup Korea on behalf of MOFAT and (3) the 2005 survey was performed by TNS on behalf of the Government Information Agency. The details of research design and methodologies applied to each survey are shown in Table 1.

[4] Yankelovich D. 1991. *Coming to Public Judgment: Making Democracy Work in a Complex World*. Syracuse University Press, New York; Klingemann, H.D. Römmele A. (eds). 2002. Public Information Campaigns and Opinion Research. A Handbook for the Student and Practitioners. Sage Publications. London.

[5] Poland Ministry of Foreign Affairs. 2010. Poles on Development Assistance: Findings from a TNS OBOP Study for the Ministry of Foreign Affairs. Warsaw, December 2010. Multiple choices allowed.

[6] International Development Cooperation Act. Article 3.

[7] Kim, S. 2010. *A Bridge over Troubled 'Worlds'? An Ethical Case of South Korea's Aid*. Paper presented at the 2010 Development Studies Association UK annual Conference Values, Ethics and Morality, Westminster, London, 5 November.

[8] Korea Information Agency. 2005. Survey result report: public opinion on Official Development Assistance. (Korean)

[9] Ministry of Foreign Affairs and Trade (MOFAT). 2008.

[10] The question allowed multiple answers (up to two).

[11] The question allowed multiple answers (up to two).

[12] Those who responded that they "know very well" of MDGs.

[13] OECD Development Centre. 2003. *Public Opinion and the Fight Against Poverty*. OECD Development Centre. Edited by Mc Donnell et al.

HOW KOREA CAN PUNCH ABOVE ITS WEIGHT ON DEVELOPMENT

By Lawrence MacDonald

Abstract

Korea has made an excellent start on becoming a global leader on development and poverty reduction, drawing on its remarkable experience in moving from destitution to affluence in a single generation. Korea's leadership during the Seoul Summit in putting development on the G-20 agenda, in hosting the Busan high-level conference on aid effectiveness, and establishing the Global Green Growth Institute have attracted favorable international attention. But Korea's development-related policies lag far behind its rhetoric and other high-income countries. Korea can address these shortcomings by participating in international development organizations, improving development-related policies in areas where there is little domestic political resistance; and setting aside part of Korea's modest aid budget as an aid innovation fund. None of these measures would require an increase in Korea's foreign aid spending. They are smart, low-cost moves that build on Koreas' tradition of punching above its weight in the global arena.

The Republic of Korea has thrust itself onto the international stage as a would-be leader on global development, achieving much in terms of international recognition. But Korea's aid program and its policies towards developing countries often fall short, even of the relatively low standards set by the established donor countries. Korea can do much better, establishing itself as a true global leader, if it takes advantage of its status as a newcomer to champion promising new approaches, just as Korean firms became household names around the world by leapfrogging over analog technology to lead the way in the digital communications revolution.

Korea has clearly signaled its ambition to be a leader on global development. Drawing on Korea's unusual experience in making the transition from poverty to affluence in a single generation, the Korean government pushed to include development issues on the G-20 agenda when it hosted the 2010 Seoul Summit, establishing an intergovernmental development working group that continues to operate, and launching a multi-year action plan. In 2011 Korea hosted the Fourth High Level Forum on Aid Effectiveness, in Busan, drawing hundreds of aid experts and official government representatives from around the world.

Korea has supported the creation of the Seoul-based Global Green Growth Institute (GGGI), a new international organization that provides advice on sustainable growth to developing countries. And Korea has joined the Development Assistance Committee (DAC) of the Paris-based Organization for Economic Cooperation and Development (OECD), the Western-dominated aid donors club.

Two men born in Korea are individually prominent in the international fight against poverty. UN General Secretary Ban Ki-moon frequently recalls the poverty of his childhood in Korea, when his family lacked electricity and he studied by kerosene light, in explaining his push to provide developing countries with sustainable energy for all. Jim Kim, an American medical anthropologist born in Korea, has recently been selected as the president of the World Bank. While Kim's selection is not a reflection of a Korean government initiative, the two high level positions further emphasize Korea's sudden new prominence in global development issues.

For all this, however, South Korea is very much a newcomer to global discussions on international development, and its aid program and non-aid policies towards developing countries rank at or near the bottom when compared to those of other high-income countries. This is not surprising, given that Korea has moved so quickly from being an aid recipient to an aid donor. Nonetheless, a frank recognition of Korea's substantial shortcomings in this regard is crucial if these are to be overcome.

I am a great admirer of the Korean people and of the effectiveness and resilience of Republic of Korea government institutions, having worked in Seoul as a reporter for AFP for two years in 1987 and 1988, a period that included the stormy transition to democracy and the hosting of the Olympics.

Although I had lived and worked in several Asian countries by the time I was posted to Seoul, I was deeply impressed by the determination of Koreans to excel internationally in fields as diverse as business, culture, and sports. I believe that Korea's push to be a leader in development is part of this drive for excellence and international prestige, and that it can achieve similar success. By drawing on traits that have been a source of national strength for Korea—openness to innovation and an eagerness to learn from experience—Korea can become a true world leader in the global fight against poverty and inequality. First, however, it is necessary to recognize where Korea currently falls short.

Korea's aid budget, at approximately $1.3 billion per year in 2011, is small not only in absolute terms but also as a share of GDP. Of the twenty-two countries ranked in the Commitment to Development Index (CDI) published annually by the Center for Global Development (CGD), Korea ranked last for aid volume in 2010, giving just 0.09 percent of its GDP (by comparison, some European donors are close to the 0.7 percent goal promoted by many development advocates).

In 2010, more than half of Korea's aid (51 percent) was tied, that is, recipient countries were required to use it to hire Korean firms or buy Korean products, a stipulation that reduces the effective purchasing power of aid since recipients are unable to seek out the best value for money; here again Korea ranks last of the twenty-two countries in the CDI. Korea also scores poorly on two other aid quality measures in the CDI: selectivity (it gives a lot of its aid to less-poor and worse-governed countries) and project proliferation (it funds a large number of small projects, raising transaction costs for recipients).

A more detailed measure of aid quality, CGD's Quality of Official Development Assistance (QuODA), sheds further light on the Republic of Korea aid programs. QuODA measures aid quality across four dimensions: maximizing efficiency (rewards donors who channel aid to poor, well-governed countries, minimize administrative costs, support global public goods, and untie aid); fostering institutions (rewards donors who help to build the recipient government's capacity); reducing burden (rewards coordination with other donors and penalizes large numbers of small projects); and transparency and learning (rewards donors for promptly releasing information and for encouraging recipient country evaluation and learning).

A comparison of Korea's performance on QuODA with that of Japan and the United States (see http://www.cgdev.org/

Figure 1

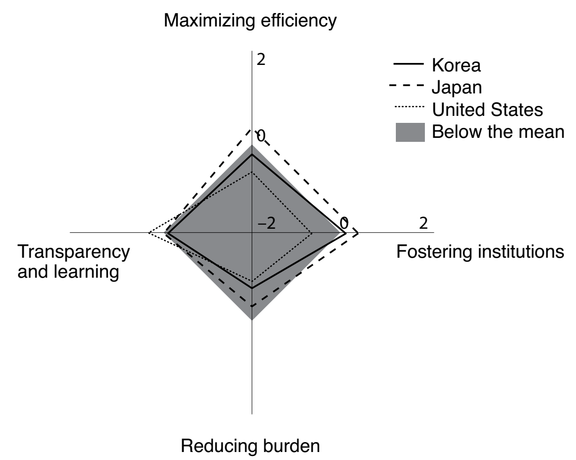
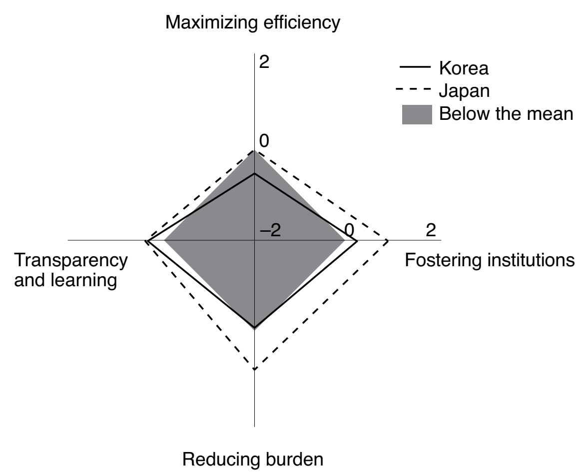


Figure 2



section/topics/aid_effectiveness/quoda?p=i&d=20,21,19) shows that Japan scores better than Korea in all four dimensions. However, Korea scores better than the United States in three: maximizing efficiency, fostering institutions, and reducing burden. The United States does significantly better than Korea in one dimension: transparency and learning.

Drilling deeper into QuODA, it's possible to compare the scores of individual aid agencies (see http://www.cgdev.org/section/topics/aid_effectiveness/quoda?p=ia&d=123,156). The Japan International Cooperation Agency (JICA) outperforms the Korea International Cooperation Agency (KOICA) in all four dimensions. KOICA and the United States Agency for International Development (USAID) score about the same.

Korea's aid score on the CDI and its rankings on QuODA provide a simple set of diagnostics, benchmarked against other donor countries, that can guide Korea's efforts to improve its foreign assistance programs. Raising the amount of aid Korea provides need not be a priority. In fact, there is a lively debate within the development community about whether or not aid actually helps development. Instead, Korean policymakers should concentrate on improving aid quality, steps that would improve Korea's ranking on the aid component of the CDI and on QuODA. Untying a larger share of Korea's aid would be one important step; improving aid allocation, so that a large share goes to poor, well-governed countries is another. Allocating a larger share of Korea's aid to activities that support global public goods, such as the fight against climate change, would help to improve Korea's QuODA score for maximizing efficiency.

But the single most important thing Korea can do is to leverage its small aid budget by becoming a champion of innovation and learning.

How? Korea should announce that it is setting aside a substantial share (say 20 percent) of its aid budget as an international "Aid Innovation Fund" that would be used to experiment with new approaches to foreign assistance. Innovations to be funded could be selected on a competitive basis, and the results monitored and evaluated by an independent entity, with the costs of the evaluation and dissemination of the results also covered by the fund.

Such a fund would meet an important global need. There are many promising new proposals for improving aid delivery, but because existing funding is committed to ongoing projects and approaches, very few new ideas are systematically tested and evaluated. As a new donor, Korea is much less bound than other donors to traditional approaches, and has greater flexibility to experiment and share the results.

CGD's proposal for Cash on Delivery (COD) aid is an example of one such innovation. Instead of the traditional approach of conditioning aid on specific policies, negotiated action plans, and the purchase of inputs (such as the purchase of textbooks or the construction of schools), funders would agree to pay for improvements in a specific area of progress, such as increases in the number of students who complete primary school and take a competency test. In theory, COD aid could be applied to any goal for which a verifiable incremental measure of progress can be identified and which is agreeable to a funder and recipient.

The ideas of COD aid have been under discussion for several years, and both donor and recipient countries have expressed interest and support. Pilot programs are now getting underway in Ethiopia and Tanzania. But launching the pilots has been a complex and time-consuming process, since available foreign assistance funds are typically committed several years in advance. Funding an innovative idea thus requires withdrawing support from an existing program, a slow and difficult process even if the program is not performing as well as initially hoped.

COD aid is but one of dozens of new approaches to aid and poverty reduction that should be tested and evaluated. What are the best techniques for increasing girls' enrollment and middle-school graduation rates? What strategies work for reducing maternal and infant mortality? What programs are effective in getting kids vaccinated? What works for promoting small and medium-sized industries? How can young people who have been uprooted from their communities by war and civil unrest—including being forced to serve as child soldiers—be reintegrated into their communities when the fighting ends?

Improved impact evaluation techniques, including randomized controlled trials (RCTs), make it possible to test new approaches to determine which work best in what settings. The International Initiative for Impact Evaluation (3IE), established in 2007 and currently based in India, serves as a funder and clearinghouse for such studies. The Abdul Lateef Jameel Poverty Action Lab (J-PAL) is one of a handful of organizations that specializes in carrying out such studies and promulgating the results.

As a first step towards establishing its own aid innovation fund, Korea should become a member of the 3IE. This could be done by a variety of Korean government organizations, with KOICA as the most logical lead entity. By becoming a member, Korea would align itself—and have increased opportunities for interaction—with many of the most forward-thinking and highly regarded funders of foreign assistance, groups such as the Bill and Melinda Gates Foundation, the William and Flora Hewlett Foundation, and the aid agencies for Australia, the UK, Norway, Sweden and the United States. A 3IE membership would give Korean officials and policymakers an opportunity to learn more about approaches to impact evaluation and promising innovations that could be worthy of Korean funding.

One possible model for a Korean aid innovation fund could be USAID's new Development Innovation Ventures (DIV) created in 2010 to fund new development initiatives with a strong emphasis on rigorous evaluation, learning and dissemination. It offers grants covering conceptual, pilot and scale-up phases. So far it has awarded twenty grants, including an inexpensive balloon tamponade to stop post-partum bleeding, a messaging campaign to reduce road accidents in Kenya, and grain storage bags to eliminate losses from insects and mold in Afghanistan. The office accepts applications on a rolling basis and applicants do not have to be from the United States.

Looking beyond aid, Korea should seek ways to improve non-aid policies that affect poor people in developing countries. Here the non-aid components of the CDI can provide a valuable guide. Each of the six non-aid components of the index has multiple indicators. Some, such as restrictions on migration, may be politically very difficult to change. Others, such as regulations concerning foreign investment, may encounter little opposition and indeed be welcomed by key constituencies who recognize an opportunity to do well by doing good. A summary of Korea's ranking on the CDI is available on the CGD Website.[1] Highlights in the most recent CDI include:

Trade: Korea has a score of 2.8, on a scale where 5 is the median, ranking 21st out of the 22 countries in the Index. Strengths include low agricultural subsidies (ranking 3rd). Weaknesses include high tariffs on agricultural commodities, and high barriers against textiles and apparel. As Korea moves increasingly into high-technology manufactured exports, these high tariffs on goods produced by developing countries could be gradually eased.

Environment: Korea scores 2.8 and ranks 22nd. Weaknesses include high tropical wood imports, low gas taxes, high carbon emissions per capita, and high fishing subsidies. Each of these is politically sensitive and thus likely to be difficult to change. Nonetheless, Korea has made green growth a national priority, one that would require addressing each of these policy areas. Raising gas taxes could be a good place to start, since it could either increase revenue or make it possible to cut taxes in other areas.

