KOREA'S ECONOMY

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PREFACE

December 2015

Dear Readers,

We are honored to present to you the 30th edition of *Korea's Economy*. Over the past 30 years, this landmark journal has documented the remarkable transformation of the Korean economy and its rapid industrialization as one of Asia's four "tigers" that began in the 1960s. The raw statistics from the World Bank[1] showing a mammoth increase in Korea's Gross Domestic Product (from $100 billion in 1984 to $1.41 trillion in 2014) and its Gross National Income (on a per capita basis from $2,360 in 1984 to $27,090 in 2014) during the lifetime of this journal do not scratch the surface of the implications of Korea's rise from the ashes of a devastating war for both the United States and the rest of the world. We trust that this journal has been important in broadening the perspective of individuals interested in the growing role Korea has played in the world economy.

For the American audience, the Korea Economic Institute of America (KEI) has also long been in the forefront in drawing back the curtain of the opaque North Korean society and documenting various opportunities and challenges that face possible unification of the Korean Peninsula.

This year, the volume contains 12 noteworthy articles written by scholars from both inside and outside of Korea. In light of this milestone edition, the papers discuss Korea's post-war economic history and implications for the future; key factors needed to foster an environment in Korea that encourages entrepreneurship and innovation to keep this "Miracle on the Han River" growing well into the future; Korea's deeper economic relations with Europe; and the vision for a united Korean Peninsula and the economic lessons learned from the German reunification experience.

KEI, created in 1982, is a U.S.-based non-profit educational organization partnered with the Korea Institute for International Economic Policy (KIEP) dedicated to promoting dialogue and understanding between the Republic of Korea and the United States on economic, policy and security relations. KEI accomplishes its mission through a combination of 10 signature programs and academic journal publications, such as *Korea's Economy*, special events, and our website (www.keia.org) and social media presence. For over 25 years, KEI has also sponsored papers at our yearly academic symposium, which are subsequently published in KEI's annual *Joint U.S.-Korea Academic Studies* journal. In addition, KEI conducts a wide range of conferences, seminars, and roundtables. These include programs in Washington, D.C., which often feature distinguished thought-leaders from Korea, as well as programs throughout the United States that include scholars, diplomats, key U.S. and Korean government representatives, and occasionally the Ambassadors from the two respective countries.

We hope that you enjoy this edition of *Korea's Economy*. We look forward to continuing to produce objective and timely analysis of issues affecting Korea's domestic economy and its economic relations with nations around the world. We invite you to be a part of the discussion by responding to our call for papers or offering opportunities for KEI to put on a forum at your local university or town.

The Honorable Donald A. Manzullo

Former Member of Congress, 1993-2013
President & CEO
KEI

Troy Stangarone

Senior Director of Congressional Affairs and Trade
Editor, Korea's Economy

[1] http://databank.worldbank.org/data/reports.aspx?source=2&country=KOR&series=&period=.

OVERVIEW AND MACROECONOMIC ISSUES

LESSONS FROM THE ECONOMIC DEVELOPMENT EXPERIENCE OF SOUTH KOREA

By Danny Leipziger

Abstract

The paper reviews some of the key aspects leading to Korea's remarkably successful economic transformation, including its consistent and aggressive pursuit of export-led growth, its investments in basic services and housing, its enviable record in human capital development and skills acquisition, its regional development policies, its strengths in planning and implementation, and its concerns about societal issues like equitable growth. The second part of the paper looks at some of Korea's challenges for the future. In this area, some concerns are raised about demographic constraints, the alarming increase in household debt and dearth of household savings, issues of energy policy, trends in the distribution of income and wealth, and a possible need for institutional revitalization. The aim of any reforms is to position Korea well for the future and to maintain its economic position and the wellbeing of its citizens.

Introduction

Korea's economic success has created a large industry of researchers who have attempted to explain and extol the virtues of Korea's economic rise. These efforts have also led to attempts at generalizing lessons and providing advice to other countries. Of course, these lessons fall into two groups: those that are very specific to Korea's economic situation and circumstances and those that are less intrinsically connected. Even in the latter group of factors, however, there must be recognition that policy formulation is only part of the story and that implementation plays an even larger role than the design of smart policies. Even those countries attempting to undertake efficacious policies may fail due to institutional weaknesses. Hence, there is a lot to learn from the development experience of South Korea.

Rather than dwell on some of the better known policy areas, however, that have been amply explored, such as the export-driven growth model, the *chaebol*-led industrialization path and the use of subsidized credit, or the repatriation of skilled professionals and adaptation of high-end technologies, in this essay the focus will be on aspects of economic policy that can be seen as inclusive. In other words, we will concentrate on those policies that led to broadly shared economic growth and wholesale improvements in the well-being of a large swath of the population. Formerly dubbed equitable growth and more recently inclusive growth, the point is that economic growth without a sharing of gains leads to exploitive societies and minimal welfare gains for the majority of the population.

This Korean experience of inclusive development is highly relevant today in light of the attention drawn to increasingly skewed distributions of income and wealth in many developed and emerging market economies. Given the evidence that many non-inclusive economic outcomes can be self-perpetuating since economic opportunities are limited and economic power perverting, it is even more instructive to learn about the way in which income gains were shared in an economy such as Korea's, namely, an economy that grew so phenomenally over many decades and escaped the economic devastation and rampant poverty that plagues so many other countries.

Six Lessons on Inclusive Growth

First and foremost, the Korean experience shows how the shift from an agrarian economy to a manufacturing-led economy went hand-in-hand with large-scale productivity gains. The W. Arthur Lewis hypothesis about surplus labor was seen in reality in the shift to labor-intensive production in 1960s Korea. Indeed, even though the process entails copying of production methods of more advanced countries like Japan, the efficient use of factor endowments, namely basically educated and motivated labor, led to large gains in employment, output and incomes. Indeed, it was only the vestigial use of subsidies that kept the rural labor force from declining even more rapidly than it did. The shift to urban settings involved huge gains in productivity per worker, and the accumulation of capital and use of technology further magnified these gains. The results were spectacular, namely, a drop in the rate of absolute poverty from close to 30 percent of the population in 1970 to one-third that level a decade later. So lesson one was that to increase the earnings of workers, one needs to employ them in higher value-added endeavors, empower them with capital, and enhance their productivity with newer technologies.

New urban work forces can either live in shanty towns, the *favelas* of Brazil and the slums of Lagos, or they can be housed in some fashion. Whether it was company housing at first or latter on public housing projects, South Korea, similar to both Hong Kong and Singapore, decided that government-supported housing was an essential ingredient of urban development. Inclusive development cannot proceed when the poor and the working poor lack assets, and one of the key assets in a dynamically growing economy is housing. Countries lacking the fiscal resources to provide adequate housing will in the end be creating urban sprawl, degradation and slums. The inability to provide basic public services, such as water and electricity, not only reduces living standards, but also creates health problems and fewer opportunities for upward mobility. Lesson two, therefore, is for governments to invest in public services and to deal with urban housing demands in a proactive manner. South Korea did this and other East Asian economies ranging from Thailand, Malaysia, Vietnam and China have done so as well, with recognized successes in distributional measures of income.

Education provides the great equalizing element for societies that are concerned with issues of economic opportunity. Governments do not always see investments in education as being beneficial for the individual household; they often do so for larger national economic reasons, such as to create a more skilled workforce. Nevertheless, the interests of the public and private sectors can overlap as seen in the significant public investment in education in South Korea that was matched by prodigious private investment by families in the education of their children. Researchers often marvel at the high educational achievement achieved with modest investment levels (as a percentage of GDP). What they fail to appreciate is the investment of private monies in education that provided almost as much effort as did government in the education challenge. In order to promote inclusive or more equitable growth, lesson three is to level the playing field with high-quality public education, with accountability by the school system and the strong involvement of parents. Similar to Finland and Singapore, and others scoring well on global examinations, Korean teachers were held in high esteem by society and education was seen as a universal goal of all those involved. Additionally the high levels of literacy achieved in the 1950s and 1960s provided the building block for a trainable workforce. This latter point is critical since a rapidly growing economy such as Korea in the 1970-1990 period witnessed rapid changes in industrial composition, a phenomenon requiring a malleable work force.

Not all urban driven development forces can capture all comers, however. Hence, South Korea did engage in some redistributive policies. These were less of the welfare type, inasmuch as pure transfer programs came rather late in the game in Korea, and more of the targeted investment variety, namely, disproportionate level of investment in rural areas and in depressed areas. The Saemaul Movement was one such program begun in the early 1970s and continued through the 1980s. Broadly speaking, it was a rural modernization and development program, aimed at those left behind by urbanization. It was accompanied by excessive (over-weighted) investment in provinces such as Cholla, known to be lagging. While it is true that some pro-agricultural policies were distortive and costly, the basic sense was that the poorer groups should not be left "too far behind." This is the sense of inclusive growth and it provides lesson four, namely, excluded or disadvantaged groups may need extra effort, more resources, and special programs to be able to benefit from the general societal gains that may elude them.

The fifth basic lesson that has important ramifications for the future pattern of economic growth revolves around planning, monitoring and evaluation. Beginning with President Park Chung-hee, the role of the government in economic planning, including Five Year Plans and the coordinating role of the Economic Planning Board; the extensive monitoring of export production versus national targets and the use of subsidized credit to generate export revenue; and the importance placed on evaluating the efficacy of policy interventions all led to a culture of accountability. Knowing how economic progress is occurring, who was left behind, how Korea was stacking up versus its competitors, these were all part of the accountability culture that enabled policymakers at first and politicians later on to track economic progress and the distribution of gains. This is not to say that equitable distribution of income was a national objective, since it clearly wasn't, or that Korean elites didn't gain enormous economic power, which they did; but rather to argue that the data was always available to show how national income was being generated and captured and outlandish gains were usually frowned upon and often punished, especially in the high growth decades.

It is natural, some would argue, that the distribution of income and more so the distribution of wealth will become more uneven as countries become richer, and this has been the case in Korea as well. Once a certain level of development has been achieved, in the case of Korea, joining the OECD or the club of advanced economies, greater efforts are needed both on the side of active redistribution of income as well as in ways to discourage the perpetuation of wealth and the lack of opportunity of the average citizen to succeed. This process has preoccupied South Korea in the course of the last decade and a half. Some efforts have been exerted to show that the elites should not dominate; however, these efforts have been weak and largely ineffective. They took the form of a ban on private tutoring, the closure of the prestigious Kyonggi High School that grounded many of Korea's top academics and bureaucrats, a few celebrated corruption cases, debates on tuition and the like. Nevertheless, the distribution of income pre-tax and post-tax is not that different and Korea seems quite a ways from the social democratic model of Europe according to OECD data. Hence, the sixth and final lesson is that complacency is not advisable when dealing with rapidly enriching countries, since the accumulation of wealth goes hand-in-hand with the exercise of economic power, especially when regulation and institutions cannot keep up with the politics of power. In this sense, Korea is no different that other OECD countries that have witnessed the same pattern of concentrated economic power.

What Next for South Korea?

While Korea's remarkable economic growth trajectory provides many lessons for others seeking to escape poverty and maximize their economic potential, unfortunately there are fewer countries that can provide lessons to Korea as an advanced economy seeking to find a new equilibrium as a just and more equal society. Recent years have tended to show Korea as rudderless in this new world.

True, Samsung TVs now dominate global consumer preferences and Hyundai and Kia are setting new records as cars of choice. Still, Korean public sentiment is distinctly unhappy, despite per capita incomes of $27,000 and material gains that were considered unattainable in 1960 or even 1980. Korea has confounded the critics. It lacked the size of a China. It lacked the resources of a Malaysia. It lacked the location of a Singapore. It didn't rely on foreign direct investment. It delayed domestic consumption until investment needs were accommodated. It deferred welfare programs until they were fiscally affordable. Korea did so many things well that it has created the impression and expectation that the country will always find the correct path. In reality, however, Korea now needs to hear new voices of advice and needs to generate a new collective view on its own future.

Some Policy Suggestions for the Future

It may be presumptuous to offer advice to a country that has been so eminently successful. Nevertheless, sometimes, outside advice can be useful in clarifying what many know but that few can openly articulate. Policymakers long accustomed to dealing with long time horizons are now forced by politics to deal with the immediate, situations repeated throughout the advanced economies. The long-run planning, monitoring and evaluation strengths are eroding and with it better policy choices are often ignored. So here are a few possible policy lessons to smooth Korea's future and maintain the great strengths and hard-won gains of the past.

Although many may dispute the necessity of continuing to generate incremental economic growth, societies' desires for more public goods and better public services as well as increasing longevity make economic growth indispensable. In the case of Korea, declining fertility and almost absent immigration are creating a long-term problem. Capital and technology with a declining labor force as now seen in Korea leads to lower long-term growth. Moreover, the lower rates of total factor productivity seen in services as compared to manufactures further lowers potential growth rates. To spur future growth, women need to be encouraged to remain in the labor force and this requires changes in cultural attitudes, better and more affordable child-care and a number of other labor market reforms. This is the first priority if Korea is to avoid being the next Japan, namely, hamstrung by demographics and condemned to eventual economic decline.

Second, household savings have almost disappeared and household indebtedness has risen astronomically. While the promotion of domestic consumption was once seen as a necessary policy to break the total growth dependence on exports and investments, it is now a drag on the economy. Much of household debt is due to poor mortgage markets and short-term, high cost mortgages. Mortgage reform is a major priority that requires government action. This is more important than becoming a financial center in Asia, and in fact, might spur that development. Without mortgage reform, consumption will suffer, birth rates will not rebound, and public confidence and perceptions will suffer. It is noteworthy that Korea ranks poorly on indices of happiness, while economic progress has been so astounding positive.

Third, energy policy needs to be reviewed. While public transportation investments are excellent, congestion and pollution pose significant challenges. It is ironic that Korea is so advanced in the export of sustainable energy sources, whether wind turbines or the development of electric cars, when, at the same time, Korea's GDP is so energy intensive and so carbon-dominated. Thinking of sustainable economic activity means that these issues need to be addressed immediately. Innovation and other measures cannot substitute for realistic energy pricing. There are lessons from Europe that can usefully be applied in the realm of energy efficiency. Increasingly we are coming to realize that a truly advanced economy is a clean economy as well.

Fourth, one cannot ignore issues of income inequality for long. Korea has been lucky, as noted earlier in the essay, to generate a participatory and shared economic growth model. But that model, based on massive employment generation, is fraying. Wages have increased in the service sector, now the dominant portion of GDP, while productivity is lagging. As costs rise, real incomes of the middle class will suffer the same declines seen in most OECD economies. At the same time, redistribution efforts are not sufficient to offset the natural accumulation of wealth, which perpetuate greater inequality and concentration of wealth.

Fifth, there is need for a re-invigoration of institutions that help guide and manage the economy and other aspects of society. In order to deal with long-run challenges in a non-political fashion, institutional reforms are needed. Some countries, notably Chile and Singapore, have been able over the years to create bi-partisan commissions to deal with issues of pensions, health care and other social programs that require long-term planning and implementation. Insofar as the set of policy priorities now has expanded beyond export diversification and macroeconomic management, the role once played by the Economic Planning Board needs to be mirrored in many other spheres of public policy. Short-term decision-making runs the risk of policy reversals and policy expediency. These were never characteristics of Korean policymaking in the past.

How to Use Korea's Legacy Strengths for the Future

One of the big advantages of Korea's economic history is that it has accomplished the very difficult and hence is well positioned, under the right circumstances, to deal with the new set of challenges. Its disadvantage is that given so rapid a trajectory, the public does not remember the food shortages, 57-hour work weeks, and fear of failure of the 1960s. A major public relations campaign is needed to re-inculcate Korean traditional values. Moreover, Korea's organizational skills and abilities to work across the public and private sectors can be mobilized to deal with the challenges of the 2015-2030 period.

In order to bring public and private priorities into better sync, corporate governance reform would seem important. Whereas government used to be the financier of the private sector, the shoe is now on the other foot and the corporate sector needs to align its growth and profit motives with other aspect of societal polices. To give a prime example, take the role of women in Korean corporations. Wage differentials are enormous, the glass ceiling for women is absolute, and talented women are forced into their own businesses or into low-paying jobs. Advancement is limited and marriage and child-rearing are impossible to reconcile with corporate responsibilities. One need only look at public and corporate policies in countries like Sweden to see how incentives can help maintain birth rates and provide for a more gender equitable and harmonious society. A national program involving the *chaebol*, public sector entities and non-governmental actors should be launched. The same drive that was once given to exports should be aimed at producing larger Korean families.

Energy pricing is another "low-hanging fruit." Korea could be a leader in electric car manufacturing for its own national market. It has the technology. It has a superb transportation grid. It has public support for energy efficient solutions, yet it has a paltry record in terms of sustainable energy policy. Again a public-private effort is required, with carrots and sticks, to make major changes in energy usage. There may be an issue of equity involved as well, but congestion taxes on the wealthy that help finance major new energy investments and cross subsidies can encourage smarter energy choices. Not only is this do-able, it is also a long-run, pro-growth policy.

The creation of a public agency to manage long-term investments should be a priority. It needs to be set above political influence. The roles of the Bank of Korea and of the Competition Commission also need strengthening to ensure their independence across political cycles. These independent entities can ensure greater institutional strength and they can garner public support if they are seen as being apolitical. Many of the long-standing policy challenges have been recognized by Korean thinkers and academics, but haven't been dealt with because of political considerations. The big strength of Korean policymaking in the past was its ability to create a long-term vision accompanied by long-term planning and solid implementation. These virtues could serve Korea well as it attempts to deal with its current set of challenges.

Conclusions

There are many areas of economic policy in which Korea set the standard in the course of four decades, 1960-2000. During that period, incomes per capita snowballed and Korea went from a manufacturer of the lowest value-added products to the global leader in electronics, appliances and automobiles. No other country in the course of the last half-century has done as well and even China's remarkable rise does not detract from the Korean success story because of China's size and the unusual and predominant role of state capitalism. In the case of Korea, government was able to use the state to create world-class private global corporations and then to withdraw into a more traditional regulatory role. Among OECD countries, Korea stands out as the prime exemplar of a state-incentivized growth strategy leading to unbelievably rapid increases in per capita income.

Korea was a global leader in the use of think tanks and economic information. Of course, each corporation now boasts its own economic research group; however, the role of the Korea Development Institute and of the economic leaders that it spawned still stands out today. Being able to adapt the best of economic thinking into practical and usable policy advice that could work in Korea was a remarkable feat. This strength still exists; however, now national expertise needs to be blended with global knowledge in ways that may seem unfamiliar to Korean policymakers. The efficient use of international experts to bring in fresh perspectives may add value to decision-making in the 21st century.

Public policy in Korea was managed by a coterie of officials who were empowered to do national service, respected, and perhaps feared at times, since they commanded such political support. This kind of power can be misused, and in some instances it was, but overall, Korea stands out among a handful of countries in which public policy was well executed and successful. At times controversial, or excessive, such as in the heavy and chemical industry phase of industrial policy promotion in the 1980s, public policy was nevertheless well coordinated and efficiently executed with a common understanding among all the economic agents involved as to what the ultimate goal was. The Korean proverb of always "camping with your back to the water" was an indication that failure was not an acceptable outcome. History has shown that success was the ultimate judge of Korea's efforts, and it can remain so going forward.

THE ROLE OF AID IN KOREA'S DEVELOPMENT

By Lee Kye Woo

Abstract

Korea's economic development is often cited as a model for other developing nations. One of about 60 countries whose per capita income was less than $300 in the 1960s, only Korea was able to attain a per capita income of more than $10,000 by 1995. Some scholars have pointed to education as the key. However, while education clearly played a significant role, Korea's spending on education was not greater than that of other developing countries at the same level of per capita income from 1962-1994. However, one underappreciated factor in Korea's development is the role of foreign aid. Official aid played an instrumental role in promoting Korea's economic and social development.

Introduction

Korea was a success case of development. A country with no significant natural resources devastated by the Korean War for three years, it rose from the ashes of the war as a "basket case" with a per capita income under $100 in 1962 to over $10,000 in 1995 at an average annual GDP growth of 10 percent. The Nobel laureate Professor Robert Lucas, Jr. called it a miracle.[1] Currently, Korea is the 13th largest producer of goods and services, and the 8th largest trader in the world with a per capita income of more than $25,000, and is actively engaged in global development cooperation as a member of OECD and its Development Assistance Committee (DAC). In the 1960s, there were about 60 developing countries, including Korea, whose per capita income was less than $300. Among these countries, Korea was the only one that attained a per capita income of more than $10,000 by 1995. Only three countries, including Brazil, attained between $3,000 and $10,000 in per capita income. Aside from the Asian financial crisis period, Korea was also the first country to graduate from the multilateral development banks' lending program and did so in the shortest time period after Singapore.

Various attempts have been made to explore the sources of Korea's remarkable growth. For example, some scholars pointed to the human capital accumulation as the source of growth. However, its contribution to the growth path was less than 10 percent.[2] Undoubtedly, education, training and knowledge dissemination must have played an important role in the development process of Korea. However, during 1962-1994, the government of Korea did not spend more of its GDP on education than other developing countries at the same level of per capita income.[3]

Since the Korean economy's spectacular growth rates were fueled by annual investment rates exceeding 30 percent of GDP, with a substantial part financed by official foreign assistance, this paper will examine the history of official aid to Korea and draw lessons relevant to donors and recipients of official aid. This paper argues that Korea's economic miracle was supported not so much by the type or amount of aid received, but rather by the efficient sectoral targeting and application of that aid by donors and the Korean government.

Overview of Official Foreign Assistance to Korea

Scale and Type of Official Foreign Assistance

In the course of Korea's social and economic development (1945-1999), total official foreign assistance amounts to about $44 billion in current prices. This amount includes public development grants of about $7 billion and public development loans of about $37 billion. The total loan amount can be divided into ODA (official development assistance) type loans of about $6 billion (with a grant element higher than 25 percent) and OOA (other official assistance) type loans of about $31 billion (with a grant element lower than 25 percent). Therefore, total ODA (grants plus ODA-type loans) was about $13 billion.

Table 1-1 Official Foreign Assistance: 1945-1999 ($ billion in current prices)

Fund	Total	Grant	Loan
ODA (grant element 25 percent +)	12.8	7.0	5.8
OOA (grant element 25 percent -)	31.2	0	31.2
Total	**44.0**	**7.0**	**37.0**

Donor	Total	Bilateral	Multilateral
ODA (grant element 25 percent +)	12.8	11.8	1.0
OOA (grant element 25 percent -)	31.2	11.0	20.2
Total	**44.0**	**22.8**	**21.2**

Source: Author on the basis of data from KOICA (2004) and Lee, J.S. (2013).

When the ODA received by Korea during 1965-1995 was compared with that of the other 59 developing countries that had per capita incomes of less than $300 during the 1960s, Korea belongs to the 10-country group that received ODA of less than 2 percent of GDP on an average annual basis. The other 50 countries received more aid than Korea did, and as many as 15 countries received more than 10 percent of GDP a year on average. Therefore, we cannot attribute the Korean economy's faster growth to the amount of aid Korea received.

Official development grants ($7 billion) accounted for only 16 percent of total official capital inflows ($44 billion) from 1945 to 1999. The rest (84 percent) were public development loans ($37 billion), especially OOA-type loans ($31 billion). During 1959-1999, when the official development loans were actively disbursed, OOA-type loans made up 84 percent of total official development loans. Official grants were scarcely available since 1975. This contrasts sharply with recent OECD/DAC development assistance, which is composed of mainly grants. Therefore, to the extent that official foreign assistance contributed to Korea's successful industrialization and fast economic growth during 1962-1995, public development loans, especially OOA-type loans, rather than official development grants, deserve credit.

Donors of Official Foreign Assistance

The major bilateral ODA donors were the United States and Japan, followed by Germany. The major multilateral donors were United Nations - Civil Relief in Korea and United Nations - UN Korea Reconstruction Agency, followed by the World Bank Group's International Development Association.

Among the public development loans of $37 billion, about $5.8 billion or 16 percent were loans with a grant element higher than 25 percent, which therefore belong to the ODA category. The other $31.2 billion or 84 percent were loans with a grant element lower than 25 percent (OOA-type loans). Total public development loans of $37 billion can also be divided into multilateral loans of $20.5 billion (55 percent) and bilateral loans of $16.5 billion (45 percent). ODA-type multilateral loans were only $0.3 billion (0.8 percent) of total public development loans, and ODA-type bilateral loans were $5.5 billion (15 percent). OOA-type multilateral loans were about $20.2 billion (54 percent) of total public development loans, and OOA-type bilateral loans were 11 billion (30 percent).

Sectoral Allocation of Aid

Since the grants were mostly allocated to foodstuffs and emergency consumption goods, and the public development loans accounted for 84 percent of total official foreign assistance, the actual sectoral application of the public development loans reflects the Korean government's strategy for allocating aid. If the emergency structural adjustment loans received in the wake of the 1997 Asian financial crisis are excluded, the government prioritized the economic infrastructure sector (51 percent), followed by the production sectors (24 percent). The social infrastructure sector was allocated about 12 percent.