Security: Korea has a score of 1.7 and ranks 22nd. Strengths include no arms exports to poor and undemocratic governments (rank: 1). Weaknesses include small financial contributions to international peacekeeping operations, an area Korea might choose to address for other reasons, including the international prestige that can come from participating in such operations.

Investment: Rich-country investment in poorer countries can transfer technologies, upgrade management and create jobs. The CDI includes a checklist of policies that support healthy investment in developing countries. Korea does relatively well, with a score of 5.9 and a rank of 8. Strengths include providing insurance against political risk for both domestic and foreign firms; and not imposing restrictions on Korean pension fund investments in emerging markets

Migration: The movement of people from poor to rich countries provides unskilled immigrants with jobs, income and knowledge. Korea scores well in its openness to foreign students from developing countries, ranking 2nd. But the small number of unskilled immigrants from developing countries is weighted more heavily and puts Korea at the bottom of the list.

Technology: The CDI captures a country's contribution to the creation and dissemination of new technologies by measuring government support for R&D and penalizing strong intellectual property rights regimes that limit the dissemination of new technologies to poor countries. Korea does quite well on these measures, scoring 6.6 to earn a rank of 2nd, Korea's highest rank on any of the seven CDI components, due in part to a large tax subsidy rate for business R&D.

This is a daunting list, a reminder of just how far Korea has to go to become a true champion of development. On the other hand, Korea's overall average score of 3.1 on the CDI represents an increase of a full point compared to 2008, and Korea is only 0.6 points behind its traditional regional rival, Japan, which has been a developed country and aid donor for decades longer.

Scores on the CDI tend to change slowly, since the underlying policies that they reflect are themselves slow to change. Nonetheless, over time a country's ranking does shift, and occasionally a big policy change can lead to a large jump—or sudden back sliding. It would be entirely in keeping with the Republic of Korea's tradition of exceptional achievement for the government to decide that it wants to be the country that has made the most rapid progress on the CDI and to implement a few key reforms that move it out of last place, trumping Japan.

A good first step to learning more—and providing comment on the design of the index itself—would be for Korea to join the CDI Consortium, a club of countries ranked in the CDI that meets annually to share ideas about how to improve the rich world's support for development.

Would Korea join a club in which it is currently ranked at the bottom of the list? I would not be surprised, since this is very much in keeping with the Korean drive to learn and excel.

My colleague David Roodman, the architect of the CDI, recalled in a blog post the reaction he received when presenting Korean officials with their country's standing in the index, soon after Korea joined the OECD-DAC.

> Before releasing the CDI last year my colleague Cindy Prieto and I visited the Korean embassy here in Washington to brief officials. We were impressed with their constructive attitude, which blended respect for the CDI and hope that Korea would improve as it took its place among donors. We congratulate South Korea on its new status and wish it the best as it accepts the attendant responsibilities.

In conclusion, Korea has made an excellent start on becoming a true global leader on development and poverty reduction, drawing on its remarkable experience in moving from destitution to affluence in a single generation. Korea's leadership during the Seoul Summit in putting development on the G-20 agenda, in hosting the Busan high-level conference on aid effectiveness, and establishing the GGGI have attracted favorable international attention.

But Korea's own policies, in foreign assistance and in non-aid policies that impact development, lag far behind its rhetoric and even the relatively low standards of other high-income countries. Fortunately, there are several steps that Korea can take rather easily to begin to address these shortcomings. These include joining international entities such as the 3IE and the CDI Consortium; improving development-related policies (and thus Korea's CDI score) in areas where there is little domestic political resistance; and setting aside a percentage of Korea's modest aid budget as an aid innovation fund. Strikingly, none of these measures would require an increase in Korea's foreign aid spending. Instead they are smart moves that are very much within the country's tradition of punching above its weight in the global arena.

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[1] http://www.cgdev.org/doc/CDI/2009/country_reports/South_Korea_2009.pdf.

KOREA'S ROLE IN ASIAN INTEGRATION

FINANCIAL INTEGRATION IN ASIA: DEVELOPMENT AND KOREA'S ROLE

By Park Young-Joon

Abstract

Since the Asian financial crisis in 1997-98, financial integration in Asia has been induced by collective intra-regional initiatives. It has manifested in various aspects, including gradual financial liberalization, increasing cross-border capital flows, establishing regional financial safety nets, and developing local currency bond markets. While financial deregulation and capital account liberalization has made progress, Asian countries have experienced sudden stops or sharp capital reversals due to external shocks and currency instability. The CMIM, a regional financial safety net, plays its role as a central platform for managing regional financial arrangements. In addition to its crisis resolution function, the CMIM can also be expanded by augmenting a crisis prevention function. Moreover, the ABMI and the ABFs were intended to achieve a more efficient recycling of Asian savings into investment in the region by developing regional bond markets. Gathering regional momentum, Korea's role as an honest broker for further financial institutional integration is important especially in 2012 as a co-chair country of ASEAN+3.

The process of Asian financial integration has been induced by the coordinated regional initiatives of financial cooperation along with real economic integration through the intra-regional free trade agreements. Unlike in Europe, economic integration in Asia emerged with the need for creating regional financial self-help measures after the Asian financial crisis in 1997-98. Since then, financial integration has manifested in various aspects: gradual financial liberalization, increasing cross-border capital flows, establishing regional financial safety nets, and developing local currency bond markets.

Asian economic regionalism has been driven by market-based forces, rather than by a grand blueprint of economic integration. In fact the Asian crisis triggered regional collective initiatives to promote financial integration in East Asia. The crisis revealed what Asia has been lagging behind in terms of its financial system and development compared with real sector integration. Poor performance in the financial sector was caused by several factors, such as: high risk vulnerability to external shocks, heavy dependence on bank financing, insufficient long-term credits and underdevelopment of regional bond markets, weakness of a financial surveillance mechanism, and the lack of competition in financial sectors and premature capital markets. This process of regional financial integration has been supported by the rationale that it achieves better allocation of financial resources and better risk sharing, as well as ultimately promoting regional economic growth.

Intra-regional initiatives have started playing a significant role in fostering financial integration. Asian policymakers realized the absence of regional mechanisms which could have helped avoid the crisis and be used to prevent future crises. They also understood the intrinsic weakness of Asian financial systems and their poor development of both regional and domestic financial markets. As a result of extensive dialogue among ASEAN+3[1] countries, they were able to push forward several initiatives for regional cooperation as part of financial integration.

The subsequent sections focus on financial institutional integration in the region. East Asia's initiatives in support of regional financial integration can be classified into four pillars: (1) the Chiang Mai Initiative (CMI) and its multilateralization (CMIM) as a commitment to provide U.S. dollar liquidity support to member countries through currency swaps in response to urgent short-term liquidity shortages and balance of payment difficulties in crisis; (2) the establishment of the ASEAN+3 Macroeconomic Research Office (AMRO) as an independent regional economic surveillance mechanism; (3) new introduction of regional crisis prevention scheme; and (4) the Asian Bond Market Initiative (ABMI) and the Asian Bond Funds (ABFs) to develop local bond markets for recycling regional capital and to mitigate the double mismatch problem.

Extent of Financial Integration in East Asia

Existing literature points out Asian financial integration lags behind its trade and real-side economic integration. Asia's intra-regional financial linkage is also weaker than the global link. This might be attributed to the lack of well-functioning regional financial institutions and underdevelopment of regional and domestic financial markets. Since the Asian currency crisis, financial market integration and cross-border financial transactions have begun to increase but do not yet reflect convergence for regional integration.

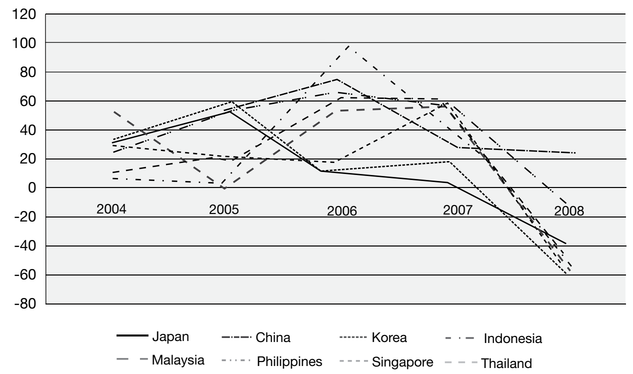
While East Asia has focused on real economic integration through regional trade agreements, the region has also begun working towards financial integration. The 1997-98 Asian crisis raised awareness on two points: (1) Asian countries need to strengthen their domestic financial sectors for managing the efficient absorption of capital inflows and the financial intermediation needs, and (2) the region needs to develop the institutional capacity to resolve cross-country contagion of common financial problems.

Increasing the degree of financial deregulation and capital account liberalization since the 1990s has led to a significant rise in capital inflows towards emerging Asian economies. This surge in capital flows consists mainly of foreign direct investment (FDI) flows, portfolio investments, and short-term banking flows. Even though China is a dominant recipient of FDI inflow in Asia, the general pattern of FDI flows is relatively stable. However, portfolio investment flows and short-term banking flows are regarded as potential sources of systematic risk to Asian economies. In fact, Asian countries experienced the risk of sudden stops or sharp capital reversals due to external economic shocks, currency instability and the double mismatch problem.

Recently the ADB warned that government authorities of emerging Asian economies should be ready to respond when volatile capital flows threaten to destabilize their financial markets. Surges in short-term capital inflows could potentially leave countries vulnerable to sudden reversals in portfolio investment and to currency instability. The huge investment from overseas has put significant pressure on the currencies of emerging economies. Recent surges in capital flows during a global financial crisis have been driven by portfolio equity flows, shown in Figure 1, as investors take advantage of earnings differential between emerging Asian markets and mature markets.

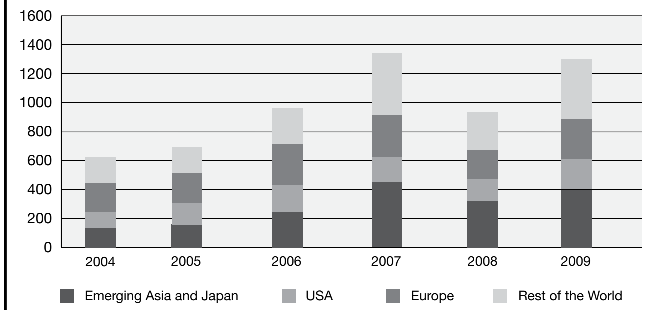
Financial integration implies an increase in capital flows and a convergence tendency for prices and returns on traded financial assets across countries. Since the 1980s, many East Asian countries have been gradually deregulating their financial markets, opening financial services to foreign investors, and

Figure 1 Portfolio Investment Flows in Equity (in U.S. billions)



Source: International Financial Statistics, IMF

Figure 2 Cross-Border Portfolio Investment (in U.S.)



Source: Coordinated Portfolio Investment Survey, IMF

liberalizing capital accounts to improve the efficiency of their financial markets and attract foreign capital. Figure 2 depicts the recent trend of the cross-border portfolio investments of eight emerging Asian countries.[2] Emerging Asia's foreign portfolio investments are increasingly being invested in the region, with intra-regional portfolio holdings rising from 17.8 percent of the region's total foreign asset holdings in 2004 to 27.6 percent in 2009. This implies a higher share of financial assets has been traded within the region and held by regional investors, which is evidence of ongoing financial integration in the regional financial market. In addition, the combined share of the United States and Europe in Asian emerging economies' total foreign portfolio has declined from 47.3 percent in 2004 to 36.9 percent in 2009. These patterns in emerging Asia's portfolio investments imply a higher degree of regional financial integration and cross-border openness.

Regional Financial Safety Nets

Overview of CMI and CMIM

After experiencing the severe contagion of the financial crisis in the region, ASEAN+3 realized the need for a regional self-help measure against the recurrence of a similar crisis in the future. The CMI was designed to address short-term liquidity difficulties as a network of bilateral swap arrangements and to supplement existing international financial arrangements. The CMI expanded the existing ASEAN Swap Arrangement (ASA), which was initially established by the five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) in 1977. However, its size of $0.2 billion was insufficient to provide emergency liquidity in crisis.

ASEAN+3 has extended ASA to the other five ASEAN members and the Plus Three countries by increasing its size to $1 billion. CMI was agreed to in May 2000 in Chiang Mai, Thailand, with the objective of establishing a network of bilateral swap arrangements to address short-term liquidity difficulties in the region and to supplement existing international financial arrangements. The ASEAN+3 finance ministers took the framework of the existing CMI and moved toward its multilateralization in May 2009, and the CMIM was finally made effective on March 24, 2010. The multilateralized CMI provides emergency liquidity support from the total fund of $120 billion under a single agreement.[3] Since the CMIM is financed in the form of promissory notes, there is no direct and immediate impact on the member country's international reserves.

The CMIM represents a highly significant institutional development for regional financial integration as it not only plays the role of financial safety nets in times of crisis, but also provides a central platform for managing regional financial arrangements. In particular, it enhances ASEAN+3 inter-governmental dialogue for further financial cooperation in related areas by using CMIM governance, including financial surveillance and the development of local bond markets. Future progress on its institutional setup will also serve to facilitate financial integration in the region and contribute to the development of both regional and domestic financial markets.

CMIM and ESM

In early May 2010, the European sovereign debt crisis and its contagion in the region led European Union policymakers to approve three lending facilities for euro area member states in serious financial distress. The first facility is a 110 billion euro support package for Greece, approved on May 3rd and provided jointly with the IMF. The second facility is the European Financial Stabilization Mechanism (EFSM)[4] with 60 billion euros. The third facility is the European Financial Stability Facility (EFSF)[5] with an amount of 440 billion euros, supplemented with a 250 billion euro IMF commitment.