This pattern of sectoral aid allocation was almost the inverse of that pursued by average OECD/DAC donors in recent years. OECD/DAC donors prioritize social and administrative

Table 1-2 Donors of Official Development Assistance: 1945-1999 ($ million in current prices)

Bilateral		
Donor		**Amount**
1.	US	5,542.35
2.	Japan	5,051.81
3.	Germany	834.93
4.	Saudi Arabia	123.54
5.	France	101.46
6.	Austria	52.77
7.	Netherlands	17.76
8.	Australia	14.01
9.	Denmark	10.46
10.	Belgium	10.15
11.	UK	9.68
12.	Canada	8.07
13.	Sweden	7.74
14.	Italy	6.31
15.	Norway	4.87
16.	Switzerland	4.53
17.	New Zealand	3.36
18.	Other	4.18
Total		**11,808.00**

Multilateral		
Donor		**Amount**
1.	CRIK	457.40
2.	UNKRA	122.10
3.	IDA	102.59
4.	WFP	98.50
5.	UNDP	69.12
6.	IBRD	40.00
7.	UNTA	32.40
8.	UNICEF	14.30
9.	UNFPA	7.69
10.	ADB	6.80
11.	ADF	6.34
12.	UNHCR	1.87
13.	Other UN Organizations	7.69
14.	Other	1.86
Total		**968.31**

Table 1-3 Donors of Public Development Loans: 1959-1999 ($ million in current prices; as a %)

	ODA-Type Loans (Grant Element 25 percent+)	OOA-Type Loans (Grant Element 25 percent-)	Total
Multilateral Loans	300.1 (1.6)	20,235.0 (98.4)	20,535.1 (100)
IDA	115.6 (100.0)	-	115.6 (100)
IBRD	147.0 (1.0)	14,671.9 (99.0)	14,818.9 (100)
ADB	37.5 (0.7)	5,555.7 (99.3)	5,593.2 (100)
EC	-	7.4 (100.0)	7.4 (100)
Bilateral Loans	5,528.4 (33.5)	10,959.6 (66.5)	16,488.0 (100)
Japan	2,861.3 (46.7)	3,262.8 (53.3)	6,124.1 (100)
US	1,958.8 (37.8)	3,221.2 (62.2)	5,180.0 (100)
France	-	3,488.8 (100.0)	3,488.8 (100)
Canada	0.7 (0.2)	460.4 (99.8)	461.1 (100)
Germany	305.5 (81.0)	71.5 (19.0)	377.0 (100)
Belgium	-	231.4 (100.0)	231.4 (100)
Sweden	-	160.8 (100.0)	160.8 (100)
Saudi Arabia	96.6 (100.0)	-	96.6 (100)
UK	-	62.7 (100.0)	62.7 (100)
Denmark	2.8 (100.0)	-	2.8 (100)
Netherlands	1.7 (100.0)	-	1.7 (100)
Hong Kong	1.0 (100.0)	-	1.0 (100)
Others*	300.0 (100.0)		300.0 (100)
Total	**5,828.5 (15.7)**	**31,194.6 (84.3)**	**37,023.1 (100)**

*Includes statistical errors
Source: Author based on KOICA (2004) and Lee, J.S. (2013).

infrastructure and services (49 percent), and give about 24 percent to the economic infrastructure and production sectors.[4] However, OECD/DAC aid recipient countries have not duplicated Korea's economic performance. Therefore, to the extent that official foreign assistance contributed to Korea's faster growth and industrialization, we can attribute them to the Korean government's sectoral aid distribution policies and practices, which were quite different from those of current OECD/DAC assistance donors and recipients.

Evolution of Official Foreign Assistance for Korea

The history of official foreign assistance to Korea evolved over several stages in accordance with political, economic and social development processes: first, the 1945-1949 period under the U.S. military government and the Korean government established in August 1948; second, the 1950-1959 period covering the Korean War (1950-53) and rehabilitation period; third, the 1960-1979 period featuring active industrialization and fast growth; and fourth, the 1980-1999 period characterized by economic and political stabilization and liberalization. Each of these periods will be studied in detail in the ensuing sections, with special emphasis placed on the role of different objectives and types of aid, as well as sectoral aid allocation policies and practices.

Official Foreign Assistance: 1945-49

Background

In the wake of World War II, Korea was liberated from Japanese colonial rule on August 15, 1945. After the peninsula was divided between U.S. and Soviet spheres of influence,

Table 1-4 Sectoral Distribution of Public Development Loans: 1959-1999 ($ million in current prices; as a %)

Sector	Amount (withdrawn)	Percent	Percent excluding structural adjustment during the 1990s
Social Infrastructure and Services	**3,001.5**	**8.1**	**12**
1. Education	1,251.8	3.4	
2. Health/Population	428.0	1.2	
3. Housing/Water	1,321.7	3.5	
Economic Infrastructure	**12,682.1**	**34.3**	**51**
1. Transportation	5,321.8	14.4	
2. Communication	1,287.5	3.5	
3. Electric Energy	6,072.8	16.4	
Production	**6,145.2**	**16.6**	**24**
1. Agriculture/Fishery	828.2	2.2	
2. Manufacturing/Mining	5,278.5	14.3	
3. Construction/Trade/Tourism	38.5	0.1	
Multi-Sector	**1,421.2**	**3.8**	**6**
1. Environment/Women	613.5	1.7	
2. Area Development	807.7	2.1	
Goods Program	**13,473.1**	**36.4**	**7**
1. Grain Goods	1,736.3	4.7	
2. Structural Adjustment	11,736.8	31.7	
Statistical error	**300.0**	**0.8**	
Total	**37,023.1**	**100.0**	**100**

Source: KOICA (2004) and OECD (2012).

social, economic and political chaos in the South exacerbated humanitarian crises brought on by Japanese colonization and World War II. Such was the context in which foreign assistance arrived in Korea.

Objective, Donor, and Content of Assistance

Assistance provided to the Korean Peninsula during 1945-49 was not for economic rehabilitation and reconstruction, but primarily for emergency humanitarian relief from the traumas the country had suffered under the Japanese colonization and during World War II, and for macroeconomic stabilization.

During the period, official foreign assistance was provided mainly by the U.S. Army Military Government in Korea, and the Economic Cooperative Administration (ECA), a U.S. government foreign assistance agency. The U.S. Army Military Government in Korea (USAMGIK) provided emergency relief and humanitarian assistance under the program called Government Appropriations for Relief in Occupied Areas (GARIOA) and rehabilitation assistance under the Economic Rehabilitation in Occupied Areas (EROA) program. However, the majority of assistance came from GARIOA.

The emergency assistance provided much-needed humanitarian relief, staving off widespread starvation, disease, and social unrest through the provision of basic necessities including foodstuffs and agricultural supplies, which accounted for 35 percent and 24 percent, respectively,

Table 1-5 Evolution of Official Foreign Assistance for Korea ($ billion in current prices)

Period	Objective of Aid	Scale and Type of Aid	Major Donors
1945-1949 U.S. Military & newly established Korean governments	• Emergency relief from the effects of World War II and Japanese colonization	• All grants • $0.7 billion	• US/AMGIK/ECA
1950-1959 The Korean War and rehabilitation	• Emergency relief from the effects of the Korean War • Rehabilitation and reconstruction after the Korean War	• Mostly grants • $2.3 billion	• US/ECA/FOA/ ICA • UN/CRIK/ UNKRA
1960-1979 Industrialization and growth	• Economic growth based on industrialization	• Grants and loans mixed • $6 billion (1962-78)	• Japan and US • Multilateral development banks
1980-1999 Stabilization and liberalization	• Economic growth based on stabilization, efficiency, balance	• All loans, especially OOA-type loans, except for the period (1997), which saw grants and loans mixed • $33 billion (1979-99)	• Multilateral development banks • Japan and U.S.

Table 2 Official Foreign Assistance to Korea: 1945-1952 ($ million in current prices)

	U.S./ AMGIK (1945-49)	U.S. ECA/SEC (1948-52)	Total (1945-52)	
			$	%
Reconstruction	69.8	6.0	75.8	11
Education	7.9		7.9	1
Housing/Health				
Food/Raw materials	416.8	196.0	612.8	87
Technical Assistance (TA)	7.7	NA	7.7	1
Total	**502.2**	**202.0**	**704.2**	**100**

Source: Author based on KOICA (2004).

of total GARIOA assistance. Indeed, by 1947, foreign grain totaled 44 percent of Korea's total grain supply, while the large amount of fertilizer supplied to Korea led to huge increases in agricultural production. Assistance for reconstruction accounted for only 14 percent of the total aid provided by GARIOA ($502,155) during the same period.

Efforts were made to implement a longer-term sustainable economic development strategy under the ECA. Although the ECA essentially operated like GARIOA, focusing on the provision of essential supplies and commodities, its aid was conditional on the implementation of macro stabilization and fiscal austerity policies.

In 1948, when the government of the Republic of Korea (ROK) led by Syngman Rhee was established, the policy objectives of the U.S. aid program were formalized under the ROK-U.S. Agreement on Aid. The U.S. imposed a strict set of controls to ensure that aid funds were allocated and used efficiently to achieve the policy objectives. The Korean government agreed to stabilize prices, privatize properties formerly owned by the Japanese, and liberalize markets, i.e., implement fair foreign exchange rate.

The exchange rate provision was a cause of often acrimonious donor-recipient conflicts over stabilization policy. The Rhee government was intent on maximizing foreign aid receipts when in use by keeping an officially overvalued currency against the dollar.[5] A Counterpart Fund account had to be established at the central bank where the proceeds of U.S. goods provided under the assistance program and sold in the marketplace were to be deposited. The allocation and uses of the Counterpart Fund had to be mutually agreed on by both governments.

The stabilization program suffered from policy inconsistencies and lack of support from the Korean government at the outset. Ultimately, however, the macro stabilization and fiscal austerity measures had real positive effects in checking hyperinflation and shoring up Korea's fiscal budget, as well as laying the groundwork for development. Consumer prices which had increased by as much as 86 percent in 1947 rose by only 4 percent in 1949.[6]

Early in Korea's development, a considerable amount of aid went into the education sector, resulting in a sharp reduction in illiteracy rates. During Japanese colonial rule, education was largely restricted to a few Koreans who received a Japanese education. Schools under the U.S. Military Government (1945-48) had clearly defined political and economic purposes: to convert Korean youths and adults to American-style democracy and provide basic skills training. The U.S. Military Government established civic schools for literacy and basic education of older students who were no longer qualified for compulsory primary education. Indeed, civic schools for adults that taught basic reading, writing and math were critical in sharply reducing the adult illiteracy rate within a very short time. By 1948, nearly 15,400 civic schools were established and more than one million adults were enrolled. About 15 million textbooks were printed and distributed for about three million children enrolled in primary education. The Korean language of *Hangeul* was formally reintroduced in the curriculum, and any elements of Japanese educational tradition were discarded.[7]

In step with the U.S. policy initiative on civic schools, the Education Act was passed by the newly established Korean government in December 1949, which gave civic schools a statutory status. Essentially, the Korean government implemented the same policy on adult education through such schools as the U.S. Military Government did. From the summer of 1946, adult education started eradicating illiteracy as well as fostering people to become democratic citizens. The Adult Education Bureau took charge of training leaders who would in turn visit cities and rural counties to train local leaders, who would then teach illiterate adults in neighborhoods and villages. The illiteracy rate fell from 78 percent in 1945 to 22 percent in 1949, and ultimately to below 10 percent in 1968.[8]

Official Foreign Assistance: 1950-59

Background

Soon after the Korean government's proposal to use a massive amount of aid for economic reconstruction through a five-year economic development plan was rejected by the U.S. Congress, the Korean War broke out on June 25, 1950. The cease-fire in 1953 left the Korean Peninsula war-torn, divided, and devastated again. South Korea suffered massive social and economic damage: civilian casualties totaled nearly 1.5 million while the destruction of properties was estimated at about $3.1 billion, leaving nearly 43 percent of residential homes and industrial facilities damaged.

Scale and Donor of Assistance

Korea received about $2.3 billion in official foreign assistance for emergency relief and reconstruction efforts during the 1950s. The economy and public finance system depended heavily on foreign aid. For example, aid accounted for about 74 percent of total government revenues and 85 percent of total imports during the period 1953-61. As in the 1940s, the major donor was the U.S. government. Multilateral efforts failed to result in a large assistance package under the UN flag, with the only exceptions being the UN-sponsored Civil Relief in Korea (CRIK) and United Nations Korea Reconstruction Agency (UNKRA), which together accounted for about 21 percent ($479 million) of total official assistance granted during the 1950s.

Objective and Sectoral Application of Assistance

The nature of aid was again emergency humanitarian relief, although some reconstruction assistance was provided by UNKRA and the U.S. Foreign Operations Administration (FOA)/International Cooperative Agency (ICA) during the latter half of the 1950s. During the 1950s as a whole, reconstruction assistance accounted for less than 30 percent of the total aid granted, with emphasis placed on physical infrastructure, industries, and education/health. As the majority of assistance came in the form of food, raw materials, and other consumable commodities (77 percent), the economy was sustained by consumption goods supplied as aid. Also, the government policy to keep the local currency overvalued to maximize proceeds of assistance and imports discouraged export-oriented industrialization and contributed to creating a chronic balance-of-payments deficit.

Although foodstuffs, raw materials and other consumption goods accounted for about 77 percent of total official aid, the Counterpart Fund, created from the proceeds of consumption goods donated as part of aid and sold in the domestic market, contributed about 30 percent - 53 percent of total government revenues during 1954-60. During the same period, about 32 percent of the Counterpart Fund (about 103.4 billion *won*) was used for the defense budget, and 45 percent went for public investment in fixed assets and financial operations. The Counterpart Fund constituted about 70 percent of total public investment and financial operations, contributing to the inception of capital formation in Korea. Therefore, the sectoral distribution of official aid, taking into account the disbursement from the Counterpart Fund, shows 54 percent for infrastructure and production sectors and 46 percent for social and government general services. This pattern of sectoral aid distribution contrasts sharply with the pattern of OECD/DAC assistance, which allocates only 24 percent for infrastructure and production sectors and 49 percent for social and government services.

UN/CRIK Aid

The U.N.'s Civil Relief in Korea (CRIK) provided multilateral assistance of $457 million, of which all but a fraction came from the U.S., as part of wartime relief efforts during 1951-

Table 3-1 Official Foreign Assistance to Korea (1945-61) ($ million in current prices; as a %)

<table>
<tr><th rowspan="2"></th><th rowspan="2">US/ AMGIK (1945-49)</th><th rowspan="2">US ECA/SEC (1948-52)</th><th rowspan="2">UN/CRIK (1951-56)</th><th rowspan="2">UN/ UNKRA (1951-59)</th><th rowspan="2">US/FOA (1953-55)</th><th rowspan="2">US/ICA (1955-59)</th><th rowspan="2">US/ PL480 (1955-61)</th><th colspan="2">Total (1945-61)</th></tr>
<tr><th>$</th><th>%</th></tr>
<tr><td>Agriculture/ Fishery</td><td></td><td></td><td></td><td>8.1</td><td>1.3</td><td>40.4</td><td></td><td>49.8</td><td>1.7</td></tr>
<tr><td>Mining</td><td></td><td></td><td></td><td>12.8</td><td rowspan="2">0.9</td><td rowspan="2">59.6</td><td rowspan="2"></td><td rowspan="2">100.3</td><td rowspan="2">3.4</td></tr>
<tr><td>Manufacturing</td><td></td><td></td><td></td><td>27.0</td></tr>
<tr><td>Physical Infrastructure</td><td></td><td></td><td></td><td>8.9</td><td>48.5</td><td>219.5</td><td></td><td>276.9</td><td>9.3</td></tr>
<tr><td>Other reconstruction</td><td>69.8</td><td>6.0</td><td>47.9</td><td>NA</td><td>1.2</td><td>19.6</td><td></td><td>144.5</td><td>4.9</td></tr>
<tr><td>Education</td><td></td><td></td><td></td><td>9.6</td><td rowspan="2">17.4</td><td>14.0</td><td></td><td rowspan="2">106.6</td><td rowspan="2">3.6</td></tr>
<tr><td>Housing/Health</td><td>7.9*</td><td></td><td>16.2</td><td>11.5</td><td>30.0</td><td></td></tr>
<tr><td>Food/Raw materials</td><td>416.8</td><td>196.0</td><td>393.3</td><td>36.2</td><td>136.0</td><td>891.0</td><td>202.6</td><td>2,271.9</td><td>76.6</td></tr>
<tr><td>TA</td><td>7.7</td><td>NA</td><td>NA</td><td>7.8</td><td>NA</td><td>NA</td><td>NA</td><td>15.5</td><td>0.5</td></tr>
<tr><td>Total</td><td>502.2</td><td>202.0</td><td>457.4</td><td>121.9</td><td>205.3</td><td>1,274.1</td><td>202.6</td><td>2,965.5</td><td>100.0</td></tr>
</table>

Source: Author based on KOICA (2004) and Kim (2012).

56. Much of the assistance came in the form of foodstuffs, and textiles and clothing, representing 40 percent and 24 percent, respectively, of total assistance granted. The UN relief efforts were crucial in relieving widespread starvation and disease in Korea during this time.

UN/UNKRA Aid

The United Nations Korea Reconstruction Agency (UNKRA) provided significant assistance ($122 million) in support of the reconstruction of Korea's economy: repairing devastated properties, providing rehabilitation supplies, transport, and services for Korean industry. One salient feature of UNKRA aid was that the proportion of aid that went toward building up the productive capacity of the economy was 70 percent, leaving 30 percent for consumption. This ratio was exactly the reverse of aid efforts under AMGIK and ECA during the 1940s and under CRIK and the FOA/ICA during the 1950s.

Since UNKRA sought to facilitate reconstruction, its aid was used to import equipment and construct new factories (glass, cement, paper, etc.). UNKRA aid was also used to rehabilitate damaged industries (smelting factories, large-scale textile factories, and coal mines). Some UNKRA aid was used to fund policy loans for SMEs in manufacturing and mining industries through the Bank of Korea (BOK), which made loans based on recommendations by the Ministry of Commerce and Industry.[9] However, UNKRA aid was only 4 percent of total official aid during 1945-61 and could not influence the sectoral distribution pattern of total aid.

Table 3-2 Official Foreign Assistance to Korea and OECD/DAC Assistance (as a %)

<table>
<tr><th>Sector</th><th>Aid to Korea</th><th>OECD/DAC Recipients</th></tr>
<tr><td></td><td>1945-61</td><td>2011</td></tr>
<tr><td>Infrastructure</td><td>49</td><td>17</td></tr>
<tr><td>Manufacturing + Agriculture</td><td>5</td><td>7</td></tr>
<tr><td>Social + Technical Assistance</td><td>4</td><td rowspan="2">49</td></tr>
<tr><td>General Government</td><td>42</td></tr>
</table>

U.S. /FOA and ICA Aid

Consumption

The U.S. FOA (Foreign Operations Administration) (1953-55) and ICA (International Cooperation Agency) (1955-59) insisted on pursuing stabilization before development, placing priority on reining in hyperinflation caused by the expansion of debt to finance the war, and on securing a minimum subsistence level of living. Thus, foreign aid was focused on increasing the supply of consumer and intermediate goods to curb inflation. FOA provided a total of $205 million, and its sequel agency, ICA, $1.3 billion. About 70 percent of their aid was for consumption goods, supplies and raw materials, such as fertilizer, wheat and energy (non-project assistance).[10] In particular, since 1954, a large quantity of wheat flour was given to Korea under the Title I of Public Law 480 (Food for Peace Program), which was used as compensation for workers mobilized under public works programs, such as soil reclamation projects for reforestation. During 1955-74, food assistance given under PL 480 was equivalent to 37 percent of total U.S. aid ($4.4 billion). The large quantity of food aid distorted food prices and incentives for farmers.[11]

Reconstruction

While maintaining their emphasis on consumption goods (70 percent of total aid), FOA (1953-55) and later ICA (1955-59) in particular provided significant aid for economic reconstruction toward the end of the 1950s. Project assistance to increase the economy's productive capacity accounted for 30 percent of total aid, of which nearly 37 percent was used to construct railways. Some of the project assistance was used to invest in manufacturing (including fertilizer, electric wire, pesticide, rubber recycling, and tire factories). In addition, about $78 million in ICA project assistance was used to build 44 new small-sized plants. Project assistance was also used to reconstruct power plants. By the end of the 1950s, much of Korea's infrastructure, including railways, roads, and harbors damaged during the war, were rehabilitated back to nearly pre-war levels, thanks to foreign aid. However, reconstruction efforts faced a major challenge in supplying adequate electric power to meet social and economic demand, since much of the electricity had been supplied from power plants in the North before the Korean War.[12]

Education

Besides physical infrastructure and productive industries (mining and manufacturing), education was an aid allocation priority. In absolute terms, the amount of aid that went toward education during the 1950s was only about $30 million or 1.5 percent of total official assistance received. However, the priority given to this sector by both the donor and recipient governments was clear. Assistance efforts after the Korean War centered on: classroom construction for basic education, secondary vocational education, teacher training, and higher education. During the Korean War, the nation lost the use of almost 70 percent of its classrooms. As such, UNESCO and UNKRA developed a five-year program for the development of Korea's education system and provided $11 million, or nearly eight percent of total aid by UNKRA, for education assistance, one half of which was used to repair schools destroyed during the Korean War. Once infrastructure reconstruction efforts were fully under way, the focus of education assistance shifted toward providing material aid, including a textbook printing factory for primary and secondary education, as well as increasing investments in higher education.[13]

Contrary to common belief, U.S. assistance in support of the Korean education system was not as sizeable as that given for infrastructure and productive industries. During 1954-61, FOA/ICA devoted only about one percent of their total assistance ($20 million) to the education sector. However, the assistance addressed the most keenly felt shortages of technical and professional human resources, which were essential for economic development. About half of the education assistance was invested in higher education, in particular Seoul National University (SNU), with another 20 percent in teacher training, and the rest in secondary vocational education.

Prior to Korea's liberation from Japan, access to higher education remained largely limited. Moreover, Korea suffered a huge shortage of skilled workers and technicians after the departure of the Japanese, who held most of the skilled jobs during their occupation. As such, a top aid priority was bolstering Korean higher education and research, and secondary vocational education to support Korea's economic development. To build up Korea's technical capacity, a considerable amount of financial and technical assistance went into upgrading Korean secondary vocational education, as well as institutions of higher learning.

To staff primary schools left vacant by the repatriation of Japanese teachers, who accounted for 40 percent of all teachers, eight new teacher training institutes were established with the help of U.S. assistance by 1951. As a result, enrollment in primary schools nearly doubled from 1.4 million in 1945 to 2.5 million in 1947. Thanks to the expansion of teacher education programs, Korea eventually achieved universal primary education in the late 1950s, while making all primary schools coeducational.[14]

Another unique feature of the U.S. education assistance was that investment in facilities, equipment, and materials did not dominate, and technical assistance accounted for about 40 percent of the total. For example, a teacher education program was carried out in cooperation with the George Peabody College of Teachers in the United States. The aim of this cooperative program was to significantly modernize the education system and its curriculum. This program benefited several universities, including SNU, Korean teacher-training institutes, junior colleges, and lower-level schooling programs. Under the Peabody Technical Assistance Program carried out between 1956 and 1962, about 40 Peabody faculty members were sent to Korea to train Korean educators in Western-style education methods. The Korean educators were trained in educational theory, curriculum development, and teaching practices through on-site technical assistance at various educational institutions in Korea. In addition, nearly 80 Korean teachers were sent to the U.S. to receive training in higher education.[15]

Another example of technical assistance is the Minnesota Program. The ICA offered a significant amount of technical assistance for about 40 developing countries under "university contracts," which enlisted U.S. universities and technical institutions to facilitate the sharing of professional knowledge and skills. The basic objectives of the technical cooperation program were: expansion of education in the fields of engineering, medicine, agriculture, and public or business administration; support of specific services or industries; expansion of research; and training of technical manpower. In Korea, the Minnesota Program provided technical and material assistance to SNU from 1954 to 1961, for the Colleges of Agriculture, Engineering, and Medicine. Later on, the program was expanded to include the fields of nursing, veterinary medicine, and public administration. Through spillover effects, the program successfully contributed to nationwide training of professionals and academics in the covered fields and modernization of related industries and services in Korea.[16]

Official Foreign Assistance: 1960-1979

Background

The 1960s witnessed sharp changes in both domestic and international arenas. Domestically, a new government was established through a bloodless military coup in 1961. The new government embarked on industrialization of the Korean economy through successive five-year economic development plans, starting in 1962. The plans aimed to enable the Korean economy to take off through industrialization: initially in export-oriented labor-intensive light industries in the 1960s, followed by export-oriented heavy and chemical industries in the 1970s.

To mobilize capital needed to implement the Five-Year Economic Development Plans, the new government initiated a series of reforms. First, it strengthened the Foreign Capital Promotion Law in 1962 to encourage foreign direct investment and promote private sector borrowing overseas supported by government guarantees. It also launched negotiations with the Japanese government in 1962 for rapprochement and reparation. The government anticipated that domestic savings would be insufficient to finance the Plans' ambitious investment programs, and made all-out efforts to mobilize foreign savings (grants, loans, and foreign direct investment, etc.). Second, the government made a drastic tax reform in 1965 to increase revenues and eradicate corruption. Third, in that same year, the government also pursued interest rate reform, raising the one-year savings account interest rate from 15 percent to 30 percent, to encourage domestic savings.

Externally, the Organization of European Economic Cooperation (OEEC) and its Development Assistance Group (DAG) were reorganized in 1962 as the Organization of Economic Cooperation and Development (OECD) and the Development Assistance Committee (DAC) with the participation of other major economies like the U.S., Japan, and Australia. This reorganization reflected the full recovery of the European economies from World War II and aimed to further economic growth through expansion of economic relations (trade, investment, aid, etc.) with developing countries. The UN designated the 1960s as the First Development Decade for economic growth of developing countries to promote economic cooperation and liberalization. Besides the traditional loan window (with interest at concessional rates) of the International Bank for Reconstruction and Development (IBRD), the World Bank Group created a credit window (soft loan without interest) for low-income countries (IDA) in 1960. The U.S., which served as the major donor for the rehabilitation and recovery of the Korean economy in the 1950s, also made a strong commitment to the economic growth of developing countries through the Foreign Assistance Act of 1961. The Kennedy Administration, however, shifted the focus of its assistance policy from grants to loans, emphasizing the responsibilities of recipient countries, and combined its two major aid agencies, the International Cooperation Agency (ICA) and Development Loan Fund (DLF), into one agency called the Agency for International Development (AID). Several European countries also established their own bilateral aid agencies.