Comparing the CMIM with the European Stabilization Mechanism (ESM), which consists of the EFSM and EFSF,

Table 1 CMIM Contributions and Purchasing Multiple

	Contributions				Purchasing Multiple	Voting Power (%)
	USD (Bil.)		Share (%)			
China	38.4	Exc. HK 34.2	32.0	28.5	0.5	25.43
		HK 4.2		3.5	2.5	2.98
Japan	38.4		32.0		0.5	28.41
Korea	19.2		16.0		1.0	14.77
Plus Three	**96.0**		**80.0**		**-**	**71.59**
Indonesia	4.552		3.793		2.5	4.369
Thailand	4.552		3.793		2.5	4.369
Malaysia	4.552		3.793		2.5	4.369
Singapore	4.552		3.793		2.5	4.369
Philippines	4.552		3.793		2.5	4.369
Vietnam	1.00		0.833		5.0	1.847
Cambodia	0.12		0.100		5.0	1.222
Myanmar	0.06		0.050		5.0	1.179
Brunei	0.03		0.025		5.0	1.158
Lao PDR	0.03		0.025		5.0	1.158
ASEAN	**24.0**		**20.00**		**-**	**28.41**
Total	120.0		100.0		-	100.0

Source: The Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers' Meeting

the ESM is the facility to cope with difficulties caused by exceptional circumstances beyond the member state's control such as its fiscal crisis. The ESM plays its role as a crisis resolution mechanism, much like the CMIM. However, while the purpose of the CMIM is to resolve short-term foreign exchange liquidity crisis by providing US dollars, the ESM aims to overcome a solvency crisis by providing euros. Accordingly, the CMIM conditionality requires no capital control, participation in the Economic Review and Policy Dialogue (ERPD), and maintenance of an appropriate level of international reserve, while the ESM conditionality focuses on fiscal and economic policies. In addition, CMIM supports short-term liquidity via currency swap arrangements, while EFSF is a special purpose vehicle (SPV) setup to make loans to euro area countries.

New ASEAN+3 Economic Surveillance Mechanism

In terms of regional macroeconomic and financial surveillance, innovation was introduced within the CMIM framework by establishing the new surveillance unit AMRO. Its mandate includes monitoring potential risk vulnerabilities and keeping track of key macroeconomic and financial condition trends, as well as minimizing the moral hazard problem arising from the crisis resolution function of the CMIM through short-term liquidity support. It is also important to ensure that potential recipient members of ASEAN+3 maintain proper conditions to repay loans from the CMIM. Established in Singapore in April 2011 by ASEAN+3 countries, AMRO is expected to perform regional macroeconomic surveillance activities, supplementing the global surveillance activities through the IMF mission of Article IV consultations.

AMRO's first director, a Chinese national, was appointed in May 2011 and leads the organization for one year of a three-year term. After his tenure, a second director, a Japanese national, will serve the remaining two years. The first director was expected to represent China's position and to focus on the IMF link. For example, China proposed that the CMIM's IMF-delink portion increase to 30-40 percent of its funds from the current 20 percent.[6] As AMRO becomes effectively operational, the level of the IMF-linked portion will be reduced.

AMRO may not be a perfect substitute for the IMF, but its role in regional surveillance will complement the work being done by the IMF. As part of becoming a solid and well-functioning institution, AMRO is expected to introduce regional policy conditionality in support of the CMIM, contribute to a membership enlargement, and introduce crisis a prevention function in the region.

Introducing Regional Crisis Prevention Function

During the global financial crisis, capital flows have shown volatile behavior especially in emerging markets. However, despite their relatively sound economic fundamentals, Asian financial markets are vulnerable to external shocks due to increasing capital flows from and to the region. Therefore, it is natural to consider a regional crisis prevention function to serve as the first firewall against financial risks.[7]

In order to design an effective crisis prevention program, the following key elements should be considered. First, a crisis prevention function needs to be equipped with ex-ante qualifications. In making the decision to provide liquidity, we need to evaluate a country's economic status and the symptoms of the financial crisis, and to minimize potential moral hazard. However, if the ex-ante qualifications were excessively strict, it would lower the chances of using the crisis prevention facility (CPF), therefore making its effectiveness uncertain and eventually eliminating the demand. Considering the trade-off between reducing moral hazard and creating potential demand for the CPF, the regional CPF should strike a balance between ex-ante qualifications and ex-post conditionality. Second, once a swap-requesting country qualifies for the ex-ante conditions, its drawing rights should be guaranteed by an agreement. This automaticity of drawing is critical for the CPF to ensure its credible activation. Third, a regional surveillance unit should properly function to support the two elements mentioned above. To screen ex-ante qualifications and guarantee automaticity of drawing, a surveillance unit should provide appropriate analyses on regional economic conditions.

ASEAN+3 can consider a two-track operation of the current CMIM as a basic framework for the CPF. Its two-track mechanism can be operated as the crisis resolution and crisis prevention functions.[8] That is, the crisis prevention function can be augmented to the current crisis resolution function of the CMIM. If this is the case, a country, showing symptoms of a financial crisis but qualifying ex-ante conditions, may request liquidity support and its drawing rights are granted for a designated period of time. According to de las Casas and Serra (2008), the use of IMF lending with the actual duration of six months or less was only for three cases out of 290 programs between 1990 and 2006.[9] In this regard, the six-month arrangement period of the regional CPF would be reasonable because the ASEAN+3 CPF is able to meet the corresponding demand for short-term precautionary lending. In designing the details of the ASEAN+3 CPF, members can refer to the IMF lending facilities for crisis prevention, such as flexible Credit Line, Precautionary and Liquidity Line, and the High-Access Precautionary Arrangements program under the Stand-By Arrangement.

In addition, regional policy conditionality by the CMIM framework can be imposed with the aid of AMRO or ASEAN+3 ERPD. In order for this scheme to be effective some prerequisites should be satisfied. For example, the surveillance function will have to be enhanced first before reducing the IMF linked portion, and it might be difficult to ensure market credibility with a limited amount of resources and a lack of reserve pooling.

Another important thing that ASEAN+3 CPF should consider is to characterize exit strategies from the crisis prevention function. If a country still requires additional liquidity support after exhausting the CPF's arrangement period, the CPF-requesting country could be deemed to have structural economic problems, rather than showing crisis symptoms. If this is the case, the crisis prevention function can be switched to the CMIM's crisis resolution track or be linked with the IMF lending facility.

Institutional Integration in Asian Bond Markets

Overview of ABMI and ABFs

After the Asian financial crisis, East Asian countries paid attention to reforming domestic financial markets and developing regional bond markets. It was widely acknowledged that excessive financial dependence on the bank-based system in the region was a cause of the crisis in 1997. The ABMI was established in 2003 to develop the Asian bond markets under the ASEAN+3 framework, and became fully operational that same year. The ABMI aims to develop efficient and liquid local currency bond markets in Asia through recycling savings and international reserves of East Asian countries. It emphasizes the creation of regional bond markets where bonds are denominated in regional currencies. It was also expected to mitigate the chronic double-mismatch problem in East Asia: currency and maturity mismatch. In this regard, developing local currency bond markets constitutes another aspect of ASEAN+3 financial integration.

The main reason behind the establishment of the ABMI and ABFs was the intention to achieve a more efficient recycling of Asian savings into investment in the region by developing local currency bond markets. The 1997-98 crisis was indeed made more severe by the absence of well-developed bond markets, which made Asian companies rely on bank loans and borrow foreign ones. International reserves and savings in Asia have been largely invested in the U.S. and Europe, and they are then re-invested in Asia. It is known that about 80 percent of Asia's portfolio investment tilts toward assets in the U.S. and Europe. As of March 2009, ASEAN+3 foreign reserves amount to 52 percent of the total reserve in the world, but most of them are still invested in assets outside of East Asia.

As regional financial authorities realized such weakness in their domestic systems, they promoted regional initiatives of the ABMI and ABFs to develop local bond markets. In fact, the size of bond markets increased from about one-fifth of total financial intermediation in East Asian countries in 1995 to approximately one-third in 2010. During the same period, the share of total outstanding local currency bonds issued in East Asia in relation to the world's total increased from about 2.5% to more than 8%.[10]

After the ASEAN+3 endorsement of the ABMI, specific actions have been taken on particular issues of the initiative. In particular, bonds were issued in local currencies by multilateral development banks. For example, the ADB issued several local currency bonds; in 2004 the ADB undertook five market-opening transactions in the region's local currency bonds in Malaysia, China, the Philippines, Thailand, and India. As well as issuing bonds, the ADB has launched a new and publicly accessible website, Asian Bonds Online, in 2004 to share information on regional markets, economies, and companies. It provides a wide range of information such as taxation, regulations, bond indices, credit ratings, settlement systems and secondary market trading.

While ASEAN+3 has been involved in developing local currency bond markets along with the ABMI, the Executive Meetings of East Asia and Pacific Central Banks (EMEAP) launched the first Asian Bond Fund (ABF 1) with a capitalization of $1 billion in 2003. ABF 1 was mandated to invest in dollar-denominated sovereign bonds issued by eight EMEAP countries.[11] However, due to its small size, ABF 1 was expected to have little effect on the market for dollar-denominated sovereign bonds in East Asia.

ABF 2, introduced in 2004 with a capital of $2 billion, was implemented to purchase local currency bonds from Asian countries. It consists of both a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). PAIF is a single bond fund index investing in local currency sovereign bonds issued in eight EMEAP countries. FoBF has a two-layered investment structure in eight single-market funds, each of which invests in local currency bonds issued in their own markets.

The ABMI and ABFs have helped the development of bond markets in East Asia and have reduced the currency and maturity mismatch problem. Accordingly, East Asian economies were able to withstand the global financial crisis showing relatively stronger resilience than the U.S. and Europe. A lot still remains to be done, however, to harmonize rules across the region, strengthen market infrastructure, overcome remaining market impediments, and tighten legal and regulatory frameworks. While Asian authorities need to promote their growth to attract more investment in the region, domestic reforms and regional cooperation initiatives are especially needed to improve accounting standards, market infrastructure, and legal systems.

Credit Guarantee Investment Facility

To develop local currency bond markets in Asia, it is essential to facilitate issuers' access to Asian bond markets. This might require guaranteed credit ratings for local currency bond investments. Moreover, local capital in Asia is required to be invested in medium- and long-term infrastructure projects that lead to Asian economic growth.[12] Therefore, Asia needs to use a large amount of savings and international reserves to fill the financial gaps and to overcome constraints in local currency financing due to the lack of investor's confidence in Asian bond markets.

Strengthening and deepening local currency bond markets can develop domestic financial markets and ultimately enhance regional financial integration and economic growth. Based upon this rationale, in 2008 ASEAN+3 agreed to establish a Credit Guarantee and Investment Mechanism (CGIM), renamed as Credit Guarantee Investment Facility (CGIF) in 2009, to provide credit guarantees to local currency bonds issued in the region and to enable them to raise medium-and long-term financing instruments by improving the conditions for issuing bonds. It is expected to facilitate capital market development and to make the regional financial system less vulnerable to external shocks. The objective of CGIF is to support the issuance of local currency denominated bonds in Asia, so as to contribute to Asian economic development and prosperity through credit guarantee schemes. It is currently in the process of finalizing its operational policies and business plan, and is expected to start its operations before the end of 2012. The CGIF will be established as an ADB trust fund with an initial capital of $700 million.[13] Major issues regarding the establishment of CGIF, such as business scope, leverage ratio and country limit, were discussed at the ASEAN+3 Finance and Central Bank Deputies Meeting in May 2011.

The CGIF is expected to have the following effects. First, high-rated issuers can seek to lengthen the maturity of their debt issuance and lower-rated issuers can also issue bonds with the aid of the credit guarantee scheme. Second, member countries' external borrowing costs can be reduced. Third, credit guarantees for local currency bonds would help reverse capital outflows and make the regional financial system sound and resilient. Fourth, supports for infrastructure bonds can serve to provide regional public goods and ultimately lead to regional economic growth.[14] In addition to credit guarantees via the CGIF, some issues are currently part of ASEAN+3 dialogue, including establishing a Regional Settlement Intermediary and Asian Bond Standards among others.

Asian Bond Markets Forum

At the fourteenth ASEAN+3 Finance Ministers meeting in Hanoi in May 2011, ASEAN+3 welcomed the progress of the Asian Bond Markets Forum with the aim of standardizing market practices and harmonizing cross-border regulations of financial transactions. It is a common platform to foster standardization of market practices and harmonization of regulations relating to cross-border bond transactions in the region.

Since its onset, it has become an important forum for bond market experts from both public and private sectors in the region. There also has been progress in the technical working group on legal and regulatory feasibility assessment of the Regional Settlement Intermediary (RSI). Another possible development relates to the enhancement of domestic rating agencies through capacity building programs, as credit rating agencies of East Asian countries are often relatively small and tend to use non-comparable methodologies and benchmarks in their rating process, needing therefore some form of standardization and harmonization across the region.[15]

Challenges of Financial Integration and Korea's Role

To promote Asian financial integration, a key priority would be laid on regional financial cooperation. Earlier discussion on progress toward financial integration was assessed in terms of regional institutional measures. An even stronger degree of financial market integration is possible if significant efforts are made toward regional institutional integration. Since it is not easy to integrate cross-border markets and harmonize regulations in the region, regional institutional development is necessary to generate benefits from economic integration.

The recent global financial crisis accelerated ASEAN+3 financial cooperation. With this momentum, Korea's role for further regional institutional integration is important, especially in 2012 as a co-chair country of the ASEAN+3 framework. In fact, Korea has been deeply involved in regional financial cooperation and also shown strong leadership in initiating detailed proposals and cooperative actions. Many important issues are currently being discussed among ASEAN+3 members, including increasing the size of CMIM, increasing the IMF-delinked portion of CMIM, operational issues of AMRO and surveillance activities, members opening bank accounts of CMIM in the central bank, introducing new regional crisis prevention facility, various issues of Asian bond markets, and regional-global cooperation with the IMF among others.

The ASEAN+3 ERPD aims to identify potential macroeconomic and financial risks, prevent crises, monitor regional capital flows and currency markets, and enhance self-help support mechanisms in the region. While the ERPD was not sufficient for regional surveillance, a new surveillance unit, AMRO, is expected to play an important role towards regional financial integration. Even though the ERPD became an information exchange mechanism on economic conditions and policies, its non-interference principle was an impediment to make effective surveillance activities. In general, three components of economic surveillance are suggested: information sharing, peer review/peer pressure, and due diligence. Currently ASEAN+3 surveillance is in transition from the information sharing stage to the next stage of a more rigorous scrutiny stage, which must involve due diligence in the future. The EU's reform of financial supervisory institutions includes the Comply-or-Explain principle for policy recommendations which makes it a more binding peer review/peer pressure. In the long-run AMRO should focus on providing the regional equivalent of IMF multilateral surveillance by moving forward to the effective peer review and pressure stage and due diligence. This would make AMRO a well-resourced professional surveillance unit, and introduce a more effective macroprudential supervisory framework for financial supervision and integration.