In the academic arena, the traditional Harrod-Domar growth theory, which emphasized physical capital accumulation as the main source of growth, was challenged by the neoclassical growth modeling of Robert Solow and the human capital theories of Theodore Schultz and Gary Becker, which emphasized population growth, technological progress, and human capital accumulation as major sources of growth.

Objectives of Aid

The 1960s marked the turning point in the history of official foreign assistance in Korea. The scale of aid increased compared with the 1950s. The objective of aid shifted from rehabilitation and reconstruction in the wake of the Korean War to economic growth through industrialization and exports. The aid was not for emergency relief or subsistence consumption, but for investment and economic growth to attain higher living standards. Compared with the 1950s, when donors took initiatives for identifying where the aid funds were needed and applying them to different sectors, the government of Korea took the initiative in this period, basing its assistance requests on its successive five-year economic development plans, starting in 1962.

Scale and Type of Aid

During the development decades (1962-1992), total capital inflows to Korea amounted to about $82 billion, of which public capital inflows, i.e., public development grants and loans, amounted to only $21 billion, or about 26 percent of the total capital inflows. The rest consisted of private capital inflows, such as commercial loans, financial institutions' borrowing, private sector bonds, and foreign direct investment. However, public capital inflows played an important initial role in leading Korean economic development. As development progressed, the importance of public capital inflows declined, and private capital inflows took over the leading role. The share of official foreign assistance declined from 38 percent of total capital inflows during the first half of the development decades (1962-78) to 22 percent during the second half (1979-1992), due to the rising share of private capital inflows. Increases in public capital inflows and investment at the initial stage of the development decades played the role of crowding in private capital inflows and investment at the later stage. This is one of the unique features of Korean economic development.

Throughout the whole development decades (1962-1992), public grants ($1.5 billion) accounted for only 1.8 percent of total capital inflows. This is another unique feature of the Korean economic development. Korea's high growth and successful industrialization took place with public development loans rather than public grants. This is also the reason why some studies of Korean economic development demonstrate that public development loans made greater contributions to high economic growth rate than grants.[17] However, loans were not particularly more effective in promoting economic growth; rather, loans were the main source of development finances, and few grants were available during the development decades.

Another feature of the capital inflows in Korean economic development is that loans (public and private) dominated capital inflows ($67 billion or 82 percent of total), compared with foreign direct investment (FDI). FDI amounted to only $7.8 billion (10 percent of total) during the development decades (1962-1992). Many development studies show that FDI made greater contributions to economic growth than loans did.[18] However, in the case of Korea, fast economic growth and industrialization was attained mainly with loans. Therefore, for fast economic growth and industrialization, the key seems to be efficiency in the application of foreign capital, rather than the type of capital, i.e., whether the capital is grants, FDI, or loans.

Public capital inflows (official foreign assistance) can be divided into public grants and public loans. The latter can be further disaggregated into ODA-type loans (official development assistance loans with a grant element greater than 25 percent of the total loan amount) and OOA-type loans (other official assistance development loans with a grant element smaller than 25 percent).

Table 4-1 Capital Inflows to Korea: 1945-1992 ($ million in current prices; as a %)

	1945-61	1962-65	1966-72	1973-78	1962-78	1979-85	1986-92	1979-92
Public Grants	**3,117**	**739**	**763**	**-**	**1,502 (9.2)**	**-**	**-**	**-**
Public Loans	5	62	1,130	3,431	4,623 (28.3)	10,105	4,688	14,79 (22.6)
Commercial Loans		71	1,950	5,858	7,866 (48.1)	7,937	5,206	13,143 (20.1)
Financial Institutions' Borrowings		-	205	1,226	1,431 (8.7)	14,881	10,296	25,177 (38.6)
Private Sector Bonds		-	-	-	-	834	4,515	5,349 (8.2)
Foreign Direct Investment		13	227	704	937 (5.7)	1,157	5,684	6,841 (10.5)
Total	**3,122**	**886**	**4,275**	**11,219**	**16,359 (100)**	**34,914**	**30,389**	**65,303 (100)**

Source: Lee, J.S. (2013).

During 1960-1990, while public grants decreased from 99 percent during the previous period (1945-60) to only 13 percent ($2.7 billion) of the total public capital inflows ($21.3 billion), ODA-type loans increased sharply to $4.7 billion, accounting for 22 percent of the total public capital inflows. Consequently, total ODA (grants plus ODA-type loans) of $7.4 billion accounted for only 35 percent of the total public capital inflows. This means that the OOA-type loans of $13.9 billion (65 percent) dominated the total public capital inflows (official foreign assistance) during the same period. This is because in 1975, Korea had to graduate from the World Bank Group's IDA loans, which were Korea's main source for soft loans (i.e., ODA-type loans). Therefore, among the official foreign assistance flows, Korea's economic development took place mainly with the OOA-type loans (with a grant element less than 25 percent). This is another unique feature of the capital inflows in Korea's economic development processes.

During 1962-1982, the Korean economy grew an average 8.2 percent per year. Studies show that about 3.3 percentage points or about 40 percent of the high growth rate can be attributed to the higher level of foreign capital inflows including official foreign assistance, especially OOA-type loans with a grant element smaller than 25 percent.[19] In fact, the GDP growth rate during 1945-1959, when foreign capital inflows were much lower, averaged only 4.4 percent per year. Moreover, the grant element of the OOA-type loans provided during 1962-1982 contrasts sharply with the current practice of DAC members, which provide official development assistance (ODA) mainly with a grant element higher than 86 percent.[20]

Table 4-2 Public Capital Inflows: 1960-1990
($ billion in current prices)

Type	1945-1960	1960-1990	1991-1999	Total
ODA Grants	3.0	2.7	1.3	7.0
ODA Loans	0.0	4.7	1.0	5.8
OOA Loans	-	13.9	17.3	31.2
Total	**3.0**	**21.3**	**19.6**	**44.0**

During the 1960s, general government revenues still depended heavily on official foreign aid, and almost half of total investment was financed by foreign savings, i.e., net transfers from public development grants and loans. Even during the 1970s, when fiscal dependence on foreign assistance declined, total investment still depended on public development loans, especially on OOA-type loans, since domestic saving rates were much lower than total investment rates.[21] The gap was filled by public development loans and other types of foreign capital inflows. For example, during 1974, while total investment was about 32 percent of GDP, the domestic savings rate was only 21 percent of GDP, leaving a gap of about 11 percent of GDP. This investment gap had to be financed by foreign savings, especially OOA-type loans.[22] Domestic savings rates were not yet high enough, and grants or soft loans were no longer available in large amounts at that time. Only after 1986 were domestic savings rates high enough to cover total investment rates.

The government played an active role in mobilizing assistance funds in a sustainable manner and coordinating donors' offers systematically. One mechanism that proved effective was the annual or bi-annual meetings of the International Economic Consultative Group for Korea (IECOK), which was established at the Korean government's initiative in 1966. These meetings, chaired by the World Bank, briefed bilateral and multilateral donors on the Korean government's development strategy and investment programs. The meetings identified needs for future assistance and described the implementation progress of existing investment projects financed by foreign assistance. This mechanism was used until the beginning of the 1980s and was replicated by the World Bank for many other developing countries.[23] Korea's experience contrasts sharply with the OECD/DAC-organized Paris Declaration for Aid Effectiveness, which emphasizes aid coordination not by recipient, but by donors.

Major Donors of Aid

Although the U.S. continued to be a major aid provider, as it was during the 1940s and 1950s, other developed countries, especially Japan, began to play an equally important role as major donors during the development decades (1962-1992). Moreover, multilateral banks, such as the IDA (International Development Association) and IBRD (International Bank for Reconstruction and Development) of the World Bank Group and the ADB (Asian Development Bank), also became a major assistance source. During 1961-1999, the IDA and IBRD financed more than 120 investment projects and structural adjustment programs with a total of $14.9 billion loans and credits. The ADB supplemented with $5.6 billion loans during the period. Consequently, aid funds during the period were concentrated on credits (no-interest loans) or loans (with interest), rather than grants. The U.S. government also shifted its aid from grants to loans under the initiative of President Kennedy's Foreign Assistance Act of 1961.

By 1960, U.S. aid, mostly in the form of grants, was declining from its 1957 peak. The U.S. and Japan each had provided more or less the same amount of ODA (grants and ODA-type loans) of $3.0 billion during 1961-1990. While the U.S. played a dominant role (64 percent) during the first half of

Table 4-3 Aid Dependency: 1962-1992 (as a % of GDP)

	1962-66	1966-72	1973-78	1979-85	1986-92
Gross Investment Rate	15.4	24.8	28.8	31.1	35.7
Domestic Savings Rate	6.4	14.8	23.4	24.8	34.6
Foreign Savings Rate	8.2	9.2	4.8	6.3	1.3
Statistical Errors	0.8	0.8	0.6	0	-0.2

Source: Lee, J.S. (2013).

the development decades (1961-1975), Japan played a more active role (58 percent) during the second half (1976-1990). Moreover, during the 1959 to 1999 period, when all public development loans were actively disbursed, Japan provided a somewhat larger amount of public development loans (a total of $6.1 billion ODA and OOA loans) than the U.S. lent ($5.2 billion). Besides the U.S. and Japan, France was a major bilateral donor, providing solely public development loans ($3.5 billion) and no grants.

Aid from Japan during the first half of the development decades (1961-1975) was given through the Reparation Fund, which was agreed to by both governments in 1965. This fund was composed of $300 million in grants and $200 million in public concessional loans at a 3.5 percent annual interest rate with a 20-year repayment period including seven years' grace. In addition, $300 million in commercial loans were also promised. These loans were to be disbursed equally over a ten-year period starting from 1965. Therefore, Japanese development loans accounted for about half the total development loans during this period (1965-1975). Also, total grants and loans, including commercial loans from Japan, during the period were more than a third of total capital inflows, including commercial loans, and were equivalent to about 23 percent of Korea's total exports.

Sectoral Distribution of Assistance

During 1945-1961, most aid was provided in the form of food, materials and other consumable goods. Since most of the aid was sold in the domestic market and converted into cash and deposited into the Counterpart Fund, which was used mainly for general fiscal expenditures and partly for the special investment and finance account, it is difficult to see the specific sectoral allocation of the aid fund. The aid fund allocated to specific investment projects was a rather minor part of the total aid fund. However, since 1962, the general fiscal account's aid dependency gradually declined, and most assistance was provided in the form of loans. Therefore, official foreign assistance tended to be earmarked for specific investment projects of a certain sector.

The overall trend of the government's emphasis on economic infrastructure and production sectors in allocating aid funds accentuated as the implementation of the development plans progressed. During the first half of the development decades (1962-1978), economic infrastructure (and service) and manufacturing sectors accounted for 73 percent of total public development loans, and the agricultural sector for 26 percent. The Japanese Reparation Fund was originally intended for the agricultural/rural sector. However, as the pressure for financing manufacturing and economic infrastructure investment mounted, a major part of the fund was devoted to economic infrastructure investment, including construction of roads, power plants, the POSCO steel factory and the Seoul-Busan Expressway. Moreover, during the second half of the development decades (1979-1992), economic infrastructure (and service) and manufacturing sectors accounted for 94 percent of total public development loans, and the agricultural sector for only 6 percent. Compared with the 1945-1959 period, the higher growth rates and more successful industrialization of Korea during the development decades (1962-1992) could be attributed to this sectoral allocation pattern of public development loan funds.

Such sectoral allocation of public development loans during the development decades in Korea differs sharply from the average OECD/DAC members'. In 2010, DAC members' ODA funds were allocated on a priority basis to the social and administrative infrastructure and service sectors by about 49 percent, while economic infrastructure and productive sectors received about 24 percent[24] (Table 3-2). This pattern of aid allocation, by neglecting the economic infrastructure and productive sectors, may have contributed to the sharply lower speed of economic growth and industrialization in other developing countries and to the running debate on DAC aid effectiveness in academic circles.[25] It was shown that aid applied to infrastructure and production sectors promotes economic growth much more than aid applied to social and administrative sectors in the short and medium terms.[26] Moreover, recent studies show that even the reduction in poverty under the Millennium Development Goals (1990-2015) owes more to economic growth than to redressing inequity by a two to one ratio.[27]

The government's emphasis on the economic infrastructure and service sectors should not mask the importance accorded

Table 4-4 Donors of ODA during 1961-1990 ($ million in current prices; as a %)

	First Half (1961-1975)	Second Half (1976-1990)
Scale	3,941.4 (100.0)	3,510.8 (100.0)
Donor		
U.S	2,506.2 (63.6)	512.0 (14.6)
Japan	1,080.0 (27.4)	2,014.3 (57.4)
Others	355.2 (9.0)	984.5 (28.0)
Type		
Grants	1,999.0 (50.7)	
Loans	1,942.4 (49.3)	3,510.8 (100.0)

to the education, training, and science/technology sectors. In particular, during the first half of the development decades (1962-1978), when industrialization programs were launched, the government allocated a substantial amount of official foreign assistance, especially grant funds, to these sectors in the form of free-standing technical assistance projects. For example, the Korea Institute of Science and Technology (KIST 1966-70: US/AID $9.1 million), the Central Vocational Training Center (1968-81: UNDP/ILO $2.6 million), the Korea-Germany Vocational Training Center (1970-75: Germany 16 million DEM), the Keum-Oh Industrial High School (1970-76: Japan 1.1 billion *yen*), the Dae-Jun Vocational Training Center (1976-83: Japan $2 million), and the Korea-Belgium Vocational Training Center (1976-80: Belgium $6 million). These technical assistance projects laid the foundation for Korea's science and technology development and technical workforce development at the inception of the industrialization programs. Favoring the infrastructure and production sectors helped promote industrialization and economic growth, shifting a much greater share of total employment toward high value-added sectors, i.e., the manufacturing and service sectors, and resulting in the improvement of living standards.

Implementation of Aid-Financed Investment

The government of Korea paid special attention to the implementation of aid-financed investment projects and programs. In 1961, the government appointed a Planning and Coordination Officer in the Prime Minister's Office with responsibility for monitoring and evaluating all important government policies and projects. In 1965, the Professors Group for Evaluation was commissioned to reinforce the system. This Group was responsible for monitoring and evaluating the implementation of the five-year economic development plans, a substantial portion of which were financed with official foreign assistance. Since then, the external and semi-independent group assisted with monitoring and evaluating all important government policies and investment projects; the results were reported at meetings attended by the president, cabinet members, heads of decentralized public agencies, public enterprises, and key members of the National Assembly four times a year. Initially, the Professors Group for Evaluation had only 15 members; however, when the group was transferred from the Prime Minister's office to the Economic Planning Board in 1981, its membership reached 107 professors.[28]

Table 4-5 Public Development Loans by Donor: 1966-1992 ($ million in current prices; as a %)

	1966-72	1973-78	1966-78	1979-85	1986-92	1979-92
US	685	867	1,552 (36)	2,660	75	2,735 (19)
Japan	256	516	772 (17)	896	1,252	2,148 (15)
International Organization	152	1,605	1,757 (38)	4,114	2,582	6,696 (45)
Germany	25	122	147 (3)	71	46	117 (2)
UK	1	105	106 (2)	376	1	377 (3)
France	6	22	28 (1)	643	668	1,311 (9)
Canada	5	145	150 (3)	436	-	436 (3)
Hong Kong		42	42 (1)	404	-	404 (3)
Others		7	7 (0)	505	64	569 (4)
Total	**1,130**	**3,431**	**4,561 (100)**	**10,105**	**4,688**	**14,793 (100)**

Table 4-6	Public Development Loans by Sector: 1962-1992 ($ million in current prices; as a %)						
	1962-66	**1966-72**	**1973-78**	**1962-78**	**1979-85**	**1986-92**	**1979-92**
Agriculture, For, Fish		512	696	1,208 (26)	889	59	948 (6)
Mining		10	-	10 (0)	37	-	37 (0)
Manufacturing		115	150	265 (6)	588	518	1,106 (8)
Economic Infrastructure+Services		493	2,585	3,078 (67)	8,591	4,109	12,700 (86)
Others	65*			65 (1)			
Total	**65***	**1,130**	**3,431**	**4,626 (100)**	**10.105**	**4,686**	**14,791 (100)**

Source: Lee, J.S. (2013).
* Data on sectoral allocation is unavailable.

Official Development Assistance: 1980-1995

Background

During the late 1970s and early 1980s, Korea's economic condition deteriorated substantially. The economy registered a negative growth rate in 1980 for the first time since the Korean War, and the inflation rate approached 30 percent per annum. Amid concerns that high inflation and overinvestment in the heavy and chemical industries might weaken the international competitiveness of Korean industries, the second oil crisis in the late 1970s precipitated the Korean economy into crisis.

The Korean government concluded that the crisis was not a temporary one, but rooted deeply in the structural problems that grew out of the government-led economic growth strategy adopted in the 1960s and 1970s. Thus, the Korean government attempted to revise its growth strategy, switching from a government-led approach to a market-led one and adopting comprehensive policy measures for economic stabilization. These policy measures were reflected in the fifth Five-year Economic and Social Development Plan, which began in 1982. The Development Plan aimed to achieve optimal economic growth in harmony with stability, efficiency, and balance. The stability and balance goals were to be attained by government actions to address imbalances in income, region, sector, and enterprise size. Government expenditures were curtailed sharply, small and medium enterprises were granted more assistance, and social security systems were expanded. Growth and efficiency goals were to be attained not by government-led strategy, but by market forces and liberalization policies, which permeated all sectors of the economy, including trade, finance and even education, especially at the higher education level.

Thanks to the weak dollar, low oil prices and low international interest rates, Korea's exports increased dramatically, and the economic growth rate returned to a high level. Consequently, the current account turned to surplus for the first time in history, domestic savings rates surpassed investment rates, and foreign debts began to decrease in 1986. The opening of Korean capital markets to foreign investors began in earnest in 1992, and when Korea joined the OECD in 1996, the liberalization policy advanced more. Consequently, with a massive volume of foreign capital flowing into Korea, the amount of foreign debts, especially short-term debts, substantially increased, leaving the economy vulnerable to a sudden foreign capital outflow. The bankruptcy of some major conglomerates in 1997 led to panic among foreign investors, and a massive foreign capital outflow followed, resulting in currency and financial crises during the latter part of 1997.

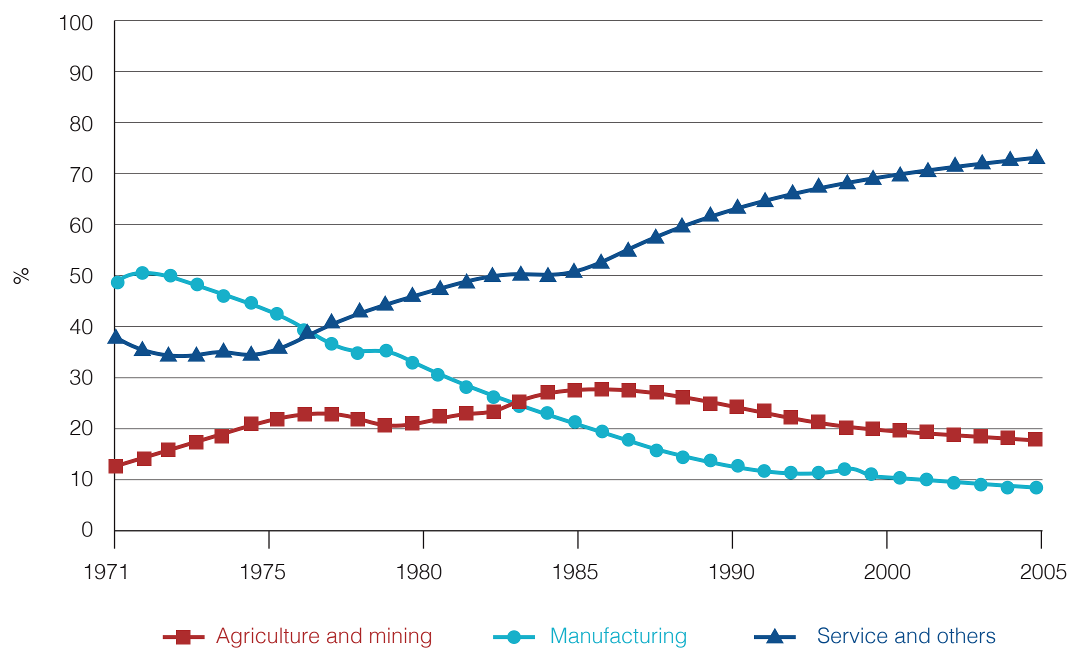
Objectives of Aid

The objective of assistance at this time was to finance investment for economic growth, in contrast to the rehabilitation and reconstruction that was observed during the 1950s in the aftermath of the Korean War, and as such was more similar to that of the 1960s and the 1970s. During the 1980s and the 1990s, however, official foreign assistance had additional objectives. It also aimed to finance the goals of the new economic and social development plans, that is, promoting efficiency and equity by supporting liberalization, innovation, and welfare/balancing programs. After 1995, it also aimed to facilitate emergency economic restructuring in the wake of the Asian Financial Crisis of 1997.

Scale of Aid

During the second half of the development decades (1979-1992), total capital inflows to Korea increased sharply to $65.3 billion, compared with only $16.4 billion during the first half (1962-1978). The increase was mainly in private capital inflows, especially in commercial loans and borrowings by

Figure 1 Shares of Employment by Industry (as a %)



Source: Eichengreen, B., D. Perkins, and K.Shin (2012) From *Miracle to Maturity: The Growth of the Korean Economy*, Harvard University Asia Center, Cambridge and London.

financial institutions. The public capital inflows rose as well from $4.6 billion during the first half of the development decades to $14.8 billion during the second half. However, the increase in public capital inflows was entirely in the form of public development loans, without public grants. Moreover, the majority of the public development loans were also not ODA-type (with a grant element higher than 25 percent), but OOA-type (with a grant element lower than 25 percent). As mentioned already, this is a unique feature of the official foreign assistance flows into Korea, if compared with the current DAC-provided ODA with a grant element higher than 86 percent for all developing countries.

Traditionally, public capital inflows, especially in the form of public grants and ODA-type loans, were for filling the gap between the total investment rate and the domestic savings rate. During the second half of the development decades (1979-92), however, the domestic savings rate rose steadily, and after 1986 savings rates were high enough to cover the total investment rate, reducing the need for public development loans. Therefore, Korea was asked to graduate from the ADB (Asian Development Bank) list of borrowers in 1988 and from the World Bank list of borrowers in 1995. The resumption of public capital inflows during the 1997-1999 period was mostly for emergency economic adjustment purposes in the wake of the 1997 Asian Financial Crisis. Korea is one of the few countries that graduated from the international organizations' credit/loan programs early and in a short period (after Singapore).[29]

Major Donors of Aid

During the latter half of the development decades (1976-1990), Japan played a more active role in providing ODA to Korea. While during the first half of the development decades (1961-1975), the U.S. provided 64 percent of total ODA (grants and ODA-type loans), during the second half of the development decades (1976-1990) Japan came to assume 58 percent of the total ODA. In addition, during the second half, Japan increased public development loans three times from $772 million to $2,148 million. During the 1990s, Japan provided a much larger amount of public development loans than the U.S. did. During the entire period of 1960-1999 when Korea received public development loans, Japan provided a larger amount of loans ($6.1 billion) than the U.S. offered ($5.6 billion). However, international organizations, especially the World Bank (IBRD), played the most dominant role during the latter half of the development decades. In particular during 1991-1999, when international organizations provided 65 percent of total public development loans, including the emergency restructuring loans in the wake of the Asian Financial Crisis, Japan provided only 21 percent of the total (Tables 1-2 and 1-3).

Sectoral Allocation of Aid

As mentioned already, as Korea's development plans progressed, the government's emphasis on economic infrastructure and production sectors grew when allocating aid funds. This trend was particularly clear during the 1980s and 1990s, and it contrasts sharply with DAC members' current practice of sectoral ODA allocation.

Conclusions and Lessons Learned

This paper has reviewed the role that official foreign assistance played at different stages of Korea's economic and social development (1945-1995), which has been praised as a miracle. From this review, we can draw some conclusions and lessons for the benefit of current and future donors and recipients of official foreign assistance.

1. Provision of consumption goods (foods, clothes, raw materials and supplies) after WWII and liberation from Japanese colonial rule was effective in staving off starvation and disease, and controlling inflation in Korea. However, it did not stimulate growth. Foreign assistance would have been more effective if the emergency relief had ended earlier, and aid funds had been provided for investment, supplementing Korea's low domestic savings. This point is relevant to many developing countries in conflicts and vulnerable situations today.

2. As part of emergency relief and humanitarian assistance, Korea received a fair amount of assistance funds on a priority basis for education, especially basic education and technical/professional education (teachers' education, secondary vocational education, and professional higher education in agriculture, engineering, medicine and nursing, public/business administration). Funding for materials and facilities did not crowd out funding for technical assistance. Such assistance programs helped achieve universal primary education in the late 1950s, relieved technical and professional human resources constraints on an emergency basis, and laid a foundation for industrialization during the 1960s and 1970s.