Korea has taken the lead in dialogue within the ASEAN+3 framework: for example, it proposed the ABMI in 2002. Korea is also expected to exhibit its intellectual leadership in the process of establishing a regional crisis prevention mechanism. It is particularly important to introduce the regional CPF because, given the stigma from the IMF lending facilities, it would be politically difficult for any government in the region to seek an IMF program. Moreover, Korea's efforts to coordinate member opinion on the current issues mentioned earlier will significantly contribute to the outcome of regional financial integration and to continuing its momentum in the future. In doing so, Korea's role as the honest broker in the ASEAN+3 framework is emphasized. For example, the ASEAN+3 negotiation on CMIM contribution shares was a fierce diplomatic battle among member countries. In the process, Korea proposed the mediated settlement on the member's CMIM contribution shares that became the agreement's final outcome. It also has an important role with regional decision-making between China and Japan. For instance, the selection process of the first director of AMRO was indeed a fierce diplomatic battle, especially between China and Japan. While Japan pioneered the institution's development, selecting a Chinese national as the first director may imply that China takes the initiative in both establishing AMRO as an international institution and setting up its tone and mandate for future institutional developments. In this regard, Korea's role in regional cooperation is important for the development of financial integration.

An important factor with Asian financial integration is the fact that Asian emerging economies have experienced financial instability when domestic markets were opened to foreign participation. The global financial crisis affected Asian financial systems in various ways, including a massive decline in capital inflows, currency values and asset prices. Deepening regional financial integration will provide more benefits to the Asian economy through efficient allocation of financial resources and risk diversification. Therefore, ASEAN+3 member countries have to keep their balance between the net benefits derived from financial integration, and the potential cost of risk vulnerability and crisis contagion in designing a regional financial institutional mechanism.

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[1] The ten ASEAN (Association of South East Asian Nations) member countries are Thailand, Malaysia, Singapore, Indonesia, the Philippines, Brunei Darussalam, Burma, Laos, Vietnam, and Cambodia. The Plus Three countries are the Republic of Korea, Japan, and the People's Republic of China.

[2] Singapore, the Philippines, Malaysia, Korea, Indonesia, India, Hong Kong, and Thailand.

[3] ASEAN+3 has agreed to double the CMIM reserve pool from $120 billion to $240 billion in May 2012. (Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting).

[4] The European Commission is empowered to contract borrowings on behalf of the EU for the purpose of funding loans made under EFSM. EFSM is a treaty-based mechanism, covering all EU Member States. Under the EFSM, the EU can borrow up to 60 billion euros to lend to any EU Member State. Under the Balance of Payments facility, support is available only to Member States which have not yet adopted the euro. (http://www.efsf.europa.eu).

[5] In order to reach its objective, EFSF can issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries which submit a request. Issues are backed by guarantees given by euro area Member States of up to 440 billion euros. EFSF is part of a wider safety net. Its funds are combined with loans of up to 60 billion euros coming from the EFSM, and up to 250 billion euros from the IMF for an overall rescue package worth up to 750 billion euros. (http://www.efsf.europa.eu).

[6] ASEAN+3 has agreed to increase the IMF-delink portion to 30% in May 2012. (Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting).

[7] The current CMIM is an arrangement of the regional crisis resolution facility in the sense that it is associated with ex-post treatment after the trigger event of a crisis that macroeconomic fundamentals have already been deteriorated.

[8] ASEAN+3 adopted "CMIM Stability Facility (CMIM-SF)" as the name for crisis resolution mechanism and "CMIM Precautionary Line (CMIM-PL)" for crisis prevention function. (Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting)

[9] de las Casas M. and X. Serra, 2008, "Simplification of IMF lending – Why not just one flexible credit facility," Banco de Espana.

[10] Capannelli G., 2011, "Institutions for economic and financial integration in Asia: Trends and prospects," ADBI Working Paper No. 308, Asian Development Bank Institute.

[11] China, Hong Kong, Korea, Singapore, Indonesia, the Philippines, Malaysia, and Thailand.

[12] Bhattacharyay (2010) estimates the financing needs for Asia's infrastructure at around $750 billion per year in energy, water, transport, telecommunications, and sanitation between 2010 and 2020. (Source: Bhattacharyay B., 2010, "Financing Asia's infrastructure: Modes of development and integration of Asian financial markets," ADBI Working Paper No. 229, Asian Development Bank Institute).

[13] Japan and China are to contribute $200 million, Korea $100 million, and the ADB $130 million. Five members of ASEAN including Malaysia, Thailand, Indonesia, the Philippines and Singapore, are to contribute US$12.6 million each; Brunei pledged to contribute $5.6 million, Vietnam $1.1 million, and three remaining countries of Laos, Cambodia and Myanmar each contributing $100,000.

[14] Park and Rhee (2011) conduct a quantitative analysis on the macroeconomic effects of credit guarantees in Asian bond markets by simulating a five-block version of the IMF Global Integrated Monetary and Fiscal model. The simulation scenarios reveal that (1) even though East Asian financial cooperation upgrades some of ASEAN+3 member countries' credit fundamentals, it helps increase both the corresponding countries' real GDP and regional real GDP, and (2) this effect is amplified as more member countries' credit ratings are upgraded. (Source: Park Y.-J. and D.-E, Rhee, 2011, "A quantitative assessment of regional credit guarantee scheme in Asian bond markets," KIEP Working Paper 11-07, Korea Institute for International Economic Policy).

[15] ADB (2010) Institutions for Regional Integration: Toward an Asian Economic Community. Manila: Asian Development Bank.

KOREA AND ECONOMIC INTEGRATION IN EAST ASIA: THE WAY FORWARD

By Françoise Nicolas

Abstract

It is now a well-established fact that intraregional trade has been expanding quite fast in East Asia in the absence of any institutional arrangements to that end. Korea has been a major beneficiary of this organization of the East Asian region. In the wake of the recent global financial crisis, however, a number of developments suggest that the region may be at a cross-road, and that substantial changes may be expected in the way the region is organized. As a traditional promoter of East Asian regionalism and as one of the best-integrated economies in the region, Korea provides an interesting case study. An analysis of Korea's reactions to the recent changes suggests that the importance of vertically-integrated production networks is likely to be shrinking in parallel with a rising role of institutional arrangements. Although East Asian economic integration will keep its specificity, the de facto and de jure dimensions are likely to be increasingly mutually reinforcing, with Korea as a key player in both areas.

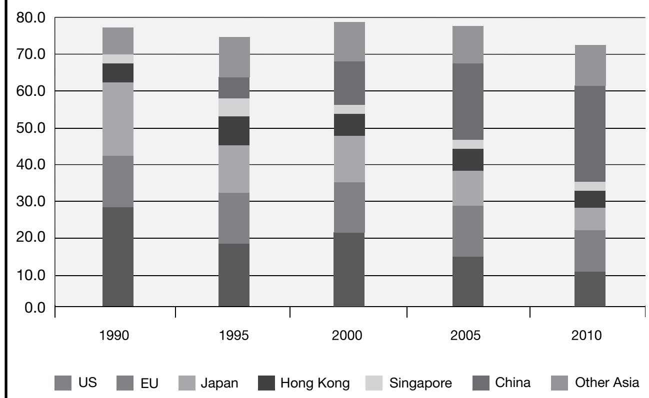
Introduction

It is now a well-established fact that intraregional trade has been expanding quite fast in East Asia (although this does not necessarily mean that the region is getting increasingly inward-oriented[1]) in the absence of any institutional arrangements to that end. Dynamic intraregional trade accounts for the strong rate of economic growth in a number of countries in the region, with Korea as a case in point. In the wake of the 1997-98 Asian financial crisis in particular, the Korean economy managed to recover swiftly thanks to its exports to rapidly growing China.

However, a widely-held consensus view claims that East Asia has been gradually shifting from a market-led (*de facto*) to an institution-based (*de jure*) form of regional economic integration. Since Korea was among the first economies to promote East Asian regional *de jure* integration through its active role in the East Asia Vision Group in particular, and since it is one of the best-integrated economies in the region, it provides an interesting case study.

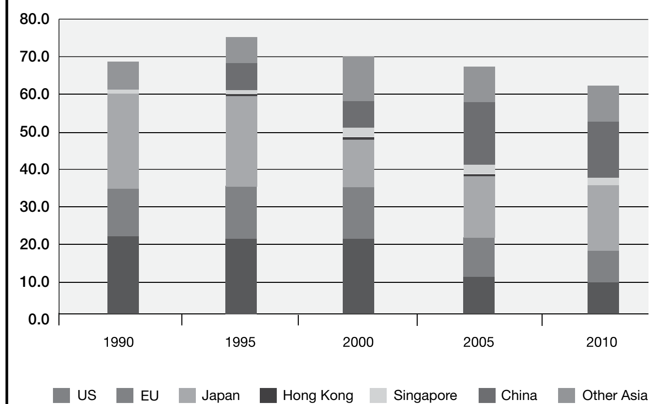
The objective of the paper is to examine the current state of play and the future prospects of regional economic integration in East Asia from a *de facto* as well as from a *de jure* perspective, focusing on the Korean case. The first section assesses Korea's participation in the regional production networks as well as its contribution to the institution-based regional cooperative efforts. The second section starts by highlighting several developments which are likely to deeply modify the economic environment in East Asia before analyzing their impacts on Korea's regional strategy and on the future organization of the region as a whole.

Figure 1 Korea's Exports by Destination, 1990-2010



Source: Author's calculation based on IMF Direction of Trade Statistics

Figure 2 Korea's Imports by Country of Origin, 1990-2010



Source: Author's calculation based on IMF Direction of Trade Statistics

Korea's Economic Integration in East Asia

Korea is Increasingly Integrated with East Asia …

As is the case with all other East Asian economies (with the notable exception of China), Korea has been trading more and more intensively with the rest of East Asia since the mid-1990s, leading to a sharp decline in the relative importance of its other traditional trading partners such as the U.S. and the EU. The combined shares of these two partners dropped from close to 40 percent in 1990 to about 20 percent in 2010. In contrast, the share of Korea's trade with East Asia rose from 33.5 percent to 48.2 percent over the same period of time. Its exports to the rest of the region rose from 33.6 percent to 52 percent, while the share of its imports coming from the same partners rose from 33.5 percent to 44.4 percent over the past twenty years.

Within the East Asian region, the most dramatic changes are the increase in China's share as an export destination as well as a source of imports, and the parallel drop in Japan's share as an export market (but, interestingly, not as an import supplier). China is now well ahead of the U.S., Japan and the EU among Korea's top trading partners (Figures 1 and 2).

Trade between China and Korea has been growing at an astoundingly average annual rate of close to 19 percent over the period 1993-2010, leading to deepening economic interdependence and the trend is still ongoing, with two-way trade between China and Korea crossing the $200 billion line in 2011. As a result the share of Korea's exports going to China more than doubled, rising from about 10 percent in 2000 to close to 25 percent in 2010, while the share of its imports from China doubled from 8 to 16.8 percent. Today China is Korea's largest export destination (it has been the case since 2003, when China overtook the U.S.) and also its largest import supplier (ahead of Japan, since 2007).

The dynamism in Sino-Korean trade has obviously to do with China's stellar economic growth and hence with its rising importance as a trade powerhouse and as an expanding market.

However, the calculation of Korea's export bias with respect to China[2] suggests that exports to this country were exceptionally dynamic, at least until recently. Although still high, the indicator has been dropping lately after reaching a peak in 2005. This suggests that Korea's exports to China are greater than expected but decreasingly so (Figure 3). On the import side, the bias indicator is much lower (although slightly rising) at about 1.40. These results reflect an asymmetry in Sino-Koran trade, with greater than expected Korean exports to China, while its imports are more or less in line with expectations.

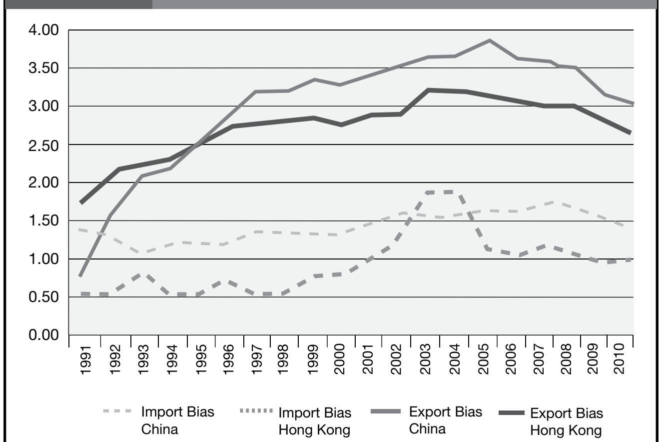
Another way of gauging whether a trade relationship is greater than expected is to resort to a gravity equation. The estimation helps determine what can be seen as the "potential" trade between a given pair of countries. As a next step, comparing the fitted values with the actual values indicates whether there is still an untapped potential or not. The evolution highlighted earlier is confirmed by the results of a gravity equation estimated for Korea's exports over the period extending until 2007.[3] The estimation suggests that Korea tends to over-export to China, while the reverse is not true. These various elements suggest that the China-Korea trade relation is a major building block of intra-East Asian integration.

Next to the two Northeast Asian partners, ASEAN countries (in particular Indonesia, Singapore and Vietnam) have emerged as important trading partners. Today ASEAN is Korea's second largest trading partner after China and ahead of Japan and the European Union. As in the case of China, the estimation of a gravity equation suggests that Korea's exports to ASEAN are greater than expected with very little untapped potential.

… Through Regional Production Networks …

A detailed analysis of the structure of Korean exports to, and imports from, East Asia (in particular China) provides a clearer picture of the way the various economies are interlinked.

Figure 3 Korea's Trade Bias



Source: Author's calculation based on IMF Direction of Trade Statistics

Using the Broad Economic Categories (BEC) classification and following Gaulier et al. (2005)[4] commodities are aggregated by stages of production and a distinction is made between i) primary goods [food and beverages, primary mainly for industry (111), primary industrial supplies (21), primary fuels and lubricants (31)], ii) intermediate goods [processed industrial supplies (22), processed fuels and lubricants (32), parts and components of capital goods excl. transport equipment (42) and of transport equipment (53)] and iii) final goods [capital goods (41), and consumption goods: food and beverages (112 and 122), passenger motor cars (51), consumer goods (61, 62, 63)].