3. The active industrialization and fast growth of the Korean economy during the development decades (1962-1995) was made possible by a large amount of foreign capital inflows, especially official and private loans, to fill the significant gap between the total investment and domestic savings rates. Foreign capital inflows, especially official development assistance, also made up a significant portion of fiscal deficits prior to the development decades.

4. Among the capital inflows, public capital inflows, i.e., official foreign assistance flows, played a pivotal role during the earlier stages of Korea's development. However, as industrialization and economic growth proceeded, private capital flows played a much more dominant role in promoting development of the Korean economy during the second half of the development decades. Earlier official foreign assistance had crowd-in effects on private capital inflows, which sustained industrialization and economic growth during the later stages.

5. However, the amount of official foreign assistance flows was not as important as the sectors in which the capital was applied. Among 60 countries, which were at a similar level of per capita income as Korea during the 1960s, Korea received the least amount of ODA as a ratio of GDP during 1965-1995 (1.4 percent), but achieved the fastest industrialization and economic growth. The sectoral application of aid seems to have been more important than the absolute level of aid for industrialization and economic growth.

6. Grants were only a very small portion of total and official capital inflows in Korea. During the development decades (1960s-1990s) when industrialization and economic growth took place in Korea, grants were scarce. Therefore, Korea's fast industrialization and growth was attributable to loans. This experience presents a case contrary to development literature, which shows that foreign direct investment (FDI) made greater contributions to growth than loans in many developing countries. This Korean experience also contrasts sharply with the current OECD/DAC-provided assistance, in which grants dominate more than 90 percent of official development assistance (ODA). Moreover, the Korean economy industrialized and grew quickly not with ODA-type loans (with a grant element higher than 25 percent), but more with OOA-type loans (with a grant element lower than 25 percent), especially during the second half of the development decades. Therefore, the type of foreign capital inflows or official foreign assistance may not be so important as the effective allocation and application of foreign capital inflows.

7. Public capital inflows or official foreign assistance flows during the development decades were applied to the economic infrastructure sectors on a priority basis, followed by the production sectors. This sectoral allocation of official aid stimulated investment and growth in the private sectors. Such sectoral allocation of foreign assistance flows is sharply different from that of the average DAC members' official development assistance flows, which place much greater emphasis on the social and administrative infrastructure and service sectors and neglect the economic infrastructure and production sectors. The slower growth of DAC aid recipients indicates that the successful industrialization and fast growth of the Korean economy can be attributed to its unique sectoral allocation

and application of official foreign assistance flows, irrespective of their type. The impact of the sectoral aid allocation pattern on economic growth is well documented on the basis of cross-country and time series panel data,[30] which found that the foreign assistance flows applied to infrastructure and production sectors promoted economic growth at a much higher rate than other sectors in the short and medium terms. This finding also has implications for poverty reduction as well. Recent studies show that the poverty reduction effect of economic growth during the Millennium Development Era (1990-2010) was twice as great as that of the reduction in inequity.[31] This sectoral aid allocation pattern should not, however, mask the priority given to the social sectors, especially education and health, and the science and technology sectors at the inception of the industrialization programs.

8. The government of Korea played an active role in mobilizing aid flows in a sustainable manner and coordinating donors' offers in a systematic way. One effective mechanism was the International Economic Consultative Group for Korea (IECOK) meetings, which began in 1966. These annual or bi-annual meetings, chaired by the World Bank, briefed bilateral and multilateral donors on the Korean government's development strategy and investment programs; they identified assistance needs and Korea's progress in implementing investment projects financed by aid. This mechanism had been used until the beginning of the 1980s and was replicated by the World Bank for many other developing countries. Aid coordination was done by the aid recipient, not by donors or donors' group.

9. The Korean government established a special arrangement for managing public development loans. For careful review and approval of the proposals for public and private development loans, it established a special inter-ministerial committee, rather than leaving the process in the hands of a sole minister. This system contributed to a careful and non-political selection of efficient investment projects and programs.

10. The government paid special attention to results-oriented monitoring and evaluation of key government policies and projects, including aid-financed investment projects and programs. For this purpose, it established the Planning and Coordination Officer in the Prime Minister's Office and commissioned the Evaluation Professors Group, an external and semi-independent group, to monitor and evaluate the implementation of the five-year economic development plans, a substantial part of which was financed by official foreign assistance. The results of their work were reported at meetings attended by the president, cabinet members, heads of decentralized public agencies and public enterprises, and key members of the National Assembly four times a year, contributing to the effectiveness of the investment and aid programs.

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FUTURE PROSPECTS FOR THE KOREAN ECONOMY

By Jung Kyu-Chul

Abstract

Korea has shaken off some of the impacts brought by the Sewol ferry disaster, but its overall pace of growth is still very weak. The Korean economy is forecast to grow by 3.5 percent in 2015, slightly higher than 3.4 percent in 2014. But there are growing downside risks in the global economy. Domestically speaking, mounting household debts and falling corporate profitability have weakened the fundamentals of the Korean economy, and structural factors, such as demographic changes, have also had negative impacts. Not only that, Korea's inflation has been very low for quite a long time. Given weak domestic demand and low inflation in the midst of growing external uncertainties, expansionary macroeconomic policies are deemed necessary. Fiscal policy needs to remain expansionary and supportive of economic activity at a level that would not pose a threat to long-term fiscal prudence. Monetary policy should remain more alert and prepared for lower inflation. Since these short-term macroeconomic policies are not enough to sustain the dynamics of the Korean economy, aggressive and full-scale structural reform policies should be implemented in parallel so as to offset slow growth resulting from structural factors such as an aging population.

Overall Economic Activity

The sinking of the Sewol ferry in April 2014 significantly hurt consumer sentiment and stalled production growth in Korea. Korea has shaken off some of the impacts brought by the disaster, but its overall pace of growth is still very weak. The global economy is on a gradual recovery path, led by the U.S., but China, EU, and Japan continue to experience decelerating growth, implying no sign of fast improvement in external conditions. Domestically speaking, mounting household debts and falling corporate profitability have weakened the fundamentals of the Korean economy, and structural factors, such as demographic changes, have brought negative impacts, too.

Production in the service industry has maintained a low but moderate pace of improvement, whereas industrial production index remains low. The capacity utilization rate in manufacturing is at an extremely low level and the inventory-sales ratio is on the rise. In particular, the rise in inventory is due more to the fall in shipment resulting from weakening demand than to voluntary stockpiling by companies preparing for future demand. These conditions will later act to pose a hindrance to production expansion. The coincident composite index, which shows overall conditions of the Korean economy, has remained slightly above the base line (100) since the second half of 2013, but its recent readings dropped to 100, meaning that the pace of Korea's economic growth has not picked up. Also, the persistently low Business Survey Index (BSI) points to an expectation that it would take a very long time for the economy to improve.

In its economic outlook released in December 2014, the Korean Development Institute (KDI) expected that the Korean economy will grow by about 3.5 percent in 2015, slightly higher than 3.4 percent in 2014, primarily on account of moderate recovery in domestic demand and slightly higher export growth. It should be noted that this outlook, however, is based on the assumption that the global economy will restore the pace of growth as expected and domestic macroeconomic policies will be expansionary and implemented as planned and without disruptions. KDI assumed that the global economy will see growth at the high end of a 3 percent range in 2015, the same as the projections by the IMF and OECD, but pointed out that there are growing downside risks, given that uncertainties over the global economy have intensified further since the release of outlooks by the IMF and OECD, and that the euro area and China might grow slower than forecasted. If the global economy in 2015 will grow at about the same pace as in 2014, it is highly likely that the Korean economy will see its growth drop to the low 3 percent range.

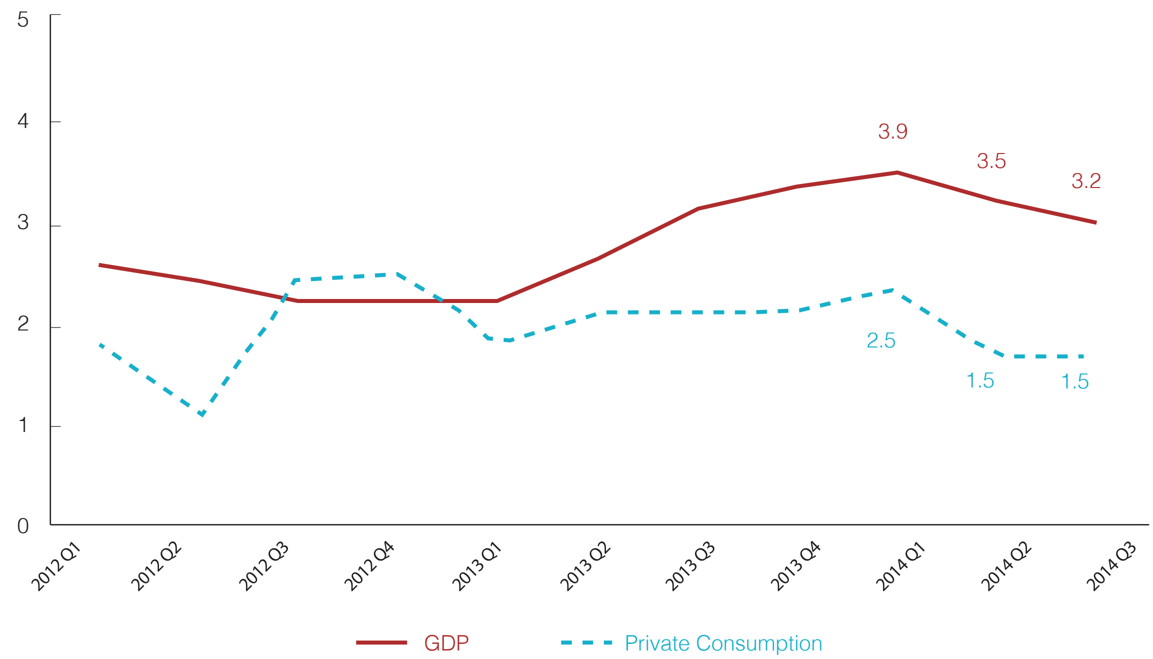
Rising household loans could pose another risk to the Korean economy. After government mitigated regulations on mortgages, household loans have skyrocketed. Thanks to yet low interest rates, debt burdens on households are not very high. However, since variable rate loans account for a considerably large share of total lending, an increase in market interest rates would lead to higher debt burdens, thereby causing a drag on the economy. The following sections present KDI's projections of economic activity by category.

Table 1 Domestic Economic Outlook (as a %, in $100 million)

	2014					2015		
	1/4p	2/4p	3/4p	4/4	Annual	1st half	2nd half	Annual
GDP	3.9	3.5	3.2	3.2	3.4	3.4	3.6	3.5
Total Consumption	2.6	1.5	2.0	1.7	1.9	2.7	2.5	2.6
Private Consumption	2.5	1.5	1.5	1.4	1.7	2.3	2.4	2.3
Total Fixed Investment	5.9	3.4	3.6	3.2	3.9	4.1	5.1	4.7
Equip. Investment	7.3	7.7	4.3	-0.3	4.7	2.5	4.1	3.3
Const. Investment	4.3	0.2	2.6	4.1	2.7	4.3	4.9	4.7
Exports	4.5	3.7	2.5	2.4	3.2	2.2	4.8	3.6
Imports	3.5	2.7	2.7	0.9	2.5	2.7	4.8	3.8
Current Account	151	241	225	288	905	387	504	890
Headline Inflation	1.1	1.6	1.4	1.0	1.3	1.5	2.0	1.8

Note: p denotes preliminary estimates of the National Accounts; columns without p are KDI's estimates.
Sources: Bank of Korea, National Accounts; KDI Economic Outlook, December 2014.

Figure 1 Changes in Real Gross Domestic Product and Private Consumption (as a %)



Source: The Bank of Korea.

Consumption

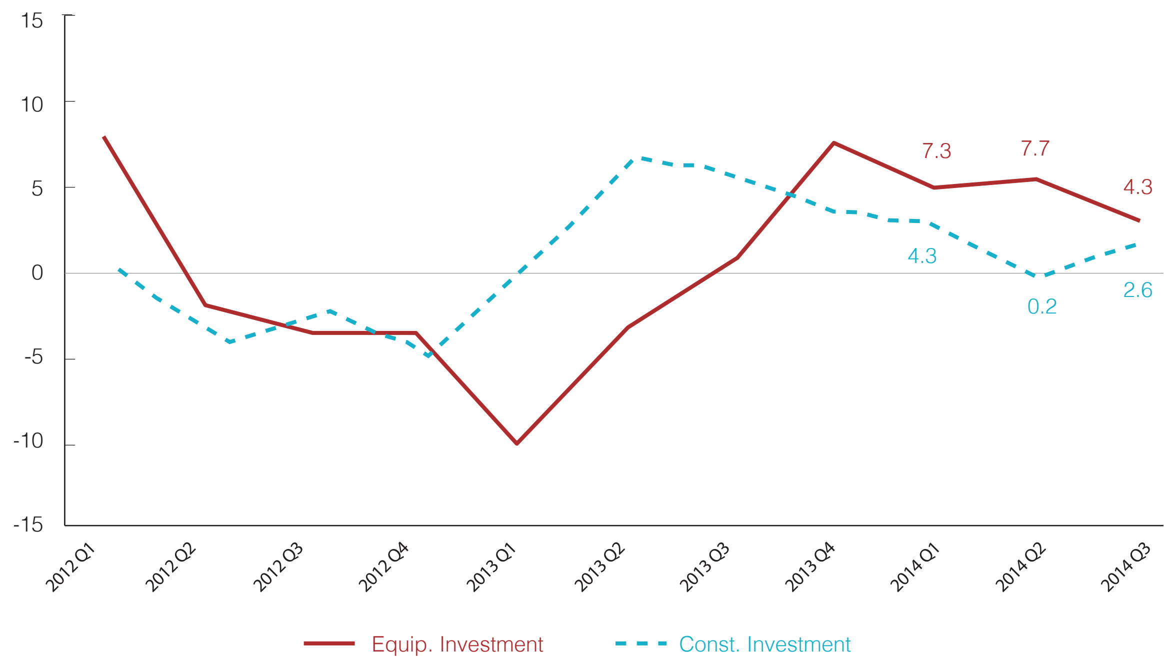
After the Sewol ferry disaster in April 2014, private consumption was in a slump with a growth rate in the mid-1 percent range from the second quarter of 2014, after gaining 2.5 percent growth in the preceding quarter and about 2 percent between 2012-2013. The contraction in consumer spending was then assumed to be temporary, but no significant rebound was observed in the third quarter of 2014.

The slump in private consumption has been driven by structural as well as cyclical factors. The real gross domestic income (GDI) in 2013-2014 expanded by about 4 percent on an annual basis, slightly higher than real GDP growth, on account of improved terms of trade brought by import prices collapsing, but the consumption growth was far below GDI growth. One structural factor behind waning private consumption is the decreasing share of allocation to households. The share of household income in gross national income (GNI) was 68 percent in 2000, but has subsided to around 60 percent since 2010. Assuming the need to strike a balance between income and expenditure in the long run, a decline in income would result in the decline in spending. Another structural factor is an aging population resulting from an increase in life expectancy. People began to live much longer, but their working period has not been extended enough to keep up with the increase. Households in the face of such condition are inclined to seek more savings in order to prepare for their post-retirement years. Compared with a decade ago, propensity to consume (the proportion of disposable income which households spend on consumption) decreased in all age groups and showed a particularly steep drop in the elderly aged 60 and over. These two factors are not only structural but also long term, hence difficult to be solved in the short term. This implies that private consumption will stay below GDP growth for a while to come. Moreover, in the second half of 2014, household debts mounted at a fast pace, causing higher debt burden on households, consequently serving to weaken households' consumption capacity. In this regard, private consumption is projected to increase by 2.3 percent in 2015, slightly higher than 1.7 percent in 2014, shaking off negative impacts of temporary factors (Sewol ferry disaster). Still, the growth of private consumption is expected to hover by 1 percentage point below the GDP growth.

Fixed Capital Investment

Equipment investment has increased by around 7 percent in the first half of 2014 and about 4 percent in the third quarter. The growth rate itself is high, but the increase was mostly attributed to the base effect of the fall of 1.5 percent in 2013, implying continued sluggishness in equipment investment. The contraction in 2012-2013 can be seen as the outcome of large-scale investment made in electrical and electronics

Figure 2 Changes in Equipment and Construction Investments (as a %)



Source: The Bank of Korea.

industries in 2010-2011, when the Korean economy began to recover from the global financial crisis. As the competition in markets for semiconductor and LCDs grew fiercer, more and more companies scrambled to build new large-scale facilities for strategic reasons. Since then, the demand for equipment investment in electrical and electronics industries has decreased, and hence relatively less investment was made in 2012-2013. The year 2014 showed a mere recovery and more uncertainties at home and abroad, discouraging aggressive investment. The average capacity utilization rate was roughly 80 percent in 2010-2011, but fell to the mid-70 percent range in the second half of 2014. The recent gradual increase in the inventory-sales ratio might serve to hamper production later. With many plants idle, a fast recovery of corporate demand for equipment investment is hardly expected. Not only that, corporate growth has shown a clear decline in recent periods. The rate of sales increase, at 10 percent or higher in 2010-2011, was recorded at -0.7 percent year-on-year in the first half of 2014, down further from 0.7 percent in 2013. Corporate profitability has deteriorated, too. The operating income-to-sales ratio was recorded at 4.7 percent in the first half of 2014, down by 0.4 percentage point from 5.1 percent a year ago. The decline in corporate profitability in the midst of falling growth has weakened investment capacity. Growing uncertainties in the global economy are another factor that makes it hard to expect a rebound in equipment investment in 2015. Equipment investment was projected to grow at a rate of 4.1 percent in 2014 and then at a slightly lower rate of 3.3 percent in 2015.

On the other hand, a somewhat positive outlook is expected in construction investment which has been in a long slump since the global financial crisis. In these periods, earnings of construction businesses dropped continuously and even posted a deficit in 2013. This downward trend, combined with delayed restructuring of the industry, has brought many companies to insolvency. Construction investment rebounded to expand by 6.7 percent in 2013, thanks to the base effect, but showed continuing sluggishness with a year-on-year growth of 1.9 percent in the first half of 2014. On the bright side, the real estate market has shown stimulation signs since deregulation on loan-to-value (LTV) and debt-to-income (DIT) and falling interest rates in the third quarter of 2014. Transactions of real estate increased, the number of unsold new house units decreased, and house prices are on the rise. Construction orders received as a leading indicator of construction investment increased fast in the third quarter of 2014, hinting at a certain degree of recovery in the future. Taken together, the construction investment is projected to grow by about 4.7 percent in 2015, up from 2.7 percent in 2014.

Figure 3 Changes in Exports and Imports (as a %)

Source: The Bank of Korea.

Exports and Imports

As the global economy entered a gradual recovery phase, Korea's exports expanded at a relatively strong pace with the low end of 4 percent range in 2013 and in the first half of 2014. Korea's export growth to the U.S. showed a temporary slowdown in the first quarter of 2014, but the pace soon picked up on account of economic recovery in the United States. On the other hand, export growth to China, Korea's largest trading partner—accounting for 26.1 percent of total trade in 2014—decreased in 2014, reversing the increase of 8.6 percent in dollar terms as of 2013. As the Chinese economy grows and matures, its growth is gradually slowing down, which is natural. This means that a rapid growth in exports as in the past might no longer be sustainable, and structural changes in the Chinese economy in the midst of its economic maturation is more likely to bring increasing burdens on Korea's exports. China's investment and debts have risen at a fast pace since the onset of the global financial crisis. In recognition of risks linked to overinvestment, the Chinese government has taken policy actions to achieve a smooth transition towards a consumption-oriented economic growth. According to KDI's analysis, Korea's exports to China are more closely linked to investment than they are to consumption. Therefore, China's downward revision of investment amount as well as its overall slowing growth could have negative impacts on the Korean economy. Not only that, exports to the EU and Japan showed continuing slowdown. Given the persistently low inflation and high unemployment rate in the EU, its economic recovery is not expected to come shortly. Japan has implemented a series of economic stimulus policies, known as Abenomics, but nevertheless negative impacts from the sales tax hike have turned out larger than expected, putting a drag on economic recovery. Japan's macroeconomic policies might bring in positive influence on its economy in the short run, but without active efforts for structural reforms in coming years, Japan is more likely to experience continued slowdown, which could pose negative impacts on Korea's exports.

Looking at Korea's exports by product category, semiconductors showed a robust growth in 2014, while other flagship products including wireless communication devices, automobile-related items and petroleum-related goods, showed continued weakness. Fast catch-up of China and other latecomers in markets for these products has raised concerns that Korea might face difficulties in sustaining its export competitiveness. Following the IMF and OECD, KDI assumed that the global economy will grow by about 3.3 percent in 2014 and by a high end of 3 percent in 2014. The IMF and OECD projected that global growth will be uneven across regions, but overall recovery is expected to be led by the US. Also, provided that the US monetary policy will be normalized during 2015, the real effective exchange rate of the won is assumed to decline by around 5 percent. Based on this assumption, KDI expected that Korea's exports will expand by 3.6 percent in 2015, higher than 3.2 percent in 2014.

Since the release of forecasts by the IMF and OECD, downside risks have been growing, triggering more uncertainties in the global economy, and thus it is becoming increasingly more difficult to expect a growth at the high 3 percent range. In this context, it can be said that relatively large downside risks exist in KDI's projection of Korea's exports.

Imports are projected to grow by 3.8 percent in 2015, higher than 2.5 percent in 2014, as domestic demand in 2015 is likely to improve, albeit moderately. However, falling prices of international raw materials, including crude oil, would make the import value in dollar terms as of 2015 to stay similar to that in 2014. The current account is projected to run a huge surplus for a long time as domestic demand is weak due to structural factors such as an aging population. These conditions, coupled with improved terms of trade resulting from falling crude oil prices, are expected to contribute to a large surplus of $90 billion (6 percent of GDP) in the current account in 2015, similar to in 2014.

Labor Market

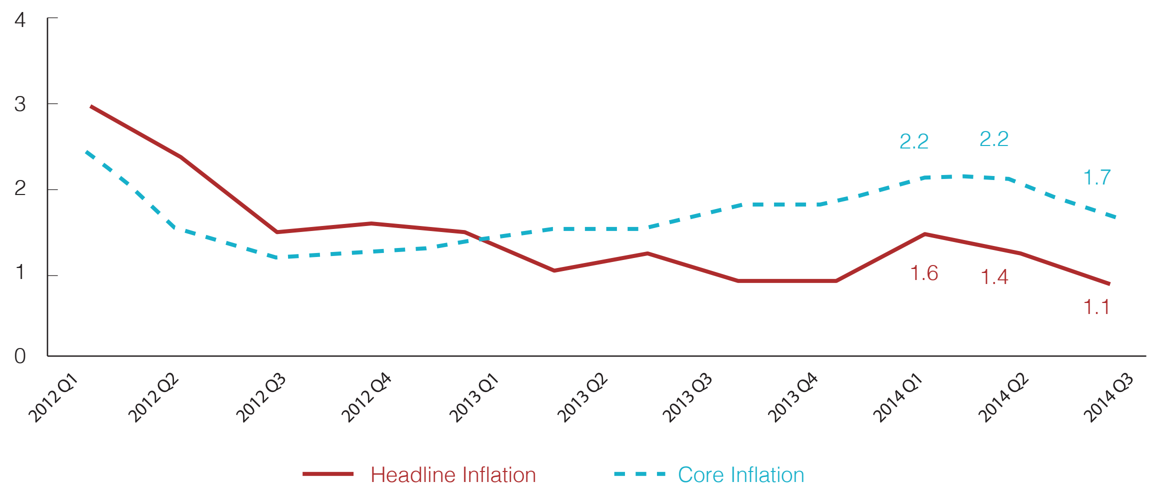
The labor market witnessed a steep rise in the number of employed persons after the year end of 2013. As the demand for labor has increased, particularly in the sector for human health and social work activities, and as government programs, such as the time-selective job system, started to bring in some positive results, the number of employed persons increased by 500,000 in the second half of 2013, higher than 300,000 in the first half, and then it expanded by 600,000 in the first half of 2014. The pace of increase slowed in the second half of 2014, but remained strong. The increase was markedly strong among the elderly aged 50 or over and temporary daily workers. Thanks to such increase, the employment rate (aged 15-64) rose fast to 65.4 percent in 2014, up from 64.5 percent in 2013. The rise itself is quantitative expansion and is deemed positive, but the fact that the rise was mostly driven by temporary, daily, and part-time workers implies that qualitative improvement might have not been secured. It is estimated that the number of employed will rise by slightly more than 400,000 in 2015, which is somewhat down from 2014 (marginally above 500,000), but means continued strength of quantitative increase. Despite the rise in the employment rate, the unemployment rate in 2015 is projected to be 3.5 percent, similar to 3.6 percent in 2014, due to the increase in job-seeking activities.

Inflation

Korea's inflation has been very low for quite a long time. On a quarterly average basis, headline inflation has run below 2 percent since the third quarter of 2012 and recently receded close to 1 percent. Given that the inflation target for 2013-2015 is 2.5-3.5 percent, Korea's inflation has consistently come in far below the target for a very long time. Such low inflation is partially due to lower prices of agricultural and petroleum products than a year ago. However, core inflation, excluding agricultural and petroleum products, peaked at only 2.2 percent over the same period, and recently dropped to the midpoint of 1 percent. This implies that supply factors are not enough to explain low inflation. There might have been other temporary factors, such as government subsidies on childcare and free school meals in 2012-2013, but even in 2014 without the subsidy effect, inflation ran low, meaning problems now faced by monetary authority are quite severe. Waning growth in domestic demand might be a demand-side factor that could explain the low inflation. When inflation is low and growth slows down, it would be natural for the authority to respond to the situation by aggressively lowering the base rate. KDI's analysis however found that Korea's monetary authority has been reluctant to take active policy measures, relying on its optimistic forecast of economic growth and inflation. The real interest rate (nominal interest rate net inflation rate) has even risen since 2012. According to the analysis, Japan's monetary authority on the edge of a severe recession in the 1990s opted for laid-back policies relying on optimistic views, which was one of the factors that led Japan into a long deflation. Korea's GDP deflator—which measures the prices of products in the entire economy and hence is a broader measure than headline inflation—was recorded at zero percent year-on-year in the second and third quarters of 2014. Korea's GDP deflator growth precedes its headline inflation, implying that low inflation will be prolonged.

According to the demand-side inflationary pressure expected for 2015, Korea's domestic demand is projected to improve moderately and its output gap (actual GDP net potential GDP), currently negative, is likely to gradually close. On the supply side, however, inflationary pressure is projected to be very low, such as slow wage growth and falling prices of international raw materials such as crude oil. Therefore, Korea's inflation is expected to remain far below its target range of 2.5-3.5 percent in 2015. When excluding temporary impacts from government policy for the price hike in cigarettes, headline inflation is projected to run at the low end of one percent in 2015. (The 80 percent hike in the price of cigarettes is expected to increase headline inflation by 0.6 percentage point.)

Figure 4 Headline and Core Inflation (as a %)



Note: Data for the fourth quarter of 2014 refer to October and November.
Source: Korean Statistical Information Service.

Conclusions and Policy Recommendations

Korea is projected to grow at a moderate pace if domestic and external conditions remain conducive. Continued moderate growth in the global economy and low oil prices will have positive impacts on the Korean economy. There are of course lingering concerns about growing downside risks in the global economy and mounting household debts in the Korean economy. Also, structural factors such as an aging population are going to make it difficult for the Korean economy to enjoy rapid growth in the future.

Main policy recommendations that may be inferred from the above projections are as follows. Above all, given continuing weak domestic demand and low inflation in the midst of growing external uncertainties, a certain extent of expansionary macroeconomic policies are deemed necessary. Fiscal policy needs to remain expansionary and supportive of economic activity at a level that would not pose a threat to long-term fiscal prudence. Monetary policy should remain more alert and prepared for lower inflation. As inflation has run below the target rage (2.5-3.5 percent) for a long time, there might be a weakening of confidence in the monetary authority and gradual decline in inflation expectations. The monetary authority should put in more policy efforts to achieve its inflation target, since the decrease in inflation expectations would not be restored easily.

These short-term macroeconomic policies are not enough to sustain the dynamics of the Korean economy. Aggressive and full-scale structural reform policies should be implemented in parallel so as to offset slow growth resulting from structural factors such as an aging population. In this context, it is essential that the government carry out its 3-year plan for economic innovation as scheduled.

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BUILDING A CREATIVE ECONOMY

THE CREATIVE ECONOMY OF THE PARK GEUN-HYE ADMINISTRATION

By Cha Doo-won

Abstract

The Korean economy has faced several crises, such as the ending of the rapid economic growth era in the 21st century, continued stagnation of per capita GDP growth since 2007 where its value exceeded $20,000 for the first time, an expected decrease in economic growth rate from 3.5 percent in 2010 to 2.1 percent in 2020, the employment rate staying around 59 percent since 2007, and a decrease in the coefficient of employment in all industries from 10.1 in 2005 to 7.9 in 2011. In addition, a rapidly aging population, the world's lowest birth rate, and the absence of next-generation growth engine technology is darkening the economic outlook. The Park Geun-hye administration, since its inauguration in 2013, suggested the "job-centered creative economy" as a core philosophy of its state affairs to solve the problems stated above. Even if it is difficult to analyze the concrete results of the creative economy, this paper intends to examine the evolution of the creative economy policy from its advent to the present to review its problems and to propose its future direction.

The creative economy policy had been a part of economic policy in Korea even before the inauguration of the Park Geun-hye administration. First of all, local governments have executed strategies to create creative cities since the 1990s. These strategies are being enforced even now as local public services to foster core creative industries, such as culture and the arts, departing from the existing regional development concept centered on manufacturing. The importance of culture and creativity as essential parts of regional development strategies has been generally perceived globally. Thus, this may be viewed as the extension of UNESCO's regional development strategy for Europe to link regional development with the creative industry under the theme of "Culture and Development."[1]

Korean government support for creative industries by local governments may be largely classified into two approaches: cultural policy and industrial policy. The cultural policy approach improves the quality of life of residents with culture and art contents as well as related infrastructure, and increases the consumption of creative products by training creative talents as well as the supply of cultural contents and infrastructure in the region. The main project of the cultural policy approach was the "Project to Create the Asian Culture Industry Cluster" that the Roh Moo-hyun administration promoted for a balanced national development and a future city model. Despite its intent, this project failed to obtain the desired results because of estrangement from local resident interests, insufficient ripple effects, inadequate experts, and so on.[2]

The industrial policy approach, unlike the creative city strategy, aims to develop specific creative industries in the industrial ecosystem and supports all or part of the value chains of creative industry businesses. For example, the Lee Myung-bak administration enforced the "Expanded Local Development Strategies" under which some central departments—the Presidential Committee on Balanced National Development, for example—guaranteed sustainability by transcending their administrative districts in order to secure regional competitiveness. Even if these strategies were equipped with the right policy orientation, they did not sufficiently accomplish policy enforcement or effectiveness. Moreover, it is hard to find a case in which these local government projects created jobs and increased income as intended by the government, let alone achieved financial independence.[3]

Secondly, there have been debates on the expansion of the creative economy concept since 2009. These debates occurred through the "Korea Creative Economy Research Network" launched with the Korea Venture Business Association to devise strategies for the Korean economy to enter into leading and advanced countries because its per capita income reached $20,000. These debates concluded that it was essential for creative economy policy enforcement to create synergy among the information and technology, traditional manufacturing, and culture industries. In addition, as the paradigm shifted from a knowledge-based to a creative-based economy, pursuing open innovation was necessary for all businesses, even as large businesses focused on the market and venture businesses on innovation.[4] The creative economy has become the national administration philosophy of the Park Geun-hye administration through these processes.

Table 1 Evolution of the Concept of Creative Economy in Korea

	Introductory Period (1990-) ➜	Expanding Period (2009-) ➜	National Administration Philosophy (2013-)
Leading Department	• Government (Ministry of Culture, Sports, and Tourism; Ministry of Knowledge Economy; etc.) • Local governments	• Private sector (Korean Venture Association)	• Government (Ministry of Science, ICT and Future Planning)
Objective	• (Industrial Policy Aspect) Local city development strategy • (Cultural Policy Aspect) Improvement of quality of life of residents	• National innovation strategy	• National economy paradigm shift (Catch-up → Leading)
Main Contents	• Creative industry (Culture, Art, etc.) centered on creative city development strategies and local service projects	• Role separation between large businesses (market) and venture businesses (innovation) as well as mutual open innovation	• Convergence of science, ICT, and various fields • New market and job creation

Source: Lee Min-Hwa and Cha Doo-Won, *Creative Economy* @ Korea, Book Concert (June 2014), pp. 88-105.

Figure 1	Creative Economy Policy Enforcement Process of the Park Geun-hye Administration

Policy Name (Announcement Period)	Creative Economy (October 2012)	→	Major Government Projects (May 2013)	→	Creative Economy Realization Plans (June 2013)	→	Three-year Economy Innovation Plan (March 2014)

Source: Cha Doo-Won, Yu Ji-Yeon, The Concept of Creative Economy and Analysis of Policies of Leading Countries, KISTEP Issue Paper 2013-01 (March 2013).

Creative Economy Policy Enforcement Process of the Park Geun-hye Administration

During her 2013 inaugural address, President Park Geun-hye defined the creative economy as:

"A creative economy is defined by the convergence of science and technology with industry, the fusion of culture with industry, and the blossoming of creativity in the very borders that were once permeated by barriers. It is about going beyond the rudimentary expansion of existing markets, and creating new markets and new jobs by building on the bedrock of convergence. At the very heart of a creative economy lie science technology and the IT industry, areas that I have earmarked as key priorities."[5]

Park Geun-hye first defined this term as a presidential candidate in the 2012 publication of Creative Economy. Since 2013, President Park Geun-hye has announced various policies to fulfill the creative economy and perform the related tasks.[6]

In *Creative Economy*, Park suggested seven strategies to lay the foundation for a creative economy: creation of new markets and jobs; development of software as a future growing business; realization of the creative economy through opening and sharing; realization of a startup nation; construction of a recruitment system to look beyond specifications; promotion of K-Move in which Korean youths move the world; and the creation of MSIP (Ministry of Science, ICT and Future Planning).[7] President Park's May 28, 2013 Cabinet meeting announced the major government initiatives to shape the 140 government projects that the 18th Commission on Presidential Transition had announced through cross-governmental reviews, such as reflection of departmental action plans and review of resources.[8] These four government administration keynotes were: economic rehabilitation, national welfare, culture prosperity, and establishment of a foundation for peaceful unification. On economic rehabilitation, the government suggested 22 creative economy-related tasks, such as construction of a creative economy ecosystem, promotion of venture businesses as well as small and medium-sized businesses, development of a new industry and market, and others.

In her first year in office, the Park Geun-hye administration concentrated on disseminating the concept of a creative economy and centering the realization of it on scientific technology and ICT. The MSIP and related authorities announced the Action Plan for the Creative Economy on June 4, 2013, for full-fledged enforcement of major government projects.[9] The Park Geun-hye administration established the "Realization of National Welfare and New Era of Hope through the Creative Economy" as its vision and announced three objectives (creation of jobs and market, reinforcement of creative economy global leadership, and a society that respects creativity), six strategies, and 24 promotional tasks. Also, the Park Geun-hye administration suggested roles and assignments by department as promotional strategies for the Korean creative economy that involved scientific technology and ICT. This was to acknowledge the limitations of advanced countries' catch-up strategies for the last 40 years and to announce the conversion into an economic paradigm to create jobs.

Furthermore, in July 2013, the Third S&T Basic Plan reinforced core measures for the realization of a creative economy for science and technology. This plan is the most comprehensive one in the field of science and technology, established every five years pursuant to Article 7 of the Framework Act on Science and Technology, and called for the expansion of 21 legal requirements. In addition, for R&D, it called for the economic growth field to the quality of life field to link with the Action Plan for the Creative Economy, making the R&D phase include technology transfer, commercialization, and job creation, as well as reflecting various medium and long-term plans for the field of science and technology.[10]

In its second year in power, the Park Geun-hye administration unveiled in March 2014 the "Three-Year Plan for Economic Innovation" that analyzed policies and suggested alternatives to problems such as the fixation of rent seeking, low economic dynamics, and overly weighted growth toward exports rather

Table 2	Action Plan for the Creative Economy with Six Strategies and 24 Promotional Tasks

Strategy 1 • Creation of the ecosystem in which creativity is rewarded fairly and it is easy to start a new company
Promotional Task 1-1 • To expand investment in creative idea and technology
Promotional Task 1-2 • To create an environment where it is easy to establish a start-up
Promotional Task 1-3 • To convert ideas and technologies into intellectual properties and to protect, utilize, and promote the same
Promotional Task 1-4 • To vitalize the commercialization of creative property
Promotional Task 1-5 • To construct a start-up safety network with which it may be possible to try again
Strategy 2 • Strengthen the competitiveness of the venture and small & medium-sized company as a key player
Promotional Task 2-1 • To establish the foundation for the growth of venture business as well as small and medium-sized businesses
Promotional Task 2-2 • To support the global market development of venture business as well as small and medium-sized businesses
Promotional Task 2-3 • To promote the coexistence and cooperation among large businesses as well as small and medium-sized businesses
Promotional Task 2-4 • To solve difficulties, such as labor shortage, etc., of venture businesses as well as small and medium-sized businesses
Strategy 3 • Creation of the new growth engine to develop new products and new markets
Promotional Task 3-1 • To create a new growth engine of the existing industry through the convergence of scientific technology and ICT
Promotional Task 3-2 • To develop software and Internet-based new industry and high-value contents industry
Promotional Task 3-3 • To create a new market through human-centered technology innovation
Promotional Task 3-4 • To develop a new market through the discovery and promotion of a new promising industry
Promotional Task 3-5 • To promote industrial convergence and market creation through regulation rationalization
Strategy 4 • Training of creative global talent
Promotional Task 4-1 • To reinforce the convergence and creative talents training
Promotional Task 4-2 • To expand education in order to infuse competitiveness and entrepreneurship
Promotional Task 4-3 • To vitalize the overseas expansion and domestic inflow of creative talents
Strategy 5 • Strengthen the Innovation Competitiveness of S&T and ICT as the basis of the creative economy
Promotional Task 5-1 • To improve the R&D system to expand potential and strengthen commercialization
Promotional Task 5-2 • To reinforce ICT innovation competency and to accelerate the creative economy
Promotional Task 5-3 • To reinforce the cooperation of industry, academy, research institution, and local government in order to create jobs
Promotional Task 5-4 • To reinforce the roles of scientific technology and ICT to solve global problems
Strategy 6 • Development of the creative economy culture in which people and government work together
Promotional Task 6-1 • To develop an environment of creativity and imagination
Promotional Task 6-2 • To fuse public resources and national ideas through Government 3.0
Promotional Task 6-3 • To innovate methods with which the government operates to realize the creative economy

Source: MSIP and related authorities, *Action Plan for the Creative Economy—Creation Plan for Creative Economy Ecosystem* (June 2013).

than domestic consumption.[11] The plan suggested three main directions for future economic policies: 1) "economy with sound foundation" through the normalization of abnormality; 2) "dynamic innovative economy" through the creative economy; and 3) "economy in which domestic consumption and export are balanced" through the revitalization of the domestic consumption. The following 11 tasks were suggested for these promotional directions: vitalization of an online creative economic town under a dynamic creative economy category; construction and diffusion of off-line creative economy innovation centers; enhancement of the competitiveness of small and medium-sized businesses; solution of management difficulties for growth of start-ups into small and medium-sized businesses; diffusion of environment for start-up and rechallenge; virtuous cycle of investment fund; expansion of M&A purchase foundation; expansion of M&A incentives; M&A deregulation; and the promotion of convergence based new industry. The plan contains more concrete action plans for the realization of the creative economy, such as the proposal of an annual action roadmap through 2017.

In the plan, the Korean government placed special emphasis on the creative economy innovation center—one for each of the 17 local governments through 2015. Each creative economy innovation center is a nonprofit corporation that is selected from organizations that belong to or are affiliated with public institutions, economic organizations, universities, research institutions, etc., through the consultation of the Minister of Science, ICT and Future Planning, a head of the relevant organization, and the city mayor or governor. The creative economy innovation center, as a regional innovation base, supports the growth and overseas expansion of small and medium-sized businesses in specialized regional industry fields through linkage and cooperation among economic innovation subjects. That is, the creative economy innovation center is an organization that supervises the realization and diffusion of the local creative economy, such as the development of local society, training of talents and businesses, etc., by fostering the center as a core base for the realization of the local creative economy. In particular, the creative economy innovation center applies various support methods and models, such as nurturing a field that the relevant large business has the advantage as a specialized local industry by matching one local government and one large business.[12]

In addition, the creative economy innovation center, with an online creative economy town (www.creativekorea.or.kr) completed in September 2013, serves as a core off-line platform for the realization of the creative economy and outcome creation. It allows various economic subjects—individuals or businesses—to collaborate and share ideas online, to support each other on mutual topics of interest (such as technology or commercialization strategies), and to have access to expert mentoring. Additional support, such as an application for intellectual property rights or a prototype for manufacturing expenses, is also provided.[13]

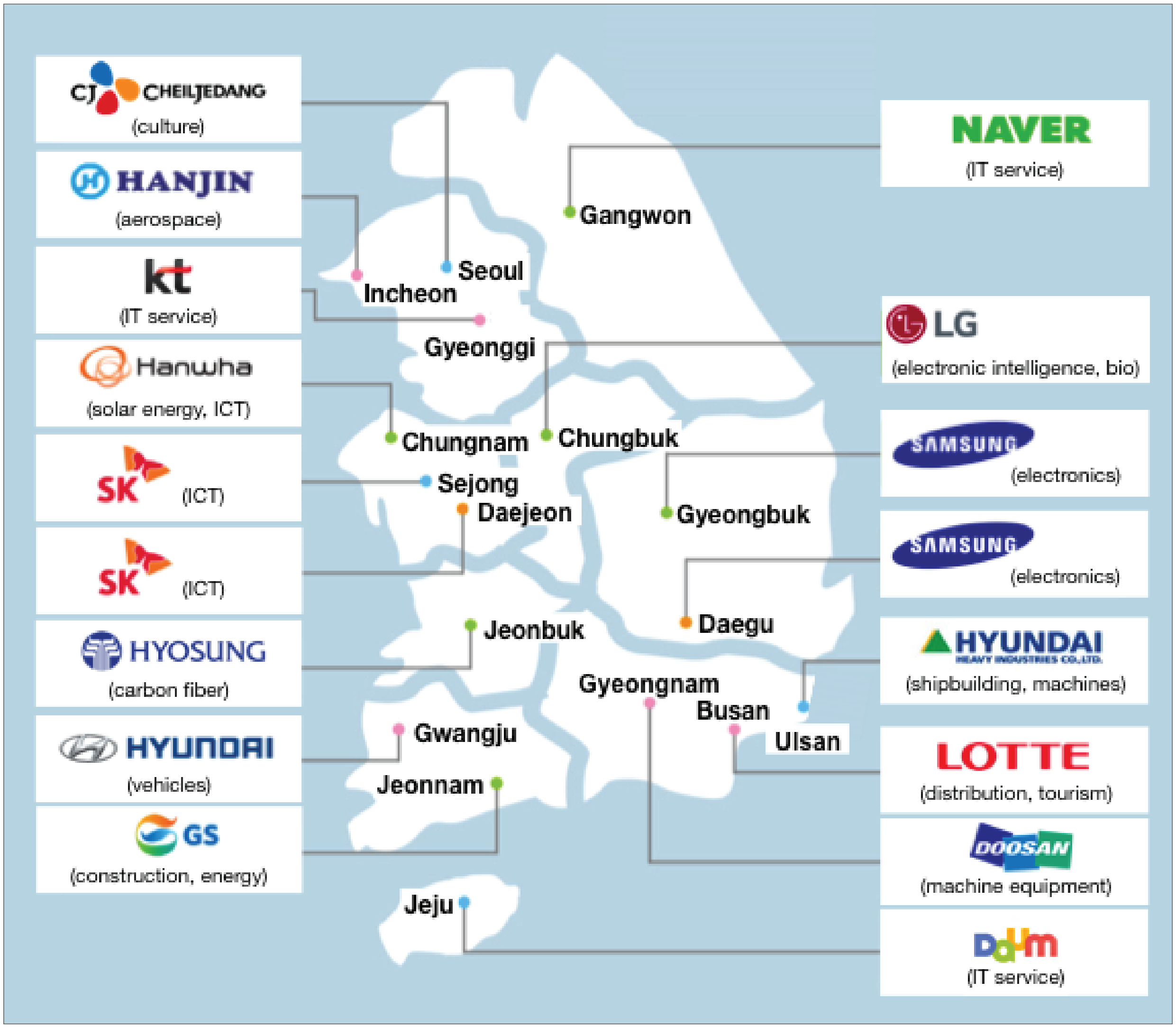
Uneasy Settlement Process of the Creative Economy: Cause of Controversy over the Creative Economy of the Park Geun-hye Administration

The definitions of creative economy and creative industry were not brand new concepts. However, the ambiguous concept of a creative economy and its policy enforcement was at the heart of controversy among the National Assembly, media, and people. Professor Galloway at the University of Glasgow stated in his paper that the British government used the terms of creative industry and cultural industry confusingly in the enforcement of the creative economy policy.[14] In 2012, the Ministry of Economy, Trade and Industry in Japan, as well as the Nomura Research Institute, redefined creative industry as "an industry that is composed of product, business, talent, etc., which are selected in a market through the added value of creativity rather than price." The Japanese government suggested that the creative industry may differ based on the policy and competitiveness of the related industry by adding three new fields, such as advertisement, art, and design, to the six fields that were proposed in the Cool Japan Strategy, which was the strategy to promote the creative industry.[15]

In addition, the UN predicted that the creative industry, as the most dynamic field in the world's economy, would provide developing countries with opportunities for new and high economic development. The organization published creative economy reports in 2008 and 2010. The creative economy has been carried out globally by advanced countries, developing countries, local governments, and international organizations. The 2010 UN creative report defined the creative economy as follows: "an evolving concept based on creative asset that potentially generates economic growth and development." Regardless of how the creative industries are defined and classified, there is no disagreement that they lay at the center of what can be labeled, in broader terms, the creative economy.[16]

As shown above, creative industry may differ based on how the government defines its scope, which will impact how a creative economy is viewed, therefore both are seen as dynamic concepts. There are still controversies over these concepts in Korea for two reasons.[17] The first one is the compatibility of the term. The term "creative economy" was first suggested in *Creative Economy*, written by John Howkins in 2001, which described the relationship between creativity and the

Figure 2 1:1 Link of Creative Economy Innovation Center by Local Governments and Large Businesses

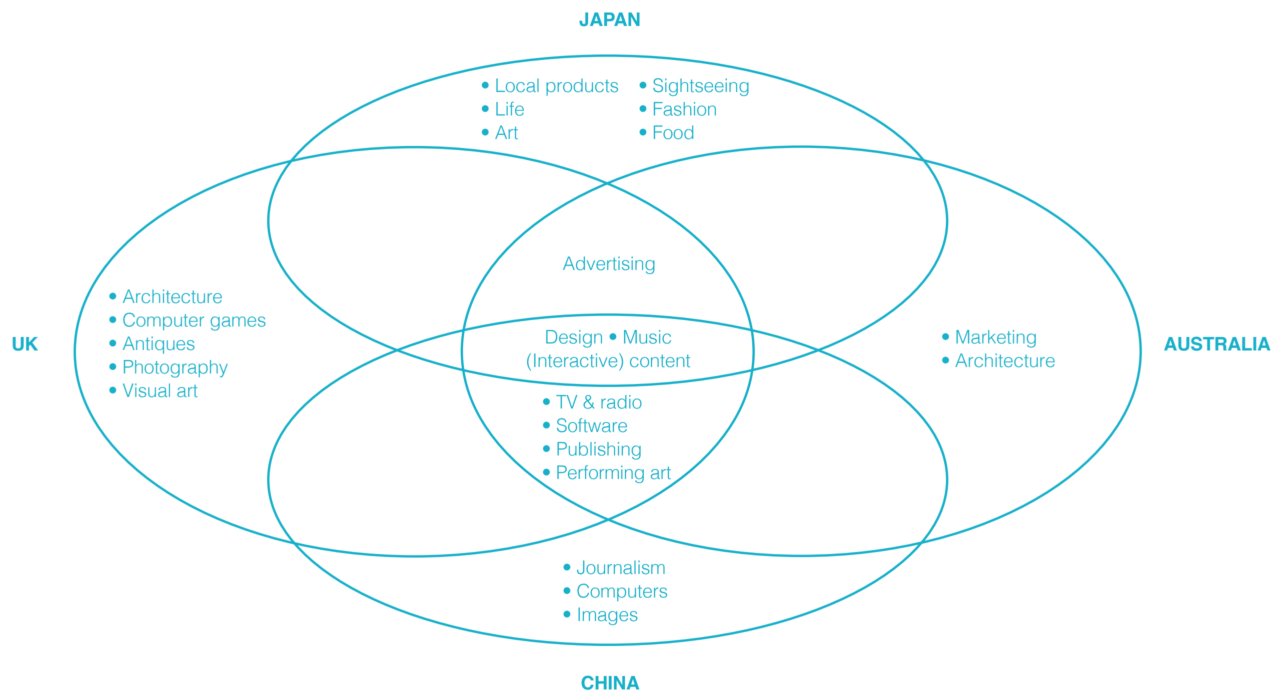


Source: MSIP, http://www.msip.go.kr.

economy,[18] and *Creative Strategy Management and Know-how in the Creative Era*, a report by the Nomura Research Institute, which suggested the creative society as a paradigm to follow the information-oriented society. It proposed for the first time the creative industry as a new growth engine to value the worth and roles of creative activities.[19] As illustrated above, creative economy, creative industry, and creative city have been widely used domestically and overseas. In Korea, these terms have been widely used in the regional development and cultural industry fields. However, when the term "creative economy," which had been used in state affairs philosophy, collided with the existing creative economy ecosystem, the confusion occurred. For example, local governments such as Seoul and Busan had already implemented strategies to promote the creative industry. Icheon (crafts and folk art), Seoul (design), and Jeonju (gastronomy) were selected for the creative city network that UNESCO constructed to share experiences, ideas, and model cases for cultural, societal, and economic development of cities since 2004.