The bulk of Korea's exports to China are intermediate goods (75 percent in 2010) and primarily for processing. Part of these intermediate products may be used to produce goods to be sold on the Chinese market, but this share is small. Most intermediate products are processed in China and exported to other countries as final products. While these intermediate goods were initially industrial supplies (22), overtime the share of parts and components (categories 42 and 53) has risen substantially to account for about 35 percent. At the same time, the share of capital goods (41) has also tended to rise (to account for 25 percent of total Korean exports to China). In contrast, consumer goods only account for less than 3 percent of Korea's exports to China.

Korea's imports from China also had a large portion of intermediate goods, but the share of final goods (and in particular consumption goods with 12.1 percent) was larger than what is observed for Korea's exports to China. As a result, Korea has a deficit in final goods trade with China and a surplus in intermediate goods.

Korea's exports to ASEAN countries such as Malaysia or Vietnam in particular are also dominated by intermediate products—parts and components of capital goods (42), as well as processed industrial supplies (22).[5] These exports are mainly semiconductors, TV screens, electronic goods, vehicles, steel, chemicals, refined petroleum products, ships and machinery, while its imports from Southeast Asia are mainly oil and gas, coal, paper, rubber, wood products and garments.

All these observations suggest that Korea, China and a number of ASEAN countries belong to regional production networks. The existence of a strong correlation between Korea's exports to China and China's exports to the U.S. provides further evidence that Korea and China are parts of the same production chain.

The tight interconnections between Korea and the rest of East Asia are also reflected in the active involvement of Korean firms in the region. Since the establishment of diplomatic relations in 1992, Korea's FDI to China has grown dramatically. Korea invested massively in China in the early-2000s, making it one of the most important sources of FDI in China. However, according to the latest Mofcom statistics, Korea's FDI in China peaked in 2005 (when it reached $5.17 billion, accounting for over 10 percent of total foreign inflows) and has been shrinking ever since to drop below 3 percent of total foreign inflows. Similarly, from Korea's perspective, while China accounted for close to 40 percent of Korea's total ODI outflows in 2003-2004, it started declining in the following years and accounted for merely 14 percent in 2011. In terms of stock, Korea lags behind Hong Kong, Taiwan, Japan, Singapore and the United States. These various observations suggest that Korea may be losing ground in the competition with other economies in the region which are closely connected to China, namely Hong Kong and Taiwan.

Next to China, Southeast Asia accounts for a non-negligible destination of Korean outward direct investment and ASEAN as a whole ranks as the second largest investment destination (after the U.S.). Korean ODI flows to the region have been particularly dynamic over the past few years, making Korea ASEAN's fourth largest investor. Most of Korea's investments are in labor intensive and export-oriented industries like footwear, garments, electronic and electrical goods and chemicals.

… With Institutional Arrangements Playing a Marginal Role

Interestingly Korea's dynamic trade with a number of its neighbors cannot be accounted for by the existence of preferential arrangements. As explained, Korea's trade is particularly dynamic with China but the two partners have not engaged in any preferential arrangement.

In contrast, Korea has an FTA with its second largest trading partner, namely ASEAN. However, the Korea-ASEAN FTA has only been in effect since 2007 for goods and 2009 for services and the sharp rise in bilateral trade predates the signing of the agreement and cannot thus be accounted for by the FTA.

The logic underlying Korea's FTA strategy is pragmatic. The country has chosen to negotiate FTAs with its major trading partners, be they neighbors or not. Today, Korea has FTAs in force with the EU, the U.S., Chile, the European Free Trade Association (EFTA), Peru, Singapore, ASEAN, and India. It has also been trying to reach an agreement with Japan for a number of years. Korea may thus be seen as a champion of bilateral agreements rather than a champion of regional trade agreements.

So far, there has been a proliferation of FTAs in the region but no major attempt at creating a formal trade block. More progress may be observed in the financial area (with the establishment of the Chiang Mai Initiative in 2000 followed by the multilateralization of the mechanism in 2011) while the opening of negotiations for the establishment of an East Asian Free Trade Area for instance is still to take place.

Looking Ahead: Changing Conditions and Their Implications for Korea

In the wake of the global financial crisis (GFC) a number of developments are likely to impact the economic environment in East Asia and change the conditions for regional economic integration and the way Korea interacts with its regional partners, in particular China. The following section examines three such developments in turn: China's shift in economic strategy, the full implementation of the economic partnership agreement between China and Taiwan, and the new project of a Trans-Pacific Partnership (TPP).

Major Factors of Change

China's Economic Strategy Shift

In China, the GFC has led to the conclusion that the development strategy followed so far was deeply flawed and that it was as a result necessary to reduce the economy's vulnerability to external demand shocks and to move away from too exclusive a strategy of export-orientation by rebalancing growth, especially through the promotion of domestic consumption. Although the awareness of the need to enhance the expansion of domestic consumption is nothing new in China and although it had already inspired the eleventh Five-Year Plan (2006-2010), the much needed structural reform has become a more explicit objective of the recently issued twelfth Five-Year Plan (2011-2015). As a result, the Chinese Government now seeks to deeply reform its economic strategy beyond the mere promotion of domestic consumption. The major objectives of the twelfth Five-Year Plan are first to rebalance the country's growth strategy by moving away from exclusive export-orientation towards developing the domestic market, and secondly to move the economy up the value chain in the coming years so as to enhance its technological independence.[6]

As a result of these strategy shifts in China, the existing form of cooperation and interconnections between China and the rest of East Asia is likely to be deeply modified. As explained by Shim (2011), East Asia's division of labor in manufacturing is based on differences in technologies and the labor productivity of the various countries. This division of labor will change as China continues to develop technologies and improve productivity, and Korea and Japan try to gain a comparative advantage by developing new technologies and new products.

Full Implementation of the ECFA between Taiwan and China

From Korea's perspective, another major recent development with potentially important implications pertains to the coming into force of the Economic Cooperation Framework Agreement (ECFA) signed between mainland China and Taiwan in June 2010. The objective of the ECFA is to "normalize" trade across the straits, in particular by putting an end to the numerous restrictions imposed by Taiwan so far on imports from the mainland. As the name indicates the agreement merely provides a framework that outlines the main content of the future FTA, before individual agreements are signed on specific issues. So far, tariffs were lowered for products covered in the Early Harvest Product list (EHP) with effect from January 1, 2011 and they are scheduled to be fully eliminated on January 1, 2013. Further follow-up talks are expected in the coming years. For the time being, the liberalization has been rather asymmetrical with higher commitment level on the part of mainland China. This agreement is no doubt of importance to Korea since Taiwan and Korea share a number of similarities in their specialization patterns and in particular in their export structures to China. The two countries are export competitors in China which is their largest export market. Although the agreement is far from being complete, rising competition may be expected from Taiwan, with Taiwanese firms able to export on more favorable terms.

TPP Project

Lastly, a recent initiative, the Trans-Pacific Partnership (TPP), is likely to bring about further changes in the way the region is economically organized. The TPP is a trade agreement currently under negotiation between nine countries in three continents, including Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, the United States and Vietnam.[8] In late 2011 three additional countries—Japan, Canada and Mexico—announced their intention to join as well. The TPP aims to establish an ambitious high-quality trade agreement encompassing issues which are not often part of a FTA, such as intellectual property rights, government procurement, environmental protection regulations, labor issues as well as small and medium enterprises.[9]

At this stage it remains to be seen whether this project will go ahead and whether it may sideline other competing schemes. From Korea's perspective the importance of the TPP lies in its being designed to allow further members to join. As a result the TPP could very well become the core of a future grand Asia Pacific trade agreement. It may thus be perceived as a competitor to the Comprehensive Economic Partnership in East Asia (CEPEA) or the East Asian Free Trade Agreement (EAFTA).

Korea's Renewed Contribution to East Asian Integration

So far regional integration in East Asia has been primarily of the *de facto* kind rather than *de jure* because the need for trade liberalization was not perceived as very high (given the type of intraregional trade), but this form of integration seems to have reached its limits. China is seeking to develop its own market rather than being exclusively a production base. This poses a challenge for its trading partners which need to adjust their economic strategies accordingly but this may also require a change in the institutional setting with better structured regional trade liberalization. Korea has to face these two challenges.

Korea's Approach to China Revisited

If China manages to reduce its dependence on the export manufacturing sector and increase its domestic consumption in line with the objectives of the twelfth Five-Year Plan, it will provide Korea with an opportunity for more stable growth based on China's final demand. But this is only possible if Korea proves able to seize this opportunity. In the wake of the GFC, the share of intermediate goods in Korea's exports has tended to decline slightly, while the share of capital goods (41) has increased. This may be indicative of Korea's ability to also cater to Chinese needs as a market rather than exclusively as an exporting engine but it may alternatively merely reflect that China's major exportable goods have changed from simple and labor-intensive goods to more complicated and capital intensive goods.

For the time being Korea may not be particularly well-positioned to take advantage of the Chinese market, compared to Taiwan. Already Korea's apparent loss of competitiveness vis-à-vis Taiwan suggests that it is time for a rethink of Korea's expansion strategy in China. The challenge for Korea is to find ways of taking advantage of the new conditions prevailing in China. As explained by Chung (2011), "South Korea should focus its investments in China's domestic market and try to shift its processing trade with China to complex (or network) processing trade, which links the markets of South Korea, China, and third countries. It should also move away from simple manufacturing toward complex manufacturing, which offers a combination of manufacturing and services. Moreover, South Korea needs to expand its business areas to include logistics, science and technology, medical science, education, and other services."[10] All this means that substantial domestic reform is needed if Korean firms are to make the best of the Chinese market, with a particularly important role played by tertiary activities.

Korea's Regional FTA Strategy

In order to enhance the expansion of China, and East Asia as a whole, as a market, reducing tariffs on final goods is required. Pushing for an East Asia-wide FTA may thus be an appropriate step forward. The past few years have seen a renewed interest in the establishment of an East Asian FTA, involving ASEAN+3 countries and possibly some other partners. In August 2009, ASEAN and its six major trading partners (China, Japan, South Korea, India, Australia, and New Zealand) reasserted their commitment to establishing an East Asia Free Trade Agreement (EAFTA) and Comprehensive Economic Partnership in East Asia (CEPEA) within the next fifteen years. For the time being, opening such an ambitious negotiation still seems to be out of the question. However, the aforementioned developments may help give new momentum to the project.

The establishment of a trilateral agreement between China, Japan and Korea or at least a bilateral agreement between Korea and China may contribute to pave the way to a broader East Asian FTA but also facilitate Korea's penetration of the expanding Chinese market. Korea may thus emerge as an important contributor if not the major driver of further *de jure* economic integration in East Asia.

In the wake of the GFC, Korea's attitude toward a Korea-China FTA has indeed changed and it is seriously considering pushing for such an FTA[11] in order to move into the Chinese domestic market further, improve the trade structure, and establish a stable framework for economic cooperation. In October 2009, the Ministers of Trade of the two countries signed an agreement to increase bilateral economic cooperation, and Seoul began to consider serious talks with Beijing about negotiating a FTA.[12] A major reason for the change in Seoul's position is the need to respond to China's FTA activism, as exemplified by the full entry into force of the China-ASEAN FTA (as of January 1st, 2010) and of the Economic Cooperation Framework Agreement (ECFA) between China and Taiwan (as of January 1, 2011). As explained earlier, Korea is in direct competition with Taiwan on the Chinese market; with the ECFA likely to improve Taiwan's competitiveness in the China market possibly at Korea's expense, the case for a China-Korea FTA is made more compelling than ever.

It is worth stressing at this stage that an FTA with China was so far not really deemed necessary because the level of tariffs imposed on intermediate goods (the most intensively traded goods) was quite low, at least much lower than on final goods, in particular consumption goods. Going ahead with tariff liberalization will thus facilitate the further expansion of bilateral trade and the diversification of such trade beyond intermediate goods.

Next to this bilateral move, a potential trilateral FTA (involving China, Japan, and South Korea) is also increasingly being envisaged. The three Northeast Asian countries agreed in October 2009 to examine the feasibility of a trilateral FTA, and committed in May 2010 to conduct a joint study on this issue.[13] The feasibility study was completed by the end of 2011. On May 14, 2012, the three parties concluded the Fifth Trilateral Summit meeting in Beijing by signing the Trilateral Agreement for the Promotion, Facilitation and Protection of Investment, and agreed to launch negotiations for a three-way FTA by the end of the year. China's determination to go ahead with this trilateral FTA has no doubt to do with Japan's interest in joining the U.S.-sponsored TPP which involves a number of countries on both sides of the Pacific, with the exception of China.

A trilateral agreement is widely believed to be instrumental in strengthening trilateral relations, hence contributing to the ongoing process of economic integration in East Asia, such as ASEAN+3 or ASEAN+6. A CJK FTA would be regarded as a milestone in regional integration, fostering prosperity not only for the region but for the world as a whole. According to some estimates, a trilateral deal may be the most promising scenario in terms of gains, but as it is certainly not the easiest one to negotiate it is not the most likely.

Whatever the means, Korea can be expected to play a key role and contribute to the deepening of economic integration at the East Asian level.

Concluding Remarks

Until recently, Korea has benefited enormously from China's opening up strategy and this explains to a large extent the deepening of its integration with East Asia. Similarly, Korea has also benefited by moving part of its production capacities to China, also contributing to the tightening of regional production networks. Recent developments call for changes in this so far successful strategy. The challenge for Korea is to adjust its policy.

Korea is probably illustrative of the possible changes in the way the whole of East Asia will be integrating in the coming years, with a shrinking importance of vertically-integrated production networks and a rising role of institutional arrangements. The emergence of East Asia as a market rather than as a production base requires substantial changes in the specialization and trade patterns of the countries in the region but it also requires institutional adjustments, and in particular a broader liberalization move. Although East Asian economic integration will keep its specificity, the *de facto* and *de jure* dimensions are likely to be increasingly mutually reinforcing, with Korea as a key player in both areas.

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[1] Hamanaka, Shintaro, "Is Trade in Asia Really Integrating?," ADB working paper series on Regional Economic Integration, No 91 (January 2012).

[2] The export bias is calculated as the ratio of the share of country's i exports to country j in country i's total exports to the share of the world's exports to country j in total world exports.

[3] The estimated model makes use of the ARTNet gravity modeling analysis tool developed by the UN Economic and Social Commission for Asia and the Pacific. (http://www.unescap.org/tid/artnet/artnet_app).