Another cause of the controversy was the fact that the Park Geun-hye administration did not set the scope of creative industry

Figure 3 Scope of Creative Industry in Various Countries



Source: Cha Doo-Won, "S&T Master Plan and its Roles—Creative Economy and the Third Science and Technology Basic Plan," Presentation Material of KISTEP-ISTIC STI Training Program for High-Level Policy Makers, Malacca, Malaysia (December 8-12, 2014).

to specific industrial fields or scientific technology fields, but instead emphasized the convergence of scientific technology, industry, culture, and industry. Thus, it was impossible to measure and explain the effects of creative economy policy, such as industry scale, employment scale, and economic ripple effects. It was also difficult for people to understand investment in the creative economy in terms of specific outcomes.[20]

The budget of the creative economy rather than the creative industry has been set since 2014. It does not include R&D investment for the creative industry, but does include government-supported projects in six categories: creation of a start-up ecosystem, support for venture businesses as well as small and medium-sized businesses, development of new industry and markets, training of globally creative talents, reinforcement of S&T and ICT capability, and culture creation for the creative economy. The cross-department creative economy budget in 2015 was 8.3302 trillion *won*, which showed a 17.1 percent (1.2192 trillion *won*) increase compared with 7.1 trillion won in 2014. This accounted for 44.3 percent of the gross government R&D budget (18.8245 trillion *won*) for 2015. In particular, the "creation of a start-up ecosystem" and "support for venture businesses as well as small and medium-sized businesses" showed a 38.6 percent (468 billion *won*) increase compared to 2014, and the "development of new industry and market" showed an 18.8 percent (560.9 billion *won*) increase compared to 2014. This illustrates that the Park Geun-hye administration focuses on outcomes of the creative economy that use scientific technologies.[21]

Conclusion

The previous Creative Economy Commission consisting of the Minister of MSIP, a chairman, vice-ministers from the relevant authorities, and members to manage and consider the primary policies associated with the creative economy was eliminated in May of 2014.[22] In its place, Park Geun-hye government restructured the governance with an eye to promoting leadership on the creative economy and departmental cooperation, while placing an emphasis on the creative economy being driven by the private sector through the following organizations: the Creative Economy Initiative Public–Private Partnership; the Public–Private Creative Economy Committee under the MSIP; the Steering Committee for the Creative Economy Initiative Public–

Table 3 Creative Economy Budget (100 million *won*)

Classification	FY 2014 (A)	FY 2015 (B)	Variation (B-A)	Variation (%)
Total	71,110	83,302	12,192	17.1
1. Creation of a start-up ecosystem	5,371	6,541	1,169	21.8
- New support for the six-month challenge platform.	-	653	653	-
- Net start-up growth R & D, etc.	5,371	5,888	516	9.6
2. Support for venture businesses as well as small and medium-sized businesses	7,248	10,943	3,695	51.0
- Gazelles business support	900	3,000	2,100	233.3
- Youth funds, anger investment fund, etc.	6,348	7,943	1,595	25.1
- Promotion of large-scale demonstration project	-	1,791	1,791	-
- Net Biomedical technology development, etc.	29,828	33,646	3,818	12.8
4. Training of globally creative talent	9,463	9,653	190	2.0
5. Reinforcement of S&T and ICT capability	17,734	18,922	1,188	6.7
- Development and support of the creative economy valley	-	308	308	-
- Support, etc., of net individual basic research	17,734	18,614	880	5.0
6. Creation of the creative economy culture	1,466	1,808	342	23.3

Source: Kim Yong-Jung and An Seung-Gu, "Government R&D Medium- and Long-term Investment Strategies for the Realization of the Creative Economy," *KISTEP Inside and Insight*, Vol. 5 (2014), pp. 45.

Private Partnership; the Regional Creative Economy Committee; and the Creative Economy Innovation Center. [23]

These governance changes mean a conversion to the creative economy innovation centers scheduled to be installed in all local governments until 2015. This also calls for a concentration of all local R&D resources in the creative economy innovation centers that will promote specialized local businesses by matching them with large businesses on a 1:1 basis. It also relies on the networking of these innovation centers to disseminate creative economy philosophy and outcome creation.

In conclusion, the Korean government uses the creative economy as a philosophy to innovate the national economy, unlike policy enforcement in other countries. Also, as shown in the creative economy budgets, the Korean government promotes the creation of an online creative economy valley, off-line creative economy innovation centers, a start-up ecosystem, support for venture businesses and small and medium-sized businesses, and the development of the new industry and markets. The Park administration reinforced these policies by including essential tasks for the creative economy into major government projects, creative economy realization plans, and the Third Science and Technology Basic Plan.[24] In 2015, its third year in power, the Park Geun-hye administration is set to make an effort to create outcomes with the "creative economy centered on job creation" and to improve people's perception as illustrated above.

Notwithstanding the efforts of the government explained above, two matters shall be considered to realize the creative economy. First, the governance of the creative economy shall cooperate with the governance of S&T, ICT, industry, convergence, etc. Even if the governance of the creative economy in the central government is established with the MSIP and the Public–Private Creative Economy Committee, and that the creative economy innovation centers are established in local governments, the strategy to link and cooperate with the governance of the relevant field is necessary to promote the creative economy more efficiently.

The Public–Private Creative Economy Committee under the MSIP supervises the creative economy with respect to the governance of the central government. However, there is no interaction with top-level organizations in the relevant field, such as the National Science & Technology Council, the IT Strategy Committee, and the Industrial Convergence Development Committee.

Table 4 Purpose and Main Functions of Creative Economy-Related Organizations

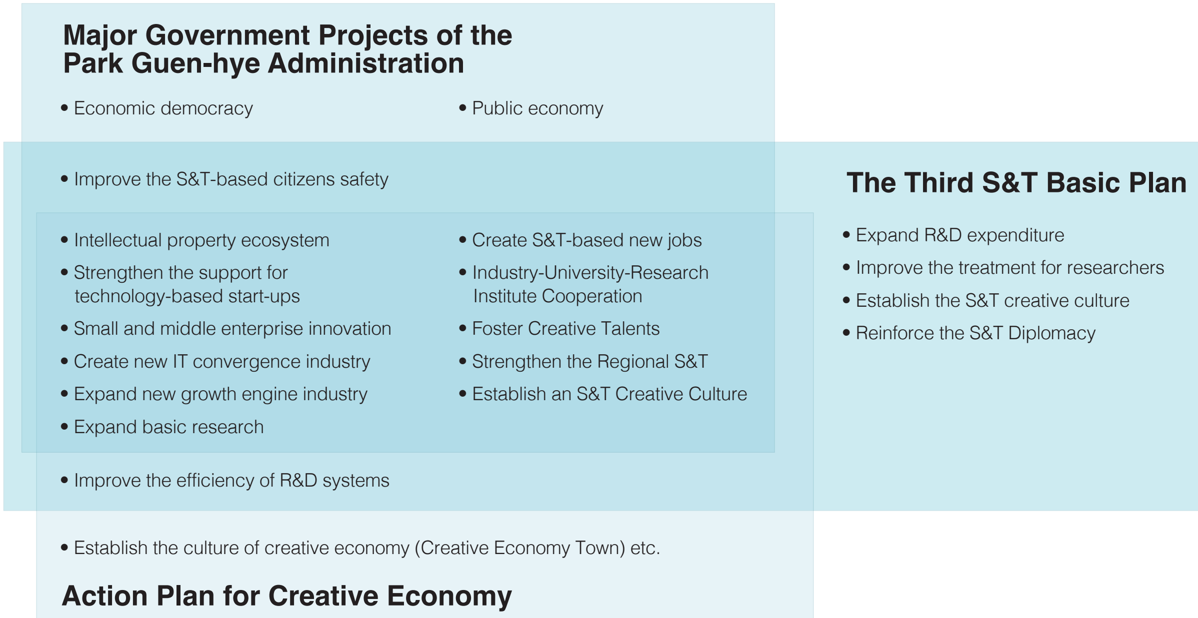
Organization Name	Purpose of Establishment and Main Functions
Public–Private Creative Economy Committee	**Purpose**: Creative economy-related cooperation channel between the public and the private sectors **Main Function**: Consult and coordinate the following matters related to the creative economy • Cooperation of the public and the private sectors • Discovery and enforcement of public and private cooperation tasks as well as the inspection of enforcement and outcomes thereof • Collection of opinion and proposal of private sector for government policies
Creative Economy Initiative Public–Private Partnership	**Purpose**: Discovery and enforcement of public and private cooperation tasks related to the creative economy as well as efficient support for local creative economy **Main Functions:** • Discovery, planning, and enforcement of public and private cooperation projects for new industry and growth engine • Discovery of enforcement projects for start-up vitalization as well as promotion of venture business and small and medium-sized business • Planning and enforcement of program related to the diffusion of the creative economy culture • Support for the operation of creative economy valley
Steering Committee for Creative Economy Initiative Public–Private Partnership	**Purpose**: Deliberation and coordination of matters with respect to the realization and diffusion of the creative economy through the cooperation among government, local government, and private businesses **Main Functions:** • Matters with respect to the cooperation of national and local government • Inspection of private and public cooperation, policy establishment, task discovery, and outcome as well as the deliberation and coordination of the collection of private opinion and recommendation for governments
Creative Economy Innovation Center	**Purpose**: An essential base for the creative economy, which supervises the realization and diffusion of local creative economy **Main Functions:** To promote the following matters in the relevant local government: • Support for small and medium-sized businesses and supervision of connection between the relevant organizations and programs • Discovery and improvement of promotion tasks for inspiration of entrepreneurship and start-up vitalization • Discovery and improvement of promotional tasks for venture business as well as for small and medium-sized businesses • Cooperation with authorities related to the creative economy • Training program development for future entrepreneurs • Promotion and support for the organization and businesses to support the start-ups • Support for the establishment and evaluation of policy related to the creative economy
Regional Creative Economy Committee	• Discovery and promotion of projects as well as private and public cooperation tasks related to the local creative economy

Source: MSIP, Rules of Installation and Operation of Public–Private Creative Economy Committee, Etc., Presidential Decree No. 25820 (enforced on December 9, 2014).

With respect to local governance, the cooperation system between the creative economy innovation center, the Regional Creative Economy Committee, and the existing regional R&D governance is not yet developed. There are 16 local governments, excluding Seojong, in which a technopark for planning of regional industry strategy and policy, promotion of small but strong businesses, and construction of regional industry network are installed, and Pohang operates the creative economy innovation center. Also, the science research complexes for growth potential development and balanced national development through the linkage of industry and R&D are installed in 10 local governments. There are 19 out of 26 government-funded research institutes that are established in 53 branches all over the country as well. Cooperation among other universities and local government research institutes is a very important matter for the realization of the creative economy. However, there has been very insufficient interaction between the Regional Creative Economy Committee and the regional creative economy innovation center.

In particular, duplicate investments for similar regional R&D programs have been pointed out as a major problem of the low investment efficiency, which was caused by the dual governance for regional R&D management and coordination.

Figure 5 Main Policy of Major Government Projects, Creative Economy Realization Plans, and the Third Science and Technology Basic Plan



Source: Cha Doo-Won and Kim Yoon-Jong, "Structure and Direction of S&T Policy of Park Geun Hye Administration," National Research Council for Economics, Humanities and Social Sciences, Final Reports (February 2014).

That is, even if the Presidential Committee on Balanced National Development analyzes and manages regional R&D projects through comprehensive evaluation of the regional development special account pursuant to the Special Act on Balanced National Development, the National Science and Technology Committee evaluates, coordinates, and deliberates the said regional R&D project separately from the perspective of national R&D.[25]

Secondly, policy continuity must be secured. Because it is difficult to create outcomes in the science and technology field, which is the essence of the creative economy, the following problems need to be addressed: quantitative outcomes that cannot reach qualitative outcomes; obsession with outcome creation in a short period of time; and lack of a new continuous growth engine.[26] The newly introduced economic system will change the governance and direction of S&T policy toward longer-term investment and research. However, the presidency is a five-year term, and future administrations could hinder R&D outcome creation and research continuity. Therefore, a systematic foundation for the continuation of creative economy policies is essential to achieving concrete outcomes.

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1 Goo Moon-Mo, "The Creative Ecological Study on Culture-oriented Projects in Regional Areas and its Policy Implications: Focusing on Conceptual Analysis," *Review of Cultural Economics*, Vol. 15, No. 3 (Korean Association for Cultural Economics: December 2012), pp. 79–112.

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3 Goo Moon-Mo, "The Creative Ecological Study on Culture-oriented Projects in Regional Areas and its Policy Implications: Focusing on Conceptual Analysis," *Review of Cultural Economics*, Vol. 15, No. 3 (Korean Association for Cultural Economics: December 2012), pp. 79–112.

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5 Park Geun-hye, Inaugural Address as the 18th President of Korea (2013).

6 Cha Doo-Won, "Research on Analysis of Current State of Policy in Leading Countries and Strategic Public Relations in the Era of Creative Economy," Final Report, Korea Institute of Science and Technology Planning & Evaluation (2014).

7 Park Geun-Hye, "Creative Economy—Long-waited for Changes," *Park Geun-Hye Will Change It* (2012). http://www.dmook.co.kr/gallery/view.asp?seq=201021.

8 Relevant Authorities, Major Government Projects (2013).

9 Ministry of Science, ICT and Future Planning and related authorities, *Action Plan for the Creative Economy—Creation Plan for Creative Economy Ecosystem* (June 2013).

10 Ministry of Science, ICT and Future Planning and the related authorities, *The Third S&T Basic Plan* (July 2013).

11 Ministry of Strategy and Finance, *Detailed Promotion Tasks for Three-Year Plan for Economic Innovation* (March 2014).

Table 5 Comparison of the Economic System Paradigm of the Korean Government

Administration (Period)	President Kim Dae-jung (1998-2003)	President Roh Moo-hyun (2003-2008)	President Lee Myung-bak (2008-2013)	President Park Geun-hye (2013-present)
Economic System Paradigm	**Knowledge Economy**	**Innovation Economy**	**Green Economy**	**Creative Economy**
Cores of R&D Policy	Foster IT and Venture Businesses	• National Science and Technology Innovation System (NIS) • Balanced National Development	• Balance of Economy and Environment • Balanced Growth	Creative Economy Centered on S&T, ICT, and Job
Main Plans and Objectives	Construct E-Government • To lead a smart era centered on mobile • To foster 20,000 ventures and create 400,000 new jobs until 2020	Construct the National Science and Technology Innovation System (NIS) • To promote global innovation cluster • Regionally balanced industrial development and formation of network national structure	Green Growth National Strategy and Five-year Plan • To become one of seven strongest green nations in 2020 and five strongest green nations in 2050	Action Plan for the Creative Economy, Three-year Plan for Economy Innovation • To create 2,380,000 jobs and obtain employment rate of 70% in 2017
New Growth Engine Industry (Main Technology)	Next Generation Growth Industry (6T) • Information Technology • Biotechnology • Nanotechnology • Space Technology • Environment Technology • Culture Technology	Next-Generation Growth Engine • Intelligent Robot • Intelligent Home Network • Future Automobile • Digital Contents/SW Solution • Next Generation Semi-Conductor • Next Generation Cell • Digital TV/ Broadcasting • New Biomedicine/ Organ • Next-generation Mobile Communication • Display	17 New Growth Engines in Three Areas • Green Technology Industry (Renewable Energy Technologies, Water Treatment Technologies, Low-Carbon Energy Technologies, Green Transportation Systems, IT Convergence Citywide, LEDs) • High-Tech Convergence (Broadcast and Communications Media, Intelligent Robots, Biopharmaceuticals and Medical Devices, Information Technology, Food Industry, Nano-Convergence) • Convergence - High Value Added Service Industry (Healthcare, Green Financing, Cultural Content and Software, Education, MICE and Tourism-related Industries)	13 Future Growth Engines • 5G Mobile Communication • Deep-Sea Offshore Plant • Smart Vehicle • Intelligent Robot • Wearable Smart Device • Realistic Contents • Customized Wellness Care • Smart System for Disaster and Safety Control • Renewable Energy Hybrid System • Renewable Energy Hybrid System • Intelligent Semiconductor • Convergence Materials • Intelligent Internet of Things • Big Data
Performance Organization	E-Government Special Committee Venture Business Vitalization Committee	S&T-centered Society Planning Group	Green Growth Committee	Public–Private Creative Economy Committee, Creative Economy Initiative Public–Private Partnership, and others.

Source: Lee Jang-Jae, The Creative Economy and Roles of Government, Science and Technology (May 2013), p. 32.

[12] Ministry of Science, ICT and Future Planning, *Rules of Installation and Operation of the Creative Economy People and Government Conference*, Presidential Decree No. 25820 (December 2014).

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[19] *Creative Strategy-Management and Knowhow in the Creative Era*, Research Center, Nomura Research Institute, Ltd. (1990).

[20] Cha Doo-Won and Yu Ji-Yeon, "The Concept of Creative Economy and Analysis of Policies of Leading Countries," KISTEP Issue Paper 2013-1 (March 2013).

[21] Kim Yong-Jung and An Seung-Gu, "Government R&D Medium- and Long-term Investment Strategies for the Realization of the Creative Economy," *KISTEP Inside and Insight*, Vol. 5 (November 2014), p. 45.

[22] Ministry of Science, ICT and Future Planning, Prior Announcement of Legislation for Abolishment of Rules of Installation and Operation of the Creative Economy Commission (May 14, 2014).

[23] Ministry of Science, ICT and Future Planning, Rules of Installation and Operation of Public–Private Creative Economy Committee, Etc., Presidential Decree No. 25820 (December 9, 2014).

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[25] Jung Jong-Seok, "Plans for Regional R&D Reform," KIET Industry and Economy (February 2012), p. 47.

[26] Cha Doo-Won and Kim Yoon-Jong, "Structure and Direction of S&T Policy of Park Geun Hye Administration," National Research Council for Economics, Humanities and Social Sciences, Final Reports (February 2014).

THE REAL KOREAN INNOVATION CHALLENGE: SERVICES AND SMALL BUSINESSES

By Robert D. Atkinson

Abstract

After decades of rapid growth led by large, industrialized chaebol firms, Korea has reached the technology frontier in many of its largest industries and run out of room for future robust growth through this model alone. Instead of focusing just on increasing technology development in export sectors, Korea should seek to grow by increasing productivity and innovation across its entire economy. Korea has become a 'dual economy' where rapid gains by large, efficient global companies are mirrored by relative stagnation in unproductive small businesses and services. To overcome this dualism, Korea needs to take serious steps to improve productivity in markers dominated by small business and service firms. Overcoming this will require a fundamental shift in Korean economic policy away from subsidizing and protecting SMEs as well toward greater efforts to spur information and communications technology (ICT) adoption by all enterprises. Absent these fundamental reforms, the likelihood that Korean per-capita GDP will continue to rapidly converge with U.S. per-capita GDP is small.

Introduction

The performance of the South Korean economy over the last half-century has been unrivaled, with Korean GDP (in dollars) increasing more than 100 fold from 1970 to 2010. Korea has developed globally competitive and innovative multinationals and excelled in areas like R&D and broadband. But today there is a real question as to whether that growth and the model it was based on – being a fast follower in technology and using that to drive manufacturing exports – can continue. Korea faces intense competition both on the commodity, cost-based side of the equation from nations like China and India and on the cutting-edge, innovation side from nations and regions like Europe, Japan and America.

In response to this new challenge the Korean government has responded with its creative economy proposal to help Korea transition to an advanced, innovation-driven economy. But there are two challenges with this as the nation's principal economic strategy response. First, going from being a fast follower to a cutting-edge innovation leader is difficult as it requires a fundamental change in corporate strategy, workforce education, and societal culture. Historically, most Korean innovation has been incremental, copying breakthroughs elsewhere and building on them through strong Korean engineering competence. But changing corporate cultures and practices to drive cutting-edge innovation – much of which ends up failing – is not so straightforward. Nor is shifting the educational system from one based on rote learning (albeit producing great global test results) to encouraging "out-of-the box" thinking and acting.

Second, and more importantly, any creative economy effort needs to go beyond just supporting the development of firms in creative sectors, for this would be inadequate to revitalize growth and get Korea on a path to surpass the U.S. in living standards. To be sure, the Creative Economy plan does include the "Vitamin Project" to revitalize existing industries through ICT, but much of the plan's focus is on growing new, innovation-based export industries. The problem though is that the lion's share of Korean jobs remains in small, low-productivity firms, many in the services sector. This points to the real challenge and opportunity for Korea: driving growth through transforming its small business and services sector. This will require two key things: dramatically reducing the share of the economy made up by small businesses and ensuring that many more enterprises increase their use of ICT technologies to drive productivity.

Substantively this task is easier than the creative economy task because it is largely about removing barriers to competition and preferences for small businesses and then letting markets drive growth. But this is much harder to do politically, which is why it has not been done. Indeed, the reason Korea leads the Organization for Economic Cooperation and Development (OECD) in small business inefficiency is precisely because Korean politics and culture resist this kind of "Schumpeterian" creative destruction. Officials interested in spurring innovation find it much easier to tout a vision of excelling in high-tech product innovation—like Samsung coming out with the latest smart phone or Hyundai developing self-driving vehicles—than a vision of creative destruction.

But there's another reason why officials in Korea and many other nations give less attention to economy-wide creative destruction: they see innovation as synonymous with the development of high-tech products. But innovation is more than new smart phones or high-tech cars. The OECD rightly defines innovation more broadly as "the implementation of a new or significantly improved product (that is, a physical good or service), process, a new marketing method, or a new organizational method in business practices, workplace organization, or external relations." For the Korean economy to prosper through innovation there needs to be robust innovation across all of these dimensions, not just high-tech products. But even Korea's manufacturing sector appears to have a narrow focus on innovation in products and process, not marketing and organizational innovation. According to the OECD, firms in nations like Australia, Canada, Germany, and Israel have two to three times more of this type of innovation than firms in Korea.[1]

This suggests that the most important task for Korean innovation policy is to embrace a broader view of innovation and a growth model based on it. Economies can increase their productivity two ways: either through the "shift effect"—which occurs when low-productivity industries lose share to high-productivity, innovation-based industries (equivalent to the product innovation model)—or the "growth effect" through which all sectors become more productive. Korea has largely adopted the "shift effect" model.

So which is best? It turns out that the lion's share of productivity growth for almost all nations comes not from changing the sectoral mix to higher-productivity industries, but from all industries and organizations, even low-productivity ones, boosting their productivity. In other words, the productivity and innovation capacity of all of a country's sectors matters more than whether it has small number of high-tech industries. This is what the McKinsey Global Institute's 2010 report, *How to Compete and Grow: A Sector Guide to Policy*, finds. Countries that outperform their peers on productivity do not have a more "favorable" sector mix (e.g., more high-tech industries), but instead have more productive firms overall, regardless of sector.

The Japan Path?

So where is the Korean economy going if Korea sticks with the narrow conception of innovation and the shift model? We only need to look to Japan to see Korea's likely future. Japan relied predominantly on an export-led, shift strategy but once it caught up to the world technological frontier by the late 1980s in industries like automobiles, consumer electronics, and semiconductors its growth slowed, precisely because these few export industries were not a large enough engine to power the entire economy. While Japan boasts world-leading exporters of manufactured products—think Hitachi, Panasonic, and Toyota—its much larger non-traded sectors are decidedly subpar. Japan's service sectors have achieved but a fraction of U.S. service-sector productivity levels. Japan's retail sector has achieved barely half of U.S. retail productivity levels, while its construction and food-processing industries have reached only 40 and 33 percent of U.S. productivity levels in these sectors, respectively. Low levels of service-sector productivity explain why after a half-century of catching up to America, between 2004 and 2010 Japan's productivity gap with the United States actually began to widen (to around 30 percent). When less than one quarter of your economy is growth oriented, you cannot grow very fast.

Charting a different path for an "Asian tiger" is indeed the Korean challenge. As Kim Jung-Woo of the Samsung Economic Research Institute notes, "Compared to the biggest OECD economies, the productivity of South Korea's service industries appears to be low. If South Korean service industries' productivity continues to remain low while their weight in the GDP grows, it could undermine the productivity of the nation's whole economy."[2] But this should come as no surprise. Fifty years of economic policy in Korea has focused on two goals: becoming an export powerhouse while protecting the rest of the economy from creative destruction. This is the main reason why total factor productivity grew more slowly in Korea than in the U.S. between 1995-2011.[3]

This is not to say that Korea's "creative economy" strategy is not useful nor may not pay off. But it is to say that if Korea ever wishes to catch up with the United States the key will be in raising domestic productivity by all firms in all sectors, including in unglamorous sectors like hotels, restaurants, retail distribution, insurance, utilities, and government services. Boosting efficiency in all of the economy, in part by using more IT but also by creating the competitive and market conditions for efficient firms to thrive, is the royal road to growth.

Industrial Dualism: Large, Productive Traded Firms vs. Small, Inefficient Domestic-Serving Firms

Korea is a classic case of what economists call a dual economy: one part with large, advanced, globally competitive firms and a much larger part with smaller and less productive firms, particularly in the services sector. One problem is that Korea's productivity in the services industry is very low. From 2000 to 2009, agriculture and manufacturing enjoyed strong rates of productivity at 5.4 and 6.5 percent respectively. But the transport, storage and communications sector had just 0.3 percent growth while finance, real estate and business activities actually saw declining productivity of -0.3 percent. Indeed, according to the OECD, 60 percent of productivity growth came from manufacturing and just 19 percent from services. As a result, services productivity levels fell from 76 percent of manufacturing in 1997 to 60 percent in 2005.[4] Additionally, service sector productivity is just 45 percent of manufacturing levels, compared with an OECD average of 86 percent.[5]

This suggests that one of the best ways to revitalize the Korean growth miracle is to transform the services sector. It is not realistic to expect manufacturing to be the growth engine going forward. This is true for two reasons. First, because a smaller share of Korean jobs are in manufacturing; for manufacturing productivity to maintain its same contribution to Korean productivity, its rate will have to increase. Second, Korean productivity is approaching global best practice levels, and as such, it will be difficult for it to enjoy the high rates of productivity as it did in the past.