[4] Gaulier, Guillaume et al., "China's Integration in East Asia: Production-sharing, FDI and hi-tech trade," CEPII working papers, No 2005-09, 2005.

[5] Cheong, Jaewon, "Korea's Intermediate Goods Trade with ASEAN," in Kagami, Mitsuhiro (ed.), Intermediate Goods Trade in East Asia: Economic Deepening Through FTAs/EPAs, BRC Research Report No 5, BRC, IDE Jetro, Bangkok (2011).

[6] In order to reach the latter objective, China is targeting seven emerging strategic industries: energy conservation and environmental protection, new information technology, biotechnology, high-level equipment manufacturing, alternative energy, alternative materials, and new energy vehicles.

[7] Shim, Sang-Hyung, "Rapidly Changing Division of Labor in East Asia," POSRI Chindia Quarterly (Autumn 2011): 17-23.

[8] The agreement builds upon another agreement reached by four Asia-Pacific economies (P4: Singapore, Brunei, New Zealand and Chile).

[9] Capling, Ann and John Ravenhill, "Multilateralising Regionalism: What Role for the Trans-Pacific Partnership Agreement?," T*he Pacific Review*, vol. 24, No 5 (2011): 553-575. Elms, Deborah and C. L. Lim, "The TransPacific Partnership Agreement (TPP) Negotiations: Overview and Prospects," RSIS working paper, No 232 (21 February 2012).

[10] Chung, Whan-Woo, "The Decrease in South Korea's Investment in China after the Global Financial Crisis," POSRI Chindia Quarterly (Summer 2011): 63-69.

[11] The two parties launched a joint study on the feasibility of a bilateral FTA in 2004 and eventually upgraded it to government-industry-academia research in 2007, but the decision to go ahead with negotiations did not materialize until 2010.

[12] Zhang, Jian, "Vigorous Waves of East Asia Economic Integration and the Sino-South Korea Trade Relationship," mimeo, Brookings Center for Northeast Asia Policy Studies (January 2010).

[13] A major advantage of such a trilateral scheme is to help defuse bilateral tensions, in particular between Japan and Korea, as well as ease China's suspicions vis-à-vis Japan's and Korea's attempts at containing its rise, as explained in Byun, See-Won, "The China-Japan-South Korea Triangle: The Shape of Things to Come," Asia-Pacific Bulletin, No 115 (June 2011).

REGIONAL INTEGRATION IN EAST ASIA: LESSONS FROM EUROPE

By Kim Heungchong

Abstract

When considering East Asian integration there are valid reasons to examine the history of European integration. First of all, regional integration deserves careful consideration, as it can contribute to extricating economies from worldwide recession, while holding the promise of creating a bigger market and leading an economic recovery. Europe remains a model for regional integration in spite of revealed defects in the monetary integration mechanism. Second, the history of European integration tells us that creating blueprints and taking another step for regional integration even in the worst of situations is very important in making continued progress. Third, the European integration process provides ample examples of the roles players in the negotiation process have played for integration. These can provide good lessons for East Asian countries in a time of growing international tension and conflicts as well as difficulties in the integration process itself. The lessons from the European integration process can be grouped into the following categories: (1) the development of a regional identity; (2) a high degree of economic integration and maturity of consumption within the region; (3) the emergence of avowed Euro-federalists; (4) the intra-regional movement of people; (5) the development of an advanced blueprint or vision for regional integration; (6) the need for exposure to binding negotiation on regional issues; (7) the need to compensate those disadvantaged by integration; and (8) the need for a core group to drive the integration process.

The world economy is still shrouded in a fog of uncertainty, even after governments of the major economies have conducted an unprecedented cooperative financial easing since 2008. The world economy has shown neither a conspicuous rebound, nor cleared out the many chronic problems in banking sectors, government budgets, and household sectors of the respective economies. Furthermore, the 2008 crisis seems to have developed into another recession just as sluggish growth of China, incipient recovery in the U.S., and the catastrophe in Europe plague the world economy.

In hard times, it may be absurd, or at least anachronistic, to argue for regional integration, as economic recession has always gone hand in hand with the emergence of chauvinistic nation-states and protectionism in trade. It would be even more out of point to argue that we need to think about European integration when Asians are earnestly drawing up a map for regional integration. Europe is now the center of the global economic crisis and many of the current difficulties in Europe are believed to be due to the system of European monetary integration, the euro-zone. The European case casts a fundamental doubt on regional integration.

Nevertheless, we have valid reasons to think things over regarding European integration. First of all, regional integration does still deserve careful consideration, as it can contribute to extricating economies from worldwide recession, while holding the promise of creating a bigger market and leading an economic recovery. Europe remains a model for regional integration in spite of revealed defects in the monetary integration mechanism. Second, the history of European integration tells us that creating blueprints and taking another step for regional integration even in the worst of situations is very important in making continued progress. Figuratively speaking, as the night is always darkest just before dawn, we need to prepare ourselves for another heyday instead of bracing for gloom and doom. Third, the European integration process provides ample examples of the roles players in the negotiation process have played for integration. These can provide good lessons for East Asian countries in a time of growing international tension and conflicts as well as difficulties in the integration process itself.

What kind of lessons can East Asia learn from the European integration process? Foremost, there is the intangible, creating a regional identity. East Asia has to continue its institutional efforts to form an East Asian identity. A person's identity may be composed of different layers. We identify ourselves at the individual level through our families, friends, and the society to which we belong. Cities where we live are another larger category which we use to distinguish ourselves from other city dwellers. Nation-states and perhaps the global village would be the biggest categories with which we identify ourselves. The European integration process shows that the formation of a supranational layer, beyond the national level, is crucial for achieving peace and prosperity in the region.

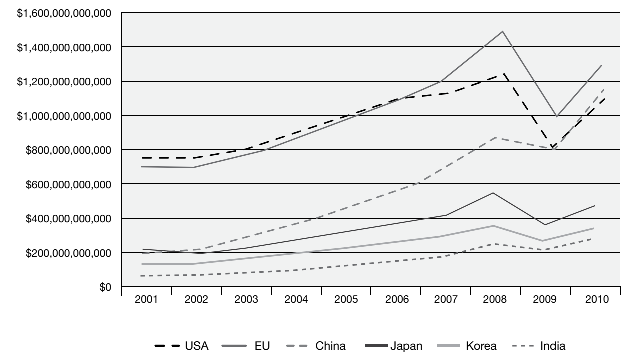
I am not sure whether East Asians think of themselves as East Asian or Asian. Creating regional perception ahead of visible regional integration achievements is the first step towards integration. This can provide a buffer for toning down the exhausting conflicts and disputes in East Asia, and negate chauvinistic behaviour which the political leaders are easily tempted to adopt.

To achieve a formation of a firm East Asian identity, it is very important that East Asian countries carry out various programs and actions under the banner of the East Asian community, rather than that of individual countries. People may perceive East Asia through a 'regional' scholarship program from which both the present and future generations may benefit. People may appreciate East Asia for its contribution to building bridges, museums, concert halls, etc., in their hometowns. Disadvantaged people in the region would not be easily tempted to be chauvinistic if they benefit from development aid programs in the name of the East Asian community. Taking the initiative in regional integration would assuage the public's irrational fear of market opening and globalization, if a regional identity is to form.

Second, East Asia should notice that there was a relatively high degree of economic integration in Europe even at the very first stage of integration in the 1950s. East Asia needs to emulate Europe in terms of trade and economic integration by encouraging intra-industry trade and building an exchange rate mechanism, which seems to be a cliché, as it has been repeated so often. I believe, however, more emphasis has to be given to the fact that Europe was a community in terms of consumption as well as intra-regional production. East Asia should move beyond the FTA and production network formation, and form a consumption network in order to raise its status as a self-sufficient economic entity. It may take time, but East Asian countries should concentrate on boosting their domestic consumption in spite of adversities within the region.

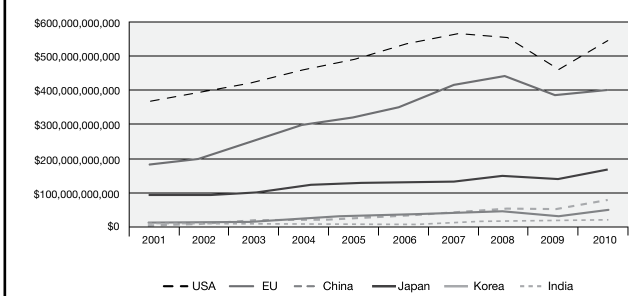
Figure 1 and Figure 2 reveal some striking facts on vulnerability of East Asian economies related to consumption. The first important finding from the figures is that in spite of dizzying economic growth among Asian economies, the U.S. and the EU still dominate other countries as the last destination of final goods. This is notably true if we compare the trends of China manifest in two figures: China has caught up with the U.S. in terms of intermediate goods trade, but never in the final goods market. China stood as the second biggest intermediate goods market, but was fourth as a final goods market. The second finding that we need to pay attention to is that the final goods market is more resilient to the economic shock than the intermediate goods market. Figure 2 shows milder V-shape than Figure 1 in the era of a global economic crisis. What the two findings tell us is, therefore, that

Figure 1 Import of Immediate Goods in Several Economies



Source: Author's calculation from BEC dataset

Figure 2 Import of Final Goods in Several Economies



Source: Author's calculation from BEC dataset

building intra-industry and intra-regional production networks is a major source of Asian countries' economic miracle, and this production network is very vulnerable to external shock. To borrow the words of a certain politician; it's the consumption, stupid, not the production!

To complete a consumption network in the region, a rise in consumption in the region is vital, but there are limitations for developing countries of the region in increasing their spending in the short-term. It could be true that the East Asian governments' export-driven policy may lead to weakening domestic consumption, but it may be the result of widening income disparities in the region. Widening income disparity prevents consumption growth from keeping pace with income growth, and the gap between consumption and income has opened up as the income gap increased. Asia has become increasingly dependent on exports as a source of economic growth in the face of flagging consumption.

Also, different consumption patterns between generations may weaken the region's consumption as a whole, and the underdeveloped financial industry could cause vulnerability among consumers in the region. Due to a very rapid change in the income level, the generational gap in consumption behavior varies much more among Asian countries than in other economies in the world. Let me explain this with an example. Korea reached $20,000 in per capita income in the mid-2000s, twenty years after most western European countries. Despite the similar level of income between contemporary Korea and Europe in the 1980s, older generations in Korea consume much less than their European counterparts in the 1980s, as they were much poorer than the previous European generation when they were young. Therefore, old frugal habits die hard. If rapid economic growth is the reason for weak consumption, then East Asian countries need to develop a policy initiative to strengthen financial intermediation, and secure liquidity backed by assets in bilateral, regional or multilateral arenas.

Moreover, we must remember that corruption in the region has negative impacts on vulnerable segments of the population. While these problems cannot all be resolved in a short period of time, East Asia must begin to strengthen its regional efforts to expand consumption. This is another lesson that East Asia should learn from the European integration process.

Third, we need to pay attention to the emergence of the "Europeans," in the process of European integration. "Europeans," who, more or less, tend to be avowed Euro-federalists, have formed a strong and loyal base of support for the integration process. As is the case for Europe, how can we, then, train or nurture true "East Asians"? Before thinking about nurturing, however, we need to pay attention to the Asian diaspora living in Asia and other parts of the world. Overseas Chinese, minorities in East Asia, Korean-Japanese and etc. may not have properly been provided with supranational playgrounds or institutional set-up where they could contribute to the building of the East Asian community. It may be easier for them to accept the East Asian identity that I have just mentioned. East Asia needs to make efforts to provide a supranational frame to the people of the region for formation of multiple nationalities and identities.

Fourth, after WWII, intra-regional movement of people in Europe substantially increased, and this trend has been strengthened afterwards. In the case of ASEAN+3, the degree of labor mobility in the region is far lower than that of Europe. More importantly, labor mobility, once showing steady increase, has stagnated over fifteen years. It is important to encourage intra-regional labor mobility through employment in foreign countries, but that is not the whole story. Short-term visits, study abroad, tours and other types of intra-regional movement of people can contribute to making a firm base for regional integration.

Fifth, creating an advanced blueprint or vision report for regional integration in East Asia would prove decisive for the entire process. The Werner report has influenced the thinking of a lot people concerning the integration process, and subsequently, the shape of the regional integration in Europe, although it was not immediately implemented. Drawing up a future with a precise plan, communicating the dream to other people, discussing the plan with experts in the field around the world, commemorating the date when the blueprint was published, is all very important for the work towards future integration.

Sixth, East Asian countries need exposure to binding negotiation on regional issues, and accumulate ample experience in solving the issues. It is important to create various forums discussing region-specific, but common issues such as intra-regional trade, intra-regional investment, environmental issues, development, gender issues, human security, etc. within our own capacity. It took many years for the European member states to acquire negotiation skills, and to reach the stage of mutual understanding.

Seventh, a varied policy mix is required for supporting the possible losers of regional integration. It is important to compensate losers during the integration process, as it can encourage them to keep engaged in the process. The Common Agricultural Policy introduced in the early 1960s, and Structural Funds refined in the 1970s played key roles in this regard in Europe, although the programs were not originally created for that purpose. On top of those initiatives, East Asia can initiate other schemes such as funds for green ODA and women's development. In the process, all countries including LDCs in the region should contribute to the creation of such funds, as it leads to enhancement of responsibility and self-motivation.

Eighth, it is recommended that a kind of core group be formed so as not to lose the momentum for integration. Germany and France have maintained a key bilateral relationship during the course of the European integration process. In East Asia, Japan and China are expected to play such a role, but if the case does not hold for the two countries, Korea is advised to initiate a type of trilateral relationship. Korea, unique in being a divided country, also needs to recognize that it should take the moral responsibility to disseminate ideas and action plans for peacekeeping, and to advocate peace and prosperity in the region. It can play an important role in initiating and leading the whole process of peace and prosperity through economic and monetary integration. In this sense, the role of Trilateral Cooperation Secretariat (TCS), based in Korea, is worthy of note.