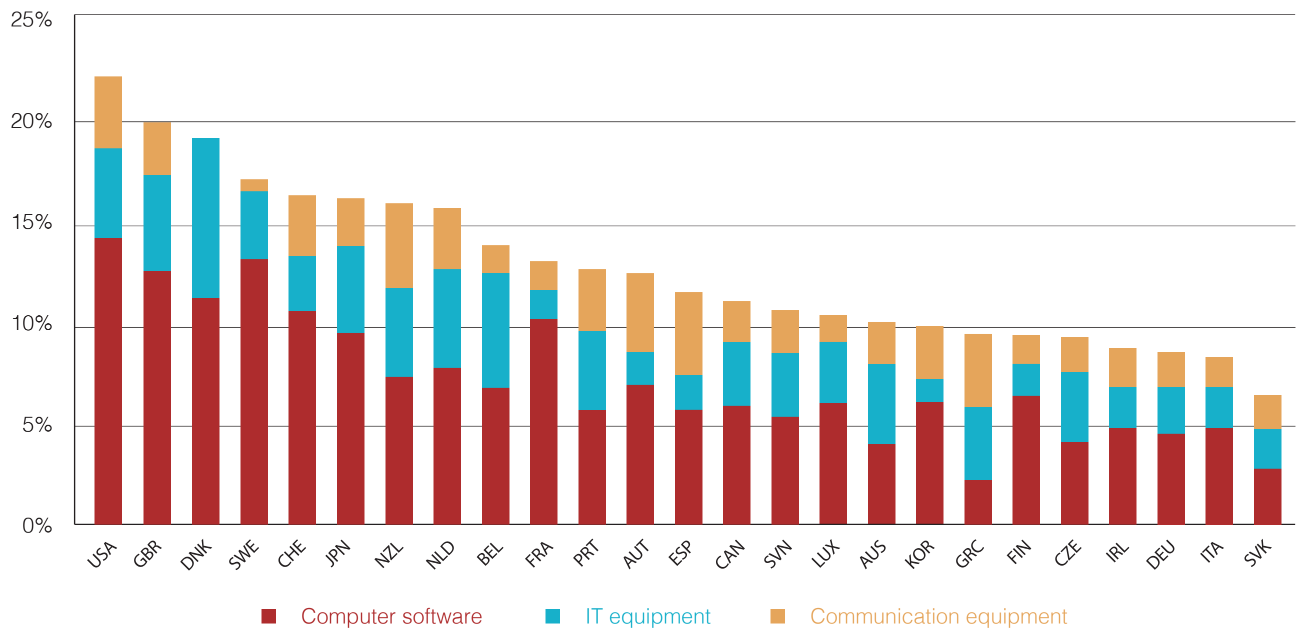
A related problem for Korea is the extremely large share of its economy made up of SMEs. SMEs, which in the manufacturing sector are defined as firms with less than 300 employees or capital of less than eight billion KRW (about $7.7 million), accounted for an astounding 99.9 percent of registered firms in Korea in 2011, which is higher than in virtually all other OECD countries. Moreover, SMEs account for a high percentage of employment, 87 percent, up from 80 percent in 2000. To contrast, U.S. firms with fewer than 300 workers employ just 44.4 percent of the workforce.[6] In Korean services, 91 percent of jobs are in SMEs.[7] To compare, in the United States, SMEs employ only 44 percent of service workers.[8]

This would not be a problem if these small firms were as productive as large firms. But they are woefully inefficient. Labor productivity in SMEs is less than a third of that in large companies, and the gap is widening.[9] It's only slightly better in services, where productivity in SME services was just 45 percent of large services companies. Not surprisingly, wages in large companies are double those in SMEs.

ICT Dualism: Great Broadband, Low IT Use by Businesses

Korea faces a second dualism, beyond that of having a great traded manufacturing sector and sub-par services and SME sectors. This dualism is around ICT. On the one hand Korea boasts one of the best broadband networks in the world and has leading IT companies (ranking second in the world in IT

Figure 1 ICT Investment as a Share of Gross Fixed Capital Formation by Asset in OECD Countries, 2011



manufacturing R&D as a share of business R&D).[10] Yet when it comes to using ICT, especially in enterprises, Korea lags far behind world leaders like the United States. Korean firms may know how to make computers, but they do not use them as well as U.S. firms do.

We see this in a number of statistics. From 2005 to 2010, IT capital contributed just 0.2 percentage points to total Korean growth, and overall eight percent of growth. Contrast that with the United States where it contributed 0.3 percentage points and 30 percent of growth. Of 20 OECD nations, 12 nations, including Germany, Japan, and the United States, had more growth from ICT investments, than non-ICT investments. But for Korea, ICT investments contributed only about 40 percent of the level of growth as non-ICT investments. The *2014 Global Innovation Index* ranks Korea 30th in software spending as a share of GDP, about one-third of U.S. levels and behind nations like Jamaica, Zimbabwe and Turkey. Korea ranked 26th out of 34 OECD nations in businesses with their own web site and ranked among the lowest in the OECD in firms selling over the Internet.[11] Similarly, relatively few Koreans use the Internet for interactions with public authorities or for online banking; less than half the rate in Scandinavian nations for example. Korea is among the leaders in terms of the percent of the population that uses the Internet to play games or create a web page. In other words, while Korea has a great IT network and IT producers, its firms have not fully utilized the power of using ICT to grow. Thus, it is not surprising that in 2011 ICT investments in Korea as a share of total business investments was just 10 percent, compared to over 30 percent in the U.S.[12]

The Path Forward: Stop Protecting Small Business and Services

Korea has erroneously assumed that small businesses are the life-force of the economy, and require consistent support from the government and protection from larger businesses and foreign competition. Yet this pro-small business policy has the effect of being an anti-growth policy that limits innovation and productivity. We see these policies and barriers in an array of areas.

Labor rigidity: Both low firm failure rates and strict employment protections have contributed to labor rigidity, lowering the ability of Korean firms to adjust supply to match market conditions. The *2012 Global Innovation Index* ranks Korea ranks 120th in the cost of redundancy of dismissal of employees. As a result, many firms keep more workers than they actually need to do the job. Moreover, to avoid the high costs of laying off workers, many Korean firms hire non-regular workers, who comprise about a third of workers in Korea (the fourth highest in the OECD). Inflexible labor markets also contribute to high rates of self-employment.

Thirty percent of Korean workers are self-employed, compared to 10 percent in other advanced economies. All three practices lower productivity.

Small firms are subsidized and favored: More than any other OECD nation, Korea unfairly favors small businesses. Policies require banks to funnel large amounts of investment into SMEs, resulting in an overabundance of debt among SME firms. In 2012, 78 percent of corporate lending went to SMEs compared to just about 25 percent in the United States.[13] In addition, public financial institutions such as the Korea Finance Corporation and the Small and Median Business Corporation provide loans directly to SMEs. In fact, only 21 percent of loans to SMEs were not guaranteed or collateralized by government.[14] At the same time the government provides 1,300 SME programs and 47 government support measures, covering taxes, marketing and employment, to promote SMEs. But a study conducted from 2003 to 2009 found that public support for SMEs had no impact on the operating profit ratio. Moreover, two support programs were shown to reduce sales growth.[15] Another form of small business subsidy is progressive corporate taxation which taxes small companies at 10 percent but large ones at 22 percent. Likewise, the Small and Medium Business Agency designates products that the government can buy only from small firms.

While well intentioned, many of these programs and policies prop up small firms that would otherwise be replaced by more efficient and innovative medium or larger businesses or even fast growing small firms. In addition, the overabundance of capital, much of it guaranteed, has resulted in serious resource misallocations. Many unprofitable firms can remain in business for years without showing a profit, or indeed earning enough to pay subsidized interest rates on their loans. Of SMEs that were unprofitable from 2000 to 2002, 63 percent were still unprofitable, and yet still in business in 2010, despite earning too little to pay interest on their loans for an entire decade. Only 10 percent went out of business, and only 27 percent became profitable again. The problem is getting worse: the bankruptcy rate in SMEs declined by 50 percent from 2007 to 2011, despite slower growth rates and repercussions from the global recession. This is why small SMEs, as a group, have had negative operating profits every year since 2006 and for one third of SMEs, earnings (before taxes) were insufficient to cover interest payments.[16]

Incentives not to grow: Korea also lavishes benefits and regulatory exemptions on SMEs. Not surprisingly, few firms want to grow and give up this cushion. Of the millions of SMEs in Korea in 2002, only a paltry 696 had graduated from SME status by 2012. These perverse incentives limit the ability of industries to gain scale economies, leading to less productivity and innovation. Moreover, because very few firms want to expand and take market share away from others, competitive pressures to innovate and improve productivity are limited.

Limited competition: A final factor contributing to the excessive "smallness" and inefficiency of the Korean economy are the policies limiting competition. Korea has the second most extensive product market regulation (PMR) in the OECD[17] and there's a clear negative relationship between PMRs and productivity.[18] Korea also has relatively high barriers to foreign trade and investment, which not only limits needed competition to keep firms focused on innovation and productivity but also limits Korea's ability to benefit from global knowledge bases. As the OECD has pointed out, Korean services are more sheltered from international competition and are subject to an array of domestic regulations that limit entry.[19] Again as the OECD points out, foreign affiliates accounted for just eight percent of services sales in 2004, but four percent of employment. This was about half the share of the OECD average. Indeed, Korea has the third lowest stock of FDI in the OECD, with just 13 percent of GDP in 2012.[20]

Korea also promotes a range of domestic policies to shelter small firms from competition. Leading these efforts is the National Commission on Corporate Partnership (NCCP), a partially government-funded organization, charged with mediating complaints of so-called unequal competition between large and small businesses. NCCP's mission is to level the playing field between large businesses and small and medium enterprises (SMEs) in two ways. First, it annually issues a "win-win scorecard" on how large businesses can "co-exist" with SMEs, designed to shame large corporations that fail "to promote shared growth with small partner firms."[21] Second, NCCP "designate(s) suitable industries for SMEs." Case in point is a recent agreement the Commission reached with the Small and Medium Business Administration to get TV Home Shopping networks to agree to not only sell more products from SMEs but also to not charge them commissions and for the government to pay costs for improving design and packaging for the selected companies. Another was their ruling that medium-sized restaurant companies cannot open new stores within 150 meters from small eateries that earn less than 48 million *won* ($42,800) in annual revenue. We also see this bias in favor of small in other Korean organizations. For example, in contrast to competition authorities in Europe and the United States, the mandate of the Korea Fair Trade Commission (KFTC) includes creating a "competitive environment" for small and medium-sized enterprises. To be sure Korean competition policy should aggressively police competitive abuses, particularly by large, dominant Korean firms, when they occur, but it should be indifferent to firm size.

All of these subsidies and protections for small firms mean that more productive firms, including high growth potential start-ups, have fewer resources than less productive firms, exactly the opposite of what is needed for a dynamic economy. As the OECD has shown, in Korea the actual distribution of workers actually lowers labor productivity below what it would be if workers were distributed randomly between low, medium and highly productive firms. In contrast, in the U.S. the actual distribution raises productivity by 50 percent over what it would be if less productive firms had the same market share. This troubling finding points to misallocated resources, low levels of competition, and limited growth potential.

The Broad Economy Path Forward

The low levels of productivity in the Korean SME and service sectors are an anchor holding back not just Korean growth but its global competitiveness. Many of these inefficient companies provide inputs for globally traded companies like Samsung and LG, and this means that they must pay more for goods and services from their supply chains.

So what does Korea need to do? The first step is to acknowledge that the future path to prosperity will come from an across-the-board innovation and productivity strategy and that any real gains will not happen unless the share of jobs held by small businesses declines dramatically.

Korea should take a number of steps to get there.

First, it should dramatically scale back its programs, including lending programs, targeted at small business. This includes dramatically cutting back on industrial subsidies. Government support for business, to the extent it is legitimate, focuses on specific measures: e.g., supporting R&D, training the workforce, etc. To the extent there is a focus on small firms, it should be to support the creation and growth of innovative "opportunity-seeking" startups.

Second, it should limit the regulatory and tax exceptions provided by small business, which only end up enabling inefficient companies to retain market share.

Third, it should significantly reduce the regulatory barriers, including product market regulations that protect incumbents and limit new entrants, including creative new start-ups.

Fourth, it should dramatically open up the economy to foreign direct investment, particularly in the service sector. Lowering barriers to investment would increase private investment in innovative activities, facilitate the diffusion of knowledge from foreign and domestic sources, and increase entry of new, highly-innovative firms into markets.[22]

Fifth, it should take steps to spur broader ICT adoption by business. Many of the steps taken above would spur more ICT adoption, in part by increasing average firm size. But Korea could take further steps. One would be to broaden the eligibility of its five percent tax credit for "industrial equipment or advanced office equipment," which now only SMEs qualify for. Allowing all firms to qualify for this would not only level the playing field between large and small firms, it would also spur large firms to adopt more ICT. Korea should also open up its international markets to ICT imports in order to get lower price and higher quality ICT products, by eliminating its discriminatory encryption and security requirements for public procurement ICT equipment and not imposing Korea-specific regulations on cloud computing services and e-commerce providers.

Conclusion

Far from fostering a dynamic, innovative economy driven by entrepreneurism and innovation by fast-growing small businesses, Korean SME policies create market distortions that will limit Korea's economy from reaching its full potential. Eliminating these distorting policies and allowing natural creative destruction would significantly increase productivity and spur economy-wide growth. Indeed, the destruction of businesses, industries and jobs, which is severely slowed in Korea, is in fact a sign of progress, because they are replaced by more efficient firms, more innovative actors, and more advanced firms.

However, taking these steps will not be politically easy. It will require an acceptance of the reality that SME bankruptcies will significantly increase as more efficient and larger companies take market share. This will be hard, for as the Korean government notes, "widespread perceptions in Korean society are that rectification of excessive favors to conglomerates and their concentration of economic power, as well as establishment of fair transaction order for SMEs and self-employed businesses are important for sustainable development and social integration." But the longest journey begins with a single step, and for Korea to move forward it needs to start taking single steps.

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SPURRING THE DEVELOPMENT OF VENTURE CAPITAL IN KOREA

By Randall Jones

Abstract

Korea has made fostering a "creative economy" a top priority to sustain economic development and avoid the "low-growth trap." The goal is to shift Korea's growth strategy from an emphasis on exports by large *chaebols* to one that favors innovation, including venture capital investment in new firms. Korea's high level of investment in R&D and education give it a strong foundation for such a strategy. However, Korea's venture capital market is still at an early stage of development and requires a comprehensive strategy to make it a growth driver. First, it is important to expand the role of business angels, who are essential both for financing and mentoring start-ups. Second, the large share of the public sector – which provides about half of venture capital investment – should be limited to avoid crowding out private investors. Third, Korea's small market for mergers & acquisitions (M&A), which discourages venture capital investors by making it difficult for them to recover their investments, needs to be expanded. Fourth, the newly-established KONEX exchange will need to strike an appropriate regulatory stance to promote venture capital investment. Fifth, it is important to make the most of human resources, including foreign entrepreneurs and both successful and failed entrepreneurs.

Korea's development from one of the poorest countries in the world in the 1950s to an advanced industrial economy was driven by exports produced by large companies, especially those in the business groups known as *chaebols*. However, as Korea has narrowed the gap with the most advanced economies, this catch-up strategy has reached its limit. Strong competition with emerging economies, notably China, in low and medium-end markets, and with advanced economies in high-end markets is making it difficult for Korea to further expand its share of global exports. In addition, the trickle-down effect from exports has declined. In 1998, 1 billion *won* of exports generated value-added of 0.65 billion *won* and 19 jobs. By 2010, the impact, adjusted for inflation, had fallen to 0.56 billion *won* of value-added and 7.9 jobs.[1]

Given the increasing weaknesses of the traditional growth model, the government of Park Geun-hye launched a plan in June 2013 to promote a "creative economy,"[2] which includes three goals:

- Create new jobs and markets through creativity and innovation
- Strengthen Korea's global leadership through a creative economy
- Create a society where creativity is respected and manifested

The success of this strategy depends to a large extent on increasing the rate of business creation and the role of fast-growing young and small firms. Firms that drive one technological wave often fail to participate in subsequent waves, as young firms have a comparative advantage in commercializing radical innovations. Firms less than five years old, regardless of their size, accounted for less than a fifth of total non-financial business employment but generated half of all new jobs between 2001-2011 in OECD countries.

Firm creation, though, is limited by the challenge of obtaining financing. The higher costs and risks of lending to small firms and potential entrepreneurs discourage such loans. To overcome these obstacles, Korea has supported financing for small companies by supplying public funds directly and by guaranteeing loans from private financial institutions since 1979. In addition, the authorities use moral suasion to encourage financial institutions to lend to small firms. Moreover, there are more than 1,300 government programs to provide assistance to small and medium-sized enterprises (SMEs). While these policies have supported lending to small firms, they also have a number of negative side effects. First, they allow weak "zombie" companies to survive thanks to public support. Second, they encourage small firms to remain small so as to stay eligible for public support, thereby foregoing the efficiency gains and economies of scale associated with growth. Third, government intervention reduces incentives for financial institutions to improve their capacity for credit evaluation of small firms, thus impeding the development of a market for SME financing and, in turn, prompting more government intervention.[3]

Venture capitalism, defined as the provision of financing at an early stage to high-potential start-up companies, can help overcome the financing problems facing small firms and potential entrepreneurs. Venture capitalists earn money by owning equity in the companies that they invest in, which usually have new technology, often in cutting-edge sectors, such as IT. One of the major tasks identified in Korea's 2013 plan to promote a creative economy is to "create the conditions to easily start new businesses through investment, rather than bank financing."

The State of Venture Capital in Korea

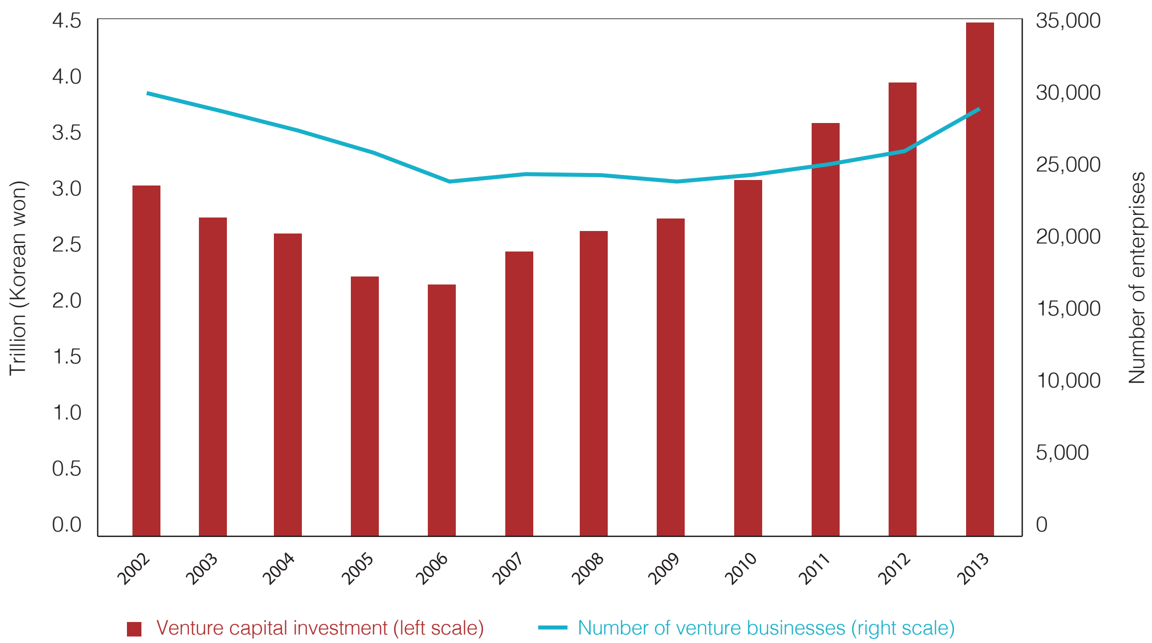
Korea jump-started its venture capital market in 1998 through a direct infusion of capital from the public sector, generous tax incentives and equity guarantees. Developing a venture capital market was part of a strategy to accelerate business restructuring and shift the economy from *chaebols* to start-ups in knowledge-based industries, foreshadowing the current government's strategy. However, these policies fuelled a bubble in the Korea Securities Dealers Automated Quotation (KOSDAQ), the secondary stock market. Following the collapse of the Information and Communications Technology (ICT) bubble, the KOSDAQ, in which about half of the listed firms had received venture capital, fell by 90 percent. Consequently, the venture capital market contracted by a quarter between 2002-2006 (Figure 1).

Korea's venture capital market has rebounded steadily since 2006, with paid-in capital more than doubling by 2013. The total number of firms with venture capital investment on their balance sheets has also been on an upward trend since 2009, although it remains below its level in the early 2000s. The number of firms classified as venture businesses by the government increased more than threefold from around 9,000 in 2000 to more than 29,000 in 2013.[4] Compared to other OECD countries, venture capital investment was relatively high in Korea at almost 0.1 percent of GDP (on a flow basis) in 2012, the third highest among countries for which data are available, although far behind Israel and the United States.[5]

Korea has great potential in venture capitalism, given its strength in innovation. R&D spending in Korea reached 4.4 percent of GDP in 2012, the highest in the OECD, with the business sector accounting for three-quarters of the outlays, one of the largest shares in the OECD. In addition, Korea's share of world patent filings reached 5.7 percent in 2011, up from 2.3 percent in 2003.[6] Korea is also well known for

Figure 1 Korea's Venture Capital Market has Rebounded in Recent Years

Cumulative amount of venture capital investment and number of firms classified as "venture businesses"*



Source: Korea Venture Capital Association (2013), *Current Situation of Venture Companies* (in Korean), and the Small and Medium Business Association.

* Firms that have received venture capital investment or have been designated by the government as a venture business by spending more than 5% of sales on R&D or having its technology certified by the government.

its educational achievements. In 2012, 64 percent of young adults (25 to 34) had completed tertiary education, the highest in the OECD. Among 15-year-olds, Korea was near the top in science in the 2012 Program for International Student Assessment (PISA) tests.[7] Moreover, the government's emphasis on promoting a creative economy creates increased opportunity for venture capitalists.

Nevertheless, despite the rebound in venture capital investment, it remains small, accounting for only 0.5 percent of total financing for SMEs, about the same as in 2004 (Table 1). Moreover, Korea's venture capital sector has a number of weaknesses. First, the number of business angels—individuals who provide capital and advice for business start-ups, usually in exchange for ownership equity or convertible debt—has plummeted from nearly 29,000 before the collapse of the ITC bubble to only 619 before rebounding to 4,870 in 2013. This is an obstacle to a vibrant venture capital sector, as the angels play an important role in mentoring start-ups and providing networking, in addition to playing a crucial role in financing start-ups at an early stage.

Second, the venture capital market and SMEs depend heavily on the government. Under the 1997 "Special Law to Promote Venture Capital Companies," the government can invest directly in venture capital-backed companies. Usually, the government injects public capital into government-managed and sponsored venture capital funds.[8] Public funding accounted for 33 percent of venture capital funds in 2012, with an additional 12 percent share for public pension funds.[9] The large government share risks crowding out private investors, in addition to creating concerns about "picking winners."

Third, venture capital funds tend to invest in relatively mature companies rather than in firms at an early stage, when such funding is most critical. Indeed, 55 percent of firms receiving venture capital investment in 2012 were older than three years and 27 percent were more than seven years old. Moreover, the share of investment by venture capital funds in firms less than three years old fell from 40 percent in 2008 to 28 percent in 2012. The limited role of venture capital funds at an early stage of a firm's development reflects a number of factors. In particular, Korea's domestic M&A market is very underdeveloped compared to other advanced countries and the role of foreign firms is insignificant. The share of venture capitalists' earnings that are realized from M&As was only 7 percent in 2011 compared to 69 percent in the United States.[10]

Table 1 Sources of SME financing (as a % of the total*)

Year	Banks	Non-banks	Equities and bonds	Venture investment	Government guarantees	Other government	Total
2004	61.1	22.7	0.6	1.2	13.6	0.8	100.0
2006	64.0	22.7	0.8	0.8	11.0	0.7	100.0
2008	68.0	21.0	0.8	0.7	8.9	0.6	100.0
2009	64.7	21.0	1.0	0.7	11.7	1.0	100.0
2010	64.5	20.7	0.7	0.8	12.3	1.1	100.0
2011	67.8	17.2	0.5	0.9	12.3	1.4	100.0

Source: Sohn, S. and D. Kim (2013), *Tasks for the Development of SME Financing*, Korea Institute of Finance (in Korean).

* Government guarantees are assumed to cover bank lending. Some of the lending by government institutions is reported as loans by banks and non-banks.

Cultural factors play a role. M&A activity in Korea historically has been associated with bankruptcy proceedings. Moreover, CEOs generally want to remain with the enterprise that they have created, making them reluctant to participate in M&As. The generally negative attitude of labor unions and non-governmental organizations to M&As is another limiting factor. In addition, government-imposed limits on diversification by the *chaebols* may discourage M&A activity.

Instead of M&As, the primary method for venture capitalists to realize returns from their investment is an initial public offering (IPO), although this is not easy for start-ups due to demanding requirements in the KOSDAQ, such as maintaining a high profitability rate. Indeed, the average net profit rate of newly-listed companies in KOSDAQ ranged from 11 percent to 16 percent over 200812, making it two to three times higher than the five percent average of all listed companies.[11] Moreover, IPOs take a long time. On average, it takes more than 14 years for start-ups to be listed on KOSDAQ, far exceeding the lifespan of most venture capital funds. Indeed, only 78 of 393 funds in 2010 were more than six years old.[12] As a result, venture capital funds tend to invest in relatively mature companies. In sum, a major weakness of the venture capital sector is that too few firms receive early-stage finance.