The regional integration movement in East Asia has taken a long time and faced adversities, but the process is still at a rudimentary stage. We need to recall that the original six countries in the European Economic Community (EEC), which we regard as more or less homogeneous economies, were identified as genuinely heterogeneous when the EEC started some fifty years ago. In those days, they recognized so many differences amongst each other that it would have been difficult for them to think about integration of these heterogeneous economies. Even without focusing on the differences between East Asian countries, it would be important to do something immediately for regional cooperation in order to bring about solid progress in regional integration. An additional implication of the European integration process is to keep the momentum of the process for cooperation by creating teams of enthusiastic policy entrepreneurs who are eager to make efforts to bring about regional integration in Korea and East Asia. This is the last, but not the least point that I would like to raise.

Dr. Kim Heungchong is the Director for Planning and Research Coordination for the Korea Institute for International Economic Policy. The views reproduced here are the author's and do not necessarily represent those of the Korea Institute for International Economic Policy.

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[1] This paragraph and next one are mainly adapted from Heungchong Kim (2012), p. 59. Kim, Heungchong (2012), "Asia and the EU: Looking for a Way in Creating Shared Value, in The Asian-Europe Agenda, Ideas for Crisis Prevention and Effective Cooperation," Europe in Dialogue 2012|04, Bertelsmann Stiftung, pp. 55-61.

[2] Lessons fifth through eighth are substantially revised and updated from Kim, H. & S. Park (2004), "The Political Economy of the EMU Negotiation and its Implications to East Asian Monetary Integration," Policy Analysis 04-10, Korea Institute for International Economic Policy.

PROSPECTS FOR NORTH KOREAN ECONOMIC REFORM

THE SUNSHINE POLICY WAS NOT, AND IS NOT, A FAILED POLICY

By Moon Chung-in

President Kim Dae-jung (KDJ) and his successor Roh Moo-hyun undertook a bold peace offensive labeled as the sunshine, or engagement, policy to induce incremental and voluntary changes in North Korea for peace, opening, and reforms through a patient pursuit of reconciliation, exchanges, and cooperation. Despite initial setbacks and a stalemate, the policy yielded some positive outcomes such as the first historic Korean summit in June 2000 and the adoption of the June 15 Joint Declaration, as well as the second Korean summit and the October 4 Joint Summit Declaration of 2007. Such developments signified a revolutionary change in inter-Korean relations. Nevertheless, the sunshine policy has confronted an array of criticism: unilateral concessions to the North without reciprocal gain, failure to resolve the North Korean nuclear issue, compromise of the South's national security posture, and neglect of human rights conditions in the North. The engagement initiative of the progressive decade was regarded as an outright failure.

My new book, *The Sunshine Policy - In Defense of Engagement as a Path to Peace in Korea*, attempts to refute these critiques and to suggest a new North Korean policy outlook. It argues from the outset that the sunshine policy has been grossly distorted and wrongly politicized. It was not the policy of appeasement, but a calculated strategic offensive to foster voluntary changes in the North. The sunshine policy did not compromise national security posture because its first principle is non-tolerance of military threat or armed provocation by North Korea. In return, President Kim officially abandoned the idea of unification by absorption and the negation of any other measures to undermine or threaten North Korea. While satisfying the two conditions, the sunshine policy attempted to achieve *de facto*, as opposed to *de jure*, unification through the promotion of exchanges and cooperation, trust-building, and peaceful co-existence. The underlying ideals were the absolute rejection of any war or major military conflicts on the Korean Peninsula, the formation of a union of North-South Korean states, the transformation of the North into a normal state, and the centrality of South Korea in managing the Korean problem and the external security environment.

The volume further claims that the sunshine policy was short of achieving intended policy goals not because of its inherent drawbacks, but because of unexpected events unfolding internally, externally, and within the peninsula. It places on North Korea the lion's share of blame for the ongoing military tensions and strained relations, citing its brinkmanship, habitual intimidations and belligerence. Nevertheless, the U.S. deserves blame as well for failing to manage the second North Korean nuclear crisis by preoccupying itself with neo-conservative rhetoric and practices during the Bush administration, which not only deteriorated North Korea-U.S. relations, but also made Pyongyang more reclusive and hesitant to seek inter-Korean exchange and cooperation. The MB government's North Korean policy also reversed many of the gains of the prior ten years. Founded on the renunciation of the previous engagement policy, its policy towards North Korea held an adherence to rigid principle over pragmatism, a hard line security stance, a failure to recognize North Korean identity, and a hope for a collapse of the regime in Pyongyang. Along with this, an unfailing arms race between the two Koreas continued to remain a challenge to the sunshine policy.

In the book, a Korean unification based on mutual consultation and consensus is singled out as the most plausible and desirable option. Neither the German model of unification by absorption nor the Vietnamese model of unification by force are considered optional. The volume contends that the sunshine policy is still relevant in realizing the unification through mutual consensus. It also argues and produces evidence that the sunshine policy was not, and is not, a failed policy. It is undue politicization of the policy that has left that impression. In fact, despite its unexpectedly short lifespan, it produced impressive results for reconciliation, cooperation, change and peace. Two Korean summits, the Kaesong Industrial Complex, the Mt. Geumgang tourist project, a large number of family reunions and South Korean visits to North Korea as well as visible changes in the North toward opening all underscore the power and relevance of the sunshine policy. Conversely, when dialogue, cooperation, exchanges and trust-building—all central to the sunshine policy—were suspended, inter-Korean relations were strained and military tension heightened. Thus, engagement is an irreversible historical trend and a mandate for Koreans.

It is all the more so given the new beginning that North Korea has recently experienced. After 17 years in power, Chairman Kim Jong-il died on December 17, 2011, and his son Kim Jung-un emerged as North Korea's new leader. He was only 29-years-old and inexperienced when he stepped up, with no concrete evidence of his performance or achievements. But the succession process since late December 2011 has been smoother than many observers had expected, as demonstrated by a lack of near-term political crisis or confusion as to the new hierarchy, as well as no immediately visible signs of factional struggles, popular revolt or systemic breakdown.

The smooth transition can be ascribed to several factors. First, Kim Jong-un's legitimacy is impeccable due to his bloodline. North Korea is a country rooted in the monolithic Suryong system, founded by his grandfather Kim Il-sung and refined by his father Kim Jong-il. No one would question his legitimacy in the Kim dynasty. Second, his power base seems unassailable as he is surrounded, and protected, by three inner circles. The first circle is the ruling family. The second circle is the Korean Workers' Party itself, which has undergone a period of revival in recent years. The third circle is the military, the Korean People's Army, of which Kim is now Supreme Commander and to whom it has apparently pledged its unfailing loyalty. A third factor in the smooth transition is the rapid conclusion of institutional arrangements for his succession. Immediately following his father's state funeral on December 28, he was declared the new Supreme Leader, and has assumed the pivotal position of First Secretary of the Korean Workers' Party, and through this the chairmanship of the party's Central Military Committee. He was also appointed as First Chairman of National Defense Commission. Less than four months after Kim Jong-il's death, his son was able to control the party, the military and the state.

So in the near term, any political crisis in Pyongyang, let alone regime collapse, appears remote. But in the medium to longer term, the new Kim Jong-un leadership is likely to face a dilemma, and this should be the focal point of international responses to the transition process. The dilemma is created by two mutually conflicting goals that the regime has set for itself. Pyongyang has been loudly promising its citizens that 2012 marks the year of North Korea's emergence as a "strong and prosperous nation" (*Gangsung Gukga*). If Kim Jong-il could claim nothing else, he did achieve at least one thing for North Korea—the ultimate "strength" of nuclear deterrence, which the North Korean state media calls his "revolutionary legacy." Now, it is up to his son to achieve the other half of the equation: prosperity. Over the past few years, there have been unmistakable signs of a push to improve the national economy—from growing trade with and investment from China, revived plans for special economic zones and official propaganda promising to improve people's welfare. But the issue at stake is whether Kim Jong-un can enhance North Korea's prosperity without being forced to undermine the source of its strength—its nuclear weapons program. But there has been a clear signal of a renewed readiness by the new regime in Pyongyang to seek international help for easing its economic difficulties. The outside world should use the new beginning in North

Korea to embark on a coordinated, constructive engagement policy to normalize, and denuclearize, the Korean Peninsula. China has taken a bold initiative in this regard by seeking a wide range of economic cooperation with the North. According to a recent Reuters report, Russia has also followed a similar suit by "writing off 90 percent of North Korea's $11 billion debt and reinvesting the balance in the reclusive Asian state, in a sign of closer engagement with Pyongyang under new leader Kim Jong-un." It is the time for South Korea, the U.S., and Japan to seek an engagement policy with North Korea in the letter and spirit of the sunshine policy.

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THE CURRENT STATE OF THE NORTH KOREAN ECONOMY[1]

By Marcus Noland

Abstract

The North Korean economy today is characterized by macroeconomic instability, widening inequality and growing corruption. Estimates of contemporary growth rates diverge significantly, but suggest that the economy has yet to re-attain its peak level of output achieved roughly two decades earlier. Inflation remains a significant issue, especially for those without access to foreign currency. The growing affluence of Pyongyang contrasts with chronic food insecurity in the hinterland. Recent months have witnessed a spate of legal and organization changes but the effectiveness of these moves remains to be seen. Given its location in dynamic Northeast Asia, North Korea's economic performance could change quite dramatically with reform. But whether the current leadership has the vision or capacity to initiate such a process is far from obvious.

The year 2012, the centennial of the birth of founding leader Kim Il-sung, is an auspicious date on the North Korean calendar. It is supposed to mark the country's passage through the gate to prosperity, but assessing the country's progress toward this goal presents significant challenges, starting with the dearth of conventional economic data. The North Korean government regards the most commonplace figures—such as the magnitude and composition of international trade—as state secrets. The data that do exist are largely produced by South Korea or international public agencies working under both severe informational constraints as well as institutional contexts that lend themselves to politicization and/or excessive credulity with respect to what data the North Korean government does release. So take what follows with a large grain of salt.

To preview the conclusions of this paper, the North Korean economy today is characterized by macroeconomic instability, widening inequality and growing corruption. Given its location in dynamic Northeast Asia, the situation could change quite dramatically with reform. But the policy preferences and capacity of the new leadership are hard to ascertain.

Macroeconomic Performance and Stability

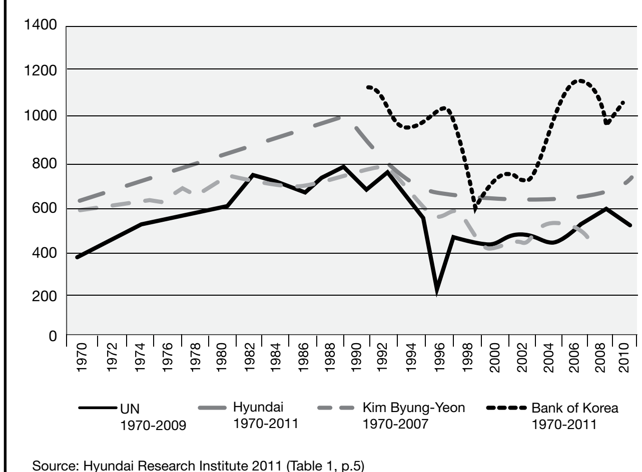
According to the official South Korean government estimates released by the Bank of Korea (BOK), the North Korean economy shrank in 2010, marking the second consecutive year of negative growth. Based on South Korean reckoning, per capita income in North Korea remains 25 percent below its 1990 peak (Figure 1). This conclusion stands in contrast to numerous anecdotal reports of improved living standards in Pyongyang, though is consistent with the less numerous reports of grim conditions in provincial cities. Stephan Haggard has called this phenomenon "Pyongyang illusion" and believes that it may well go beyond typical urban- or capital-bias in governance and represents an attempt by an insecure regime to forestall any Tahrir Square type activity in the capital city.[2]

It is unclear how the South Korean government calculates these figures. The estimate is apparently constructed by applying estimated North Korean value-added weights of unknown derivation to estimates of North Korean output obtained through classified methods such as satellite imagery and possibly human intelligence. Ergo, this estimate may differ significantly from the true underlying figure due to the inadequacy of the calculation method, and in any event, it is not subject to any verification by outside analysts. The BOK figure is then subject to interagency discussion and it is widely acknowledged that at times it has been subject to a high degree of politicization. Once a consensus is reached, it is announced to the public via the BOK.

In March 2012, the Hyundai Research Institute (HRI) released a study that came to a quite different conclusion, estimating that the economy grew by 4.7 percent in 2011 (Figure 1). Careful examination of the HRI methodology gives one pause, however. Kim Chun-gu estimated a panel cross-country regression of per capita income levels on infant mortality data, and then combined the estimated regression coefficients with the North Korean figures to derive a counterfactual projection. Since the United Nations only publishes the infant mortality data at five-year intervals, the HRI researcher used grain harvest data, which has a correlation with infant mortality of -0.69 to interpolate the missing data. As one can see from Figure 1, this technique generates an oddly smooth per capita income series.

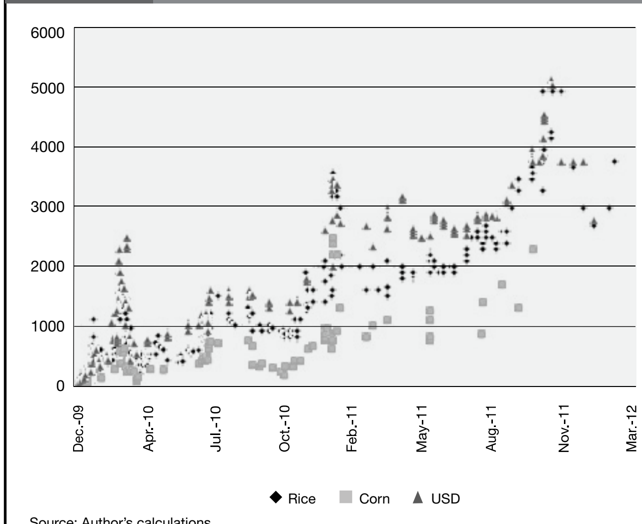
Whatever the particulars of recent growth performance, if one steps back, what is really striking about Figure 1 is that all of the sources estimate that North Korean per capita income today is lower than it was twenty years ago. Indeed, according to the HRI estimate, North Korean per capita income first reached the level it attained last year in 1974!

Figure 1 Per Capita Income Estimates 1970-2011 (in U.S. Dollars)



Source: Hyundai Research Institute 2011 (Table 1, p.5)

Figure 2 Post Currency Reform Price Trends 2010-2012 (in North Korean *won*)



Source: Author's calculations

In short, these estimates of growth performance are highly uncertain and in any event, the aggregate figures may obscure very different developments in different parts of the country or among different socio-economic groups.

Our grasp of the situation may be a little better with respect to inflation. Figure 2 reproduces data on prices for rice, corn, and the black market exchange rate for the U.S. dollar since January 2010 (i.e. after the huge step-jump in real prices in December 2009 following the currency reform). A simple regression of the prices (technically their logarithmic values) against time suggests that since the beginning of 2010, inflation on an annualized basis has averaged 131 percent for rice and 138 percent for corn. The won has depreciated against the dollar at a 136 percent annualized rate. A monthly breakdown of price movements suggests that while remaining high, the rate of inflation has attenuated, declining in 2011 relative to 2010.

The co-movement of the black market exchange rate and grain prices would be consistent with a small, open economy in which prices are roughly constant in hard currency terms, but are skyrocketing in terms of the rapidly depreciating domestic currency. In the extreme this could depict an economy that was effectively becoming dollarized.

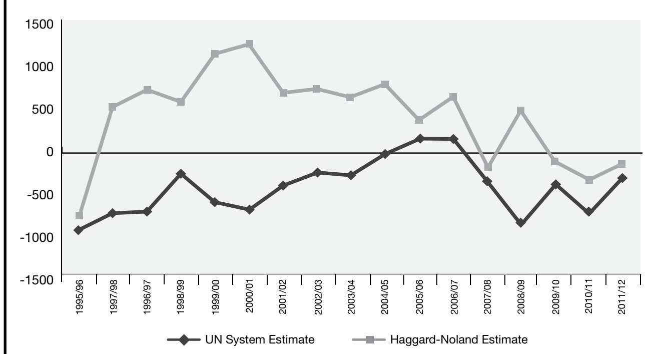
The rise in the relative price of corn to rice would be consistent with a deteriorating situation in which households are shifting demand away from the preferred staple (rice) toward the cheaper, less preferred grain, corn. This pattern could signal belt-tightening by households, which would be consistent with recent FAO-WFP and U.S. government assessments documenting continuing food availability problems.

Most worrisome, however, are recent post-harvest observations. Unlike 2010 when, as would be expected, the price of rice fell after the harvest, the rice price has been rising continuously since the harvest. Corn prices, which tend to fall even more dramatically after the harvest, for example by nearly 50 percent in the three months following the harvest in 2010, have also continued to rise since the harvest.

These trends—sustained inflation, the rise in the relative price of a less preferred grain, and continued food price increase immediately following the harvest—do not augur well for North Koreans without access to hard currency.

These conclusions are reinforced by examination of the quantitative grain balances (Figure 3). Both estimates produced by the UN system, as well as an alternative series that I constructed with Stephan Haggard, indicate that North Korea is below the minimum human needs line. Indeed, our estimate of the shortfall is quite similar to the U.S. government's 240,000 metric ton assessment of North Korean needs. From this perspective, the apparent

Figure 3 Minimum Cereals Requirement Surplus/Deficit (in thousands of metric tons)



Source: Author's calculations

failure of the "Leap Day Deal" to resume humanitarian aid in return for concessions on the nuclear front does not bode well for chronically food-insecure North Korean communities.

These trends of growing scarcity do not appear to be confined to staples. During the winter, the press reported growing anxiety over rising coal prices (used for winter home heating), although these reports are impossible to substantiate. Some observers attribute the scarcity of coal in local markets to the diversion of domestic coal supplies to the Chinese export market, and it was reported that North Korea had suspended anthracite coal exports to China precisely over concerns about spreading internal shortages.[3]

There have also been reports of increased irregularity in the supply of electricity and water in Pyongyang, though the interpretation of these stories is problematic. Under conditions of significant excess demand, outages are a function of both the level of production (and efficiency in distribution) as well as rationing among alternative users. These allocation choices are subject to at least a certain degree of political control. Factories may go without power if the needs of Pyongyang residents are considered more essential. Similarly, outages in Pyongyang may imply that other user needs are being prioritized. The same story can play out at the local level, and such conflicts over distribution reportedly occur among local actors and with the central authorities. Moreover, conditions tend to deteriorate in winter, when some communities, which have detached from the unreliable national grid by relying on local mini-dams to generate hydropower, re-attach themselves to the grid as local rivers and streams freeze rendering the dams unusable. However, one source suggests that power shortages reduced the regime's capacity to jam foreign radio broadcasts—even stations operated by the South Korean intelligence service and the Ministry of National Defense, as well as keep their own foreign radio service on the air.[4] Of course these reports of deteriorating conditions have to be set against the claim that Orascom now has one million cell phone subscribers, and anecdotal reports of traffic jams in Pyongyang.

In sum, while there is considerable uncertainty regarding macroeconomic performance, it does not appear to be particularly strong. What can be established with greater confidence is that inequality is on the rise, and a considerable share of the North Korean population is economically insecure regardless of the headline growth number.

Policy Changes

North Korean economic policy is not unchanging, though there are questions as to its aims and effectiveness, deepened by the recent leadership transition and uncertainty regarding both the policy process and the regime's underlying preferences.

The new corporation law, which apparently does not apply within the special zones or with respect to foreign-invested companies, retains vestiges of central planning.[5] In Article 21 it specifies corporate hierarchy, defining the roles of manager, chief engineer, and assistant manager, and indicates that the assistant manager is to report to the manager and the chief engineer, while the chief engineer reports to the manager. Articles 29 and 30 indicate that written plans must be submitted to the authorities annually, and this plan must be followed on a daily, monthly, quarterly, and index basis. Article 44 states that "the appropriate amount of labor is scientifically determined and managed based on socialist distribution principles and a precise socialist wage system must be implemented." Sales must be based on supply plans and contracts. "Those sales that do not follow the plan and contract cannot be sold" (Article 42). Ultimately, the state is in charge: "the managing organization has the jurisdiction to close down corporations for unreasonable or lack of prospects that does not meet the standards and demands of the national policy and reality" (Article 18).

In 2010, North Korea published revised regulations regarding the existing Rason special zone, and last year released new ones for the Hwanggumpyong and Wihwa Island special economic zones under development. There has long been a compelling case to develop Rason, primarily as a port serving Northeastern China (Noland and Flake 1997). After languishing for years, it now appears that the zone is on the verge of meeting at least some of its promise. The Chinese are surfacing the dirt road linking Hunchun with Rason and the Russians are refurbishing the rail link. The next priority would be to dredge the harbor. North Korea also claims that China will build a 600,000 kilowatt coal-fired power plant, but corroboratory evidence regarding that claim is elusive. In the meantime, transmissions lines are being built to bring electricity in from China (Abrahamian 2012).

So progress is evident; the deeper question is whether this initiative will be a catalyst for broader development. One simple leading indicator would be if off-ramps are built on the road between the port and China. If they are, the road could become the main artery of a growth corridor in that part of North Korea. If not, the highway would be a metaphorical tunnel from China to the sea. North Korea will make money off the port, but the project will effectively be an enclave, and not a catalyst for broader development.

But as a recent review of the uneven history of special economic zones around the world released by the World Bank concluded, it is important to distinguish between political support and the primacy of political objectives in the design of such projects which must have a clear commercial rationale to succeed (Farole 2011). Successful zones embody clear and transparent rules and regulations administered by a capable management authority, and are integrated into the broader national economy. In the case of Rason, the law gives extraordinary power and discretion to the Rason City People's Committee, though relative to the previous rules, which gave more authority to the central government, the localization of decision-making may encourage greater pragmatism. Backwards and forwards linkages to the rest of the economy have been slight, but this could change if the development of the refurbished transportation links are managed properly.

With regard to the Hwanggumpyong and Wihwa Island zone, China reportedly rejected the initially decreed rules, complaining about problems relating to taxation, accounting, the security of investment, management autonomy, and the remittance of profits, despite the fact that the terms under discussion for Chinese activities in the zones (the right to use Chinese currency and cell phones; the establishment of independent banks; internet access; and the right to lend and sub-lease leased land) compared favorably to either those that exist at the South Korea-oriented Kaesong Industrial Complex (KIC) or at Rason. Indeed, a comparison of the Rason and the Hwanggumpyong and Wihwa Island zone rules implicitly reveal China's influence on the latter. The Hwanggumpyong and Wihwa Island regulations are far more detailed, more clearly delineating the responsibility of the zone's management committee, the provincial People's Committee, and the central government, as well as affording foreign investors greater investor rights.

KIC enjoys broad political support in South Korea and has remained relatively insulated from the downturn in North-South relations. It has expanded steadily and approximately 50,000 North Koreans are now employed in the zone.

In 2000 North and South Korea reached an agreement on double taxation (as well as pacts on account settlement, repatriation of profits, and dispute settlement), and the North has concluded double taxation treaties with a number of other countries including Egypt, home to its biggest foreign investor, Orascom Telecom, but apparently it has not reached a similar agreement with its largest trade and investment partner, China. Given the country's demonstrated ability to reach such agreements with other countries, presumably it is just a matter of time. That said, an unprecedented survey of Chinese enterprises found that fear of expropriation does in fact deter investment in North Korea (Haggard, Lee, and Noland 2012).

In parallel to these legal changes, there have been shake-ups in some of the bodies that intermediate North Korea's foreign economic relations. In late 2011, the government announced a decision to initiate a "10-Year State Strategy Plan for Economic Development" and to set up a new agency called the State General Bureau for Economic Development, out of the state price bureau. The government also designated a supra-cabinet body to oversee foreign direct investment under the 10-year plan. The Taepung Group is effectively a holding company for joint ventures and other initiatives outside the central plan. It has been headed by a Chinese-Korean businessman with ties to the North Korean military and has a board consisting of regime heavyweights. This decision put this group effectively into competition with the Joint Venture and Investment Commission (JVIC), something akin to a conventional inward investment promotion agency. Now rumors are circulating that the two organizations will be merged as part of an economic development plan to be announced during the Kim Il-sung centenary.[6] If this does in fact take place, the implications are unclear. The positive interpretation is that it would establish a one-stop shop for investment approval. The more cynical view is that it would further consolidate the gatekeeping role of the Taepung Group and enhance that body's capacity for the extraction of rents from foreign investors.

Corruption

The preceding possibility leads quite naturally into a consideration of corruption more broadly. Surveys of North Korean refugees and Chinese enterprises operating in North Korea depict it as an increasingly corrupt place, and in the most recent Transparency International survey, North Korea placed dead last, tied with Somalia in 182nd place (Haggard and Noland 2011, Haggard, Lee, and Noland 2012).[7] The situation not only represents a drag on growth, but could impair the regime's capacity to govern, as the parochial interests of corrupt officials diverge from the policy preferences of Pyongyang.

The situation is exacerbated by the macroeconomic imbalances discussed at the outset of the paper. In the two years since the November 2009 currency reform, North Korea has experienced high and sustained inflation. One implication is the ever-widening gap between the official and black market exchange rates, and understandable reluctance of foreign exchange earners to convert their revenues into North Korean won at the official rate. One press report claimed that the Chosun Trade Bank was offering the carrot of better-than-official rates to obtain foreign currency deposits, while the regime was also brandishing the stick of special inspections of units suspected of hoarding foreign exchange. One response by enterprise managers has been to stash foreign exchange earnings into local trade banks where bank officials are bribed to disguise the magnitude of the deposits and to maintain access to foreign exchange loans. The reputed consensus among market participants was that deposits in banks controlled by the central government were subject to seizure in the run-up to the Kim Il-sung centenary.

Uncertainty following the death of Kim Jong-il seems to have intensified these contradictions. IFES reports that "the DPRK government is forcing businesses and trading companies to deposit all foreign currency earned in the trade bank. However, most companies prefer to hold on to their foreign reserves to avoid complex deposit and withdrawal processes."[8] IFES continues, "They also seem to be using private money brokers to exchange money…Recognizing this, North Korean authorities have been cracking down on such illegal 'private money exchangers' every year." In other words, the North Korean banking system is being drained of reserves as fearful depositors hoard foreign exchange.

According to more recent reporting, this pressure to hoover up hard currency has now extended to households. Authorities have allegedly banned foreign currency transactions, though Pyongyang banks are now issuing foreign currency denominated debt cards which can be used, creating an incentive for people to turn in their foreign exchange.

While the scheme might work at the retail level, it is harder to imagine it working at the wholesale level, especially in so far as the actual wholesale purchases of consumer goods are largely done in China and there is no particular reason to expect that Chinese merchants would readily accept this form of payment. The net result is likely to be disrupted supply and worse financial terms for the North Korean importers. Previously, a similar attempt to ban the use of foreign exchange in the aftermath of the 2009 currency reform was quietly shelved.

Conclusion

Today's North Korean economy is characterized by macroeconomic instability, an uneven track record on policy change, and growing inequality and corruption. Given North Korea's location in one of the most dynamic regions in the world, the economy could potentially respond quite dramatically to reform. Whether the current leadership has the vision or capacity to initiate such a process is far from obvious. Some of the policies described in the previous section have allegedly been ascribed to Kim Jong-il's "dying wish" and it would not be at all surprising if more policies in the future were legitimated in this way. But at some point Kim Jong-un and the new leadership will have to take ownership of policy. That transition may well have begun on April of this year, the centennial of the birth of Kim Il-sung.

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Leading Economic Indicators for Korea

	2004	2005	2006	2007	2008	2009	2010	2011
Growth Rate of Real GDP (%) Annual change at Chained 2005 Constant Prices	4.6	4	5.2	5.1	2.3	0.3	6.3	3.6
GDP Current US$ billions	722.4	844.7	951.1	1,049.3	930.9	834.4	1,014.7	1,116.4
GNI Per Capita US$	15,082	17,531	19,691	21,632	19,161	17,041	20,562	22,489
Current Account US$ billions, BOP basis	32.3	18.6	14.1	21.8	3.2	32.8	29.4	26.5
Consumer Prices (%) Annual Change at 2005 = 100 Constant Prices	3.6	2.8	2.2	2.5	4.7	2.8	3.0	4.0
Unemployment Rate (%)	3.7	3.7	3.5	3.2	3.2	3.6	3.7	3.4
Inward Foreign Direct Investment US$ billions, actual basis	9.0	7.1	4.9	2.6	8.4	7.5	8.5	4.7
Stock Price Index Average	833	1074	1352	1713	1530	1429	1765	1983
Exchange Rate Average Won/US$	1,144	1,024	955	929	1,103	1,276	1,156	1,107

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