Fourth, while the government has emphasized support to the supply side of the venture capital market, demand-side conditions appear to be the key constraint. The Korea Venture Capital Association states that it is becoming increasingly difficult to find good investment opportunities in Korea, leading some of its members to establish operations overseas, particularly in China and Vietnam.[13] In addition, there are complaints that the most talented individuals in Korea work at *chaebols* or in the government rather than becoming entrepreneurs. A number of OECD countries are shifting their policy orientation towards measures to strengthen the demand side by enhancing the quality of the business proposals that entrepreneurs present to potential funding sources. Such an approach recognizes that the development of the venture capital industry has followed, rather than preceded, the availability of attractive opportunities in other countries.

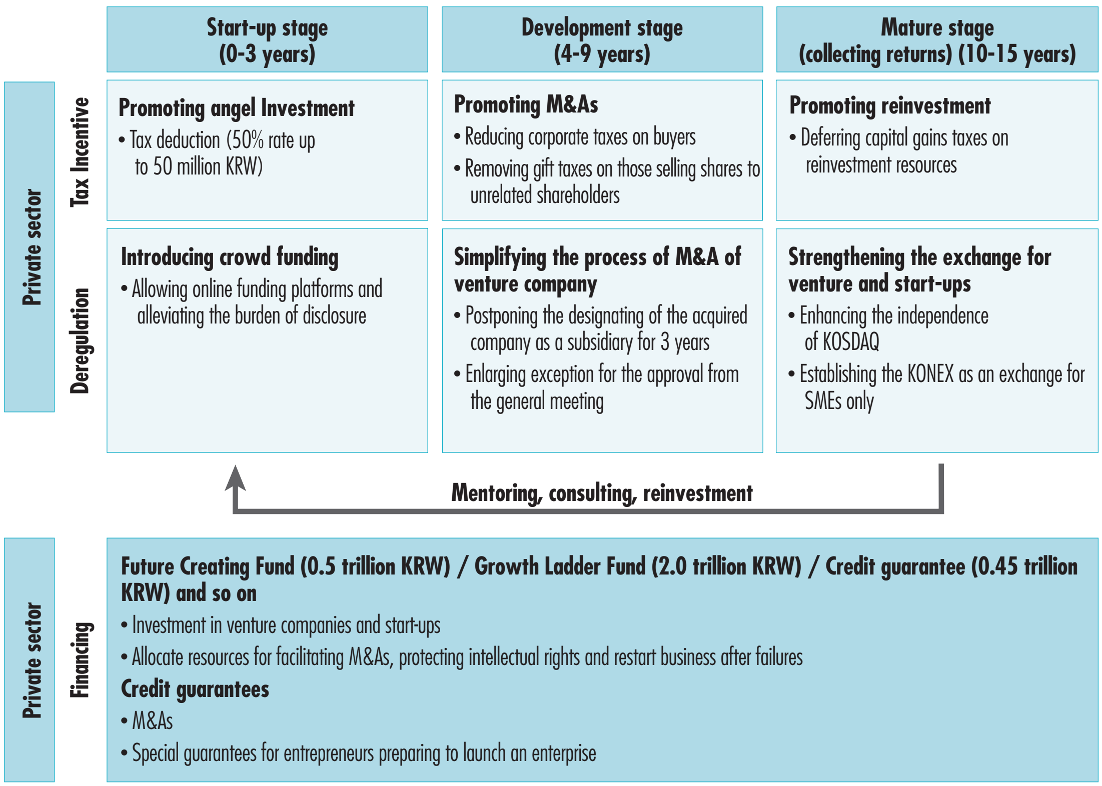
Fifth, reinvestment by venture entrepreneurs who have already achieved success is relatively small for a number of reasons, including the tax system and financial market practices. For example, when shares are sold at more than 30 percent above the market price, the sale is subject to the maximum gift tax of 50 percent instead of the 11 percent capital gains tax. Such high tax rates limit the scope for reinvesting gains in the venture capital market. Finally, the social stigma attached to failure limits the opportunity for entrepreneurs to try again.

Policies to Develop Venture Capitalism and Promote a Creative Economy

In May 2013, the government launched the “Measures to develop a virtuous cycle in the venture start-up capital ecosystem” to address obstacles that hinder the development of a sound venture capital sector (Figure 2). The initiative includes measures to:

- Promote angel investment and introduce crowd-funding
- Expand public sector funding for venture capital
- Develop the market for M&As involving venture businesses and business angels
- Strengthen the role of KONEX and KOSDAQ for start-ups
- Create an environment that encourages reinvestment by both successful and failed entrepreneurs

Figure 2 The May 2013 “Measures to improve the venture start-up ecosystem”



Source: Ministry of Strategy and Finance, Ministry of Science, IT and Future Planning, Ministry of Justice, Ministry of Trade, Industry and Energy, Financial Supervisory Committee, Fair Trade Commission and Small and Medium Business Administration (2013), *Policy Measures to Create a Virtuous Cycle in the Venture Start-up Capital Ecosystem* (in Korean).

Promoting Private-Sector Financing through Business Angels and Crowdfunding

It is crucial to promote a shift from loans to investment-oriented financing of start-ups, given the critical importance of risk-sharing between entrepreneurs and their sources of financing during the first three years of a firm’s existence. Business angels play an important role in this regard. Government support for business angels has been available in Korea for some time, including eight public funds that match the investments by private investors. In addition, tax incentives for angel investors will be strengthened. For example, the amount of venture capital investment that they can deduct from their aggregate income in calculating personal income tax will be raised from 30 percent to 50 percent of that investment. Tax incentives have been found to increase both the number of angel investors and the amount invested. In addition to financing, the expertise, networks and close interaction that business angels bring to start-ups is essential for their success. The government should support the development of the necessary quality, skills and experience among angel investors.

Crowdfunding via online platforms will be introduced to allow start-ups to receive financing from a large number of small investors. Crowdfunding is defined as the collective effort of many individuals who network and pool their resources, usually through social networking via the Internet, to invest in new projects. It thus creates a new channel for ordinary citizens to fund companies in exchange for shares in the business. Crowdfunding helps novice entrepreneurs obtain financing without red tape, thereby saving time and money. Gaining hundreds of investors via websites could also increase online popularity for a start-up as investors tweet and post about the company so as to protect their investment. By 2011, there were an estimated 700 platforms, primarily at an early stage of financing, raising a total of around $1.5 billion globally. However, with the legal and institutional framework still in its initial stages, crowdfunding’s role as a source of start-up financing remains marginal.

The Korean government is also developing online platforms, such as the “Infinite Imagination Start-up Platform,” launched in 2013 to allow potential entrepreneurs to propose ideas that are then voted on by the online community. Those with the winning ideas can start a business or sell the idea to someone else and share the profits with the company that purchases it. The objective is to provide potential entrepreneurs with help in design, marketing and production. The program began with 30 to 40 projects in 2013 and expanded to 100 in 2014.

However, Korea should proceed carefully with its plan to make crowdfunding a major source of financing. From a company perspective, relying on crowdfunding would mean losing the guidance and networks provided by seasoned angel investors. In contrast to business angels, who tend to spend considerable time and money on due diligence before investing, investors in crowdfunding are primarily members of the general public. In addition, entrepreneurs with poor proposals who are rejected by experienced investors after detailed due diligence might turn to crowdfunding, creating the risk of fraud. Moreover, an idea launched via the Internet is easily copied. For such reasons, crowdfunding is not currently allowed in most OECD countries, although active crowdfunding platforms exist in Belgium, France, Germany, the Netherlands, the United Kingdom and the United States. In the United States, firms can sell up to $2 million of unregistered securities through crowdfunding through an exemption from Securities and Exchange Commission regulations. Individual investment is restricted to $10,000 or 10 percent of the investor's annual income—whichever is less. The need for investor protection depends on the amount of money raised. If large sums are raised through individual investors using crowdfunding, stronger investor protection is needed, although this would negate the advantage of crowdfunding, i.e. less regulation.

Foreign investment is playing an increasingly large role in Korea. According to the Small and Medium Business Administration (SMBA), foreign assets invested in Korean start-ups increased from 124 billion ($114 million) *won* in 2003 to 428 billion *won* ($395 million) and it is expected to reach 700 billion *won* ($645 million) in 2014. The SMBA is negotiating with foreign venture capital firms to create a "Korea Fund."

An Appropriate Role for Public Financing of Venture Capital

The Korean government has created a number of programs to fund venture capital investment (Table 2). For example, it launched the "Future Creation Fund," totaling 500 billion *won* ($460 million) to finance start-ups, with the private sector providing two-thirds of the Fund. Of the total, 200 billion *won* is reserved for investment in start-ups and firms less than three years old. To encourage private-sector investors, they will receive a certain share of the profits upfront before dividing the rest with the government. In the case of a loss, the government will bear up to 20 billion *won* alone before private investors suffer any loss.

Given that public funds account for nearly half of venture capital investment, it is important to avoid an excessive supply of public funds relative to the number of high-quality investment projects, which would tend to crowd out private investment. Inevitably, a portion of such large public support goes to firms that are not really venture capital-backed enterprises. The success of such public investment program depends on their design and implementation. The government's emphasis on a fund-of-funds approach, in which it invests primarily in venture capital firms rather than directly in start-up firms, has been identified as good practice internationally. Such an approach is more effective because it channels public funds through existing market-based systems. In addition, public funds should be utilized where market failure is most serious, suggesting a focus on early-stage financing where funding shortages are most likely.

Promoting M&As to Help Venture Capitalists

Korea is trying to facilitate M&As involving new start-ups, thereby allowing investors to withdraw their capital at an early stage. First, the government will provide financial support for M&As including venture capital-backed firms. For example, the newly-established Growth Ladder Fund of 2 trillion *won* ($1.8 billion) will provide financing to firms that do not qualify for bank loans, while the Korea Credit Guarantee Fund will provide guarantees of up to 100 billion *won* ($92 million) for private financing (Table 2). Second, M&As can receive more favorable tax treatment; for sellers, the 11 percent capital gain tax will be applied instead of the gift tax, whose rate goes up to 50 percent. Third, regulations related to M&As are also being liberalized; 1) when large companies buy shares in a small company, the designation of the smaller firm as a subsidiary can be postponed for three years, thus avoiding the regulations imposed on *chaebol* affiliates; and 2) when the merger of two SMEs creates a firm too large to be classified as an SME, the new entity can nevertheless maintain the legal status of SME for three years, thus allowing favorable treatment. Fourth, the legal process for M&As is being deregulated. In some case, M&As will only need to be approved by the board of directors rather than by a vote at the shareholders' general meeting.

Such policies should help expand Korea's M&A market, which is relatively small. However, the M&A market is limited by the early stage of development of Korea's capital market and the cultural factors noted above, which will be more difficult to overcome. Finally, a successful launch of KONEX, supported by the plan to relax the legal requirements, and a larger role for KOSDAQ, would also help promote both M&As and IPOs.

Table 2	New Programs to Promote a Creative Economy

Program	Objective	Funding (Korean *won*)	Organization responsible
Future Creation Fund	Promoting investment-oriented financing	500 billion[1]	KVIC
Special Credit Guarantee for Entrepreneurs	For setting up a firm	50 billion[2]	KOTEC
Fund for M&As	To promote M&As	200 billion	Growth Ladder Fund[3]
Credit guarantees for M&As between small firms	To promote M&As	100 billion	KCGF
Fund for Next Venture Generation	Facilitating re-investment by successful venture entrepreneurs	100 billion	KVIC
Intellectual Property Rights Fund	To buy patents and technology from small firms	200 billion	Growth Ladder Fund[3]
Restart Support Fund	To give a second chance to failed entrepreneurs	100 billion[4]	Growth Ladder Fund[3]

Source: 2014 *OECD Economic Survey of Korea*.

[1] The private sector provides 350 billion *won*. Of the total, 200 billion *won* is reserved for firms less than three years old.
[2] Up to 500 million *won* per entrepreneur.
[3] The KDB and IBK put money into this Fund along with private financial institutions.
[4] The Fund is to increase from 40 billion *won* in 2013 to 100 billion won in 2017.

Expanding the Roles of Exchanges: KONEX and KOSDAQ

Promoting venture capital also requires increasing direct financing from capital markets, which play a very minor role for start-ups at present. To this end, the government established the Korea New Exchange (KONEX) in July 2013. Greater investment-based financing, as opposed to bank lending, depends in part on the success of KONEX in fulfilling its role as an exchange for start-ups and avoiding the path of KOSDAQ, which moved away from this role. KONEX has eased the difficulties facing start-ups younger than three years by significantly relaxing the requirements for listing and disclosure. For example, the number of mandatory disclosure items was reduced to 29 compared to 64 in KOSDAQ. KONEX also facilitates the participation of smaller companies, requiring firms to meet only one of three listing conditions.[14] In addition, the preferential tax incentives currently given to investors in KOSDAQ will be expanded for those in KONEX. For major shareholders, who own more than 4 percent of shares or shares whose value exceeds 4 billion *won* (1 billion *won* in the case of KONEX), a preferential capital gains tax rate is applied.[15] If a venture capital fund buys new shares in companies that are listed in the KONEX that are less than two years old, corporate taxes on capital gains and dividends and the securities transactions tax are not applied.

The key to the sound development of KONEX is to correctly balance investor protection and market dynamism. Excessive investor protection would make the market unattractive to companies and investors alike. On the other hand, inadequate investor protection would be harmful to the market's development as it would increase the risk of moral hazard, as well as illegal activities by listed companies. On the investor side, it could also lead to irrational investments and possibly a bubble, as occurred in KOSDAQ in the late 1990s. Disappointed investors, who were negatively affected by the burst of a bubble or bad behavior by listed companies, would then leave the market. Therefore, a balanced regulatory stance is necessary.

The government will also make KOSDAQ more open to start-ups. This exchange, which was originally established to support venture businesses, has been criticized as being ill-suited for innovative companies hoping to raise capital due to its conservative management focusing on investor protection.[16] In 2012, only 21 new companies were listed in KOSDAQ, compared to 171 in 2001. As noted above, it takes more than 14 years on average for start-ups to be listed on KOSDAQ. To reorient KOSDAQ toward helping venture businesses raise capital, its management will be separated from the Korea Stock Exchange (KSE), the main exchange, which lists mainly large firms, and KOSDAQ's listing committee will include more specialists on technology. In addition, the requirements for an IPO are being relaxed while not significantly reducing investor protection.[17]

Developing the Necessary Human Capital

Entrepreneurship is another important aspect of promoting venture capital investment. As President Park stated at Davos in 2014, entrepreneurship is the "driving force of sustainable, inclusive growth." In Korea, however, top students from the leading universities tend to choose prestigious jobs in *chaebols* or the government and it is difficult to overcome such traditional values to make entrepreneurship more attractive. Effective entrepreneurial education in secondary and tertiary education would be helpful. The government is taking useful steps, such as encouraging public research institutes to establish start-ups using their own technology and ideas. To better tap foreign entrepreneurship and technology, visas will be extended to foreigners willing to start a business in Korea. Although the visas are for only two years, they can be renewed if the foreigners continue doing business in Korea. Moreover, start-up visa holders who stay in Korea for three years or more, attract investment of at least 300 million *won* ($276 thousand) and hire two or more Korean citizens are eligible for permanent residency.

The government hopes to establish a conduit through which the capital and know-how of successful entrepreneurs can be channeled to new start-ups. When entrepreneurs reinvest capital gains received from selling shares in existing companies, the capital gains tax on the sales is deferred until the entrepreneur sells the shares in the second venture. In addition, the government established a "Fund for Next Venture Generation" for reinvestment by successful venture entrepreneurs (Table 2). The fund was set at 100 billion *won* ($92 million) in 2013, with the government providing up to 60 percent of that amount, with the remainder coming from the entrepreneurs.

Thanks in part to generous public funding, financing does not appear to be a severe obstacle at present to venture capital investment. Instead, the problem appears to be on the demand side, as venture capital investment is slowed by a lack of attractive business opportunities. A number of countries are shifting the orientation of programs to the demand side to enhance the quality of the investment projects proposed by venture businesses. As noted above, the development of the venture capital industry cannot proceed more rapidly than the creation of attractive projects.

Finally, the lack of a second chance for those who fail in a business venture makes potential entrepreneurs hesitate to launch risky start-ups. In the United States for example, the ten-year survival rate for start-ups is 35 percent. The lack of second chances for failed entrepreneurs in Korea prevents the experience and knowledge gained from past failure to benefit the venture capital market. The government should ensure that entrepreneurs who experience "honest failure" have additional opportunities to create new ventures. The government will expand the "Restart Support Fund," which is exclusively reserved for failed entrepreneurs who want to launch a new company, from 40 billion *won* in 2013 to 100 billion *won* ($92 million) in 2017 (Table 2). The credit recovery of failed entrepreneurs who are already personally delinquent should also be facilitated.

Conclusion

Korea has been among the fastest growing OECD countries during the past decade. However, subdued growth in recent years has revealed structural problems, such as high household debt, a lagging service sector and weak SMEs. This has raised concerns about Korea's traditional catch-up strategy led by exports produced by large *chaebol* companies. The success of Korea's new growth strategy of fostering a "creative economy" depends in large part on developing the venture capital sector based on a comprehensive strategy that: 1) expands the role of business angels, who are essential both for financing and for mentoring start-ups; 2) limits government financing to avoid crowding out private-sector investors; 3) develops Korea's currently small market for mergers & acquisitions to help venture capital investors recover their investments; 4) develops the newly-established KONEX exchange to promote capital-market financing for start-ups; and 5) promotes effective use of human resources.

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1 *Extended 2010 Input-Output Tables* (in Korean), Bank of Korea (2012).

2 *The Park Geun-hye Administration's Creative Economy Blueprint: "Creative Economy Action Plan and Measures to Establish a Creative Economic Ecosystem,"* http://english.mosf.go.kr/eco/view.do?bcd=E0005&vbcd=N0001&seq=3289&bPage=1.

3 R. Jones and M. Kim, "Promoting the Financing of SMEs and Start-ups in Korea," *OECD Economics Department Working Paper*, No. 1162 (2014).

4 In contrast to other countries, though, a Korean firm that does not receive investment from a venture capitalist can still be designated as a venture business by spending more than 5 percent of sales on R&D or having its technology certified by the government.

5 International comparisons of venture capital are found in the OECD's *Entrepreneurship at a Glance*.

6 *OECD Science, Technology and Industry Outlook 2012*.

7 *PISA 2012 Results: What Students Know and Can Do (Volume I)*, OECD (2013).

8 S. Lim and Y. Kim, "How to Design Public Venture Capital Funds: Empirical Evidence from South Korea," *Journal of Small Business Management* (2014).

9 *Policy Measures to Create a Virtuous Cycle in the Venture Start-up Capital Ecosystem* (in Korean), Ministry of Strategy and Finance, Ministry of Science, IT and Future Planning, Ministry of Justice, Ministry of Trade, Industry and Energy,

Financial Supervisory Committee, Fair Trade Commission and Small and Medium Business Administration (2013).

10 This compares earnings from M&As as a share of earnings from IPOs and M&As combined. The data are reported by the Korea Venture Capital Association.

11 *Policy Measures to Create a Virtuous Cycle in the Venture Start-up Capital Ecosystem* (in Korean), Ministry of Strategy and Finance, Ministry of Science, IT and Future Planning, Ministry of Justice, Ministry of Trade, Industry and Energy, Financial Supervisory Committee, Fair Trade Commission and Small and Medium Business Administration (2013).

12 J. Yang, H. Noh and H. Lee, *Proposals for Enhancing Financial Support for SMEs*, Woori Finance Research Institute (February 2013) (in Korean).

13 *Industry and Technology Policy in Korea*, OECD (2014).

14 The three conditions are: 1) sales revenue of more than 1 billion *won* ($921 thousand); 2) capital of more than 0.5 billion *won*; or 3) profits of more than 0.3 billion *won*.

15 In both KOSDAQ and KONEX, the capital gains tax is exempted for minor shareholders.

16 *Policy Measures to Create a Virtuous Cycle in the Venture Start-up Capital Ecosystem* (in Korean), Ministry of Strategy and Finance, Ministry of Science, IT and Future Planning, Ministry of Justice, Ministry of Trade, Industry and Energy, Financial Supervisory Committee, Fair Trade Commission and Small and Medium Business Administration (2013).

17 For example, the minimum age requirement for firms (currently three years) and the period during which major shareholders should retain their shares (currently one year) will be reduced.

ECONOMIC RELATIONS WITH EUROPE

KOREA'S ECONOMIC RELATIONS WITH THE EU AND THE KOREA-EU FTA

By Kang Yoo-duk

Abstract

Since the late 1990s, Korea has sought a FTA with its trade partners, while the EU has been pivoting to Asia since the mid-2000s in search of a FTA partner. The Korea-EU FTA was important for both sides: Korea had been recording the most important trade surplus with the EU; and from the EU's point of view, the trade deal with Korea was its first FTA attempt with an Asian partner. Despite optimistic expectations, Korea's exports to the EU decreased since the Korea-EU FTA was implemented. Reasons for this unusual change in trade include the economic recession in Europe, Korea's concentrated export structure, relocation of Korean firms' production base abroad, and an increase in imports of certain products such as crude oil. Classic statistics on exports and imports will lose their role in assessing the outcomes of FTAs, and the strategy of governments and firms in the post-FTA era must change.

Introduction

The European Union (EU) is an important economic partner for Korea both in trade and investment. If the EU is considered a single economic area, it is fourteen times larger than the Korean domestic market and it has always been an important export destination of Korean companies. Trade with the EU accounts for 10.4 percent of Korea's total trade in 2014 and it is the third most important partner after China (21.4 percent) and the U.S. (10.5 percent). European companies have been very active in investing in Korea. According to European statistics, they represent more than 40 percent of the cumulative total FDI (Foreign Direct Investment) since 1962.[1] For the period 2008-12, European companies were the largest contributors to inward FDI into Korea with investment totaling $22 billion. Korean companies are also increasingly active in investing in Europe. Half of Korean cars sold in European markets are produced in the assembly lines in Slovakia and the Czech Republic, and Korean electronics companies made a number of important investments from R&D centers to production facilities in Europe. In financial sectors, Korea's economy is more closely related to European financial markets. According to statistics from the Bank for International Settlement (BIS), European banks have very important exposures to the Korean economy. Almost half of Korea's external liabilities are with European banks, which means that both economies are increasingly interdependent. In this context, creating a more stable economic framework is beneficial to both Korea and the EU and this was the basic background that Korea and the EU agreed to launch a FTA negotiation in 2007. As of early 2015, the Korea-EU FTA is the only FTA that the EU has implemented with an Asian country.

This article reviews Korea's economic relations with the EU, focusing on the Korea-EU FTA implemented in July 2011. The FTA should be understood from mutual economic interests as well as its overall trade policy. The Korea-EU FTA was the first FTA that Korea implemented with a large trading partner, and from the EU's perspective, it is the first completed agreement in a new generation of FTAs.

The first section of this article reviews the background of the Korea-EU FTA from both the Korean and EU perspective. We describe the economic and political background of the FTA in the context of the overall trade policy of Korea and the EU. The second section sheds light on the negotiation process of the FTA, focusing on arguments emphasized during the negotiation. The third section examines the trade statistics for three years of the FTA. In order to compare changes in trade before and after the FTA, we discuss important factors which affect trade between both sides during the implementation of the FTA. Finally, we discuss future prospects of Korea's economic relations with the EU in the post-FTA era.

Background of the Korea-EU FTA

Korea's Perspective

Negotiating a FTA with the EU was scheduled in the FTA roadmap announced in September 2003. This medium-term FTA plan reflected and expanded upon Korea's first FTA, the Korea-Chile FTA. Even though trade with Chile accounted for a very small part of Korea's total, the first FTA provoked significant controversy and its ratification took more than one year. In order to obtain public support, the Korean government set up the FTA roadmap which states four principles of the Korean government's FTA policy: 1) multiple-track FTAs; 2) advanced and comprehensive FTAs; 3) transparent procedures in FTA preparation; and 4) diplomatic consideration in FTA policy.[2] The roadmap also announced trade partners to be considered for FTAs on the basis of concrete economic criteria, such as economic feasibility and large and advanced economies. It organizes FTA partners into two groups: partners in the near future (negotiation in two years) and those for medium-term perspective (negotiation in more than three years). The EU was included in the list of medium-term perspective FTAs with the United States and China. One reason for this differentiated schedule is that they are large trade partners, and the impact of the FTAs will be much more significant than FTAs with small countries. Another reason is that the EU exercised a de facto moratorium on new FTA negotiations from 1999 to 2006.[3]

In the meantime, trade and investment with European countries had been rapidly increasing. In 2007, the EU became the second largest trade partner for Korea after China. After its first FTA with Chile, Korea initiated new FTA negotiation with the European Free Trade Association (EFTA). The FTA with EFTA was generally considered as a preparatory step to one with the EU, because its member countries have maintained free trade status with the EU, adopting most of EU's trade regulations. The Korea-EFTA FTA was concluded after only 10 months of negotiation.

EU's Perspective

In the mid-2000s, EU business circles and external trade surroundings put increasing pressure on the EU to pursue bilateral FTAs. There were increasing concerns that industries of emerging countries like India, Brazil and China would become more competitive than European ones, as their rapid economic growth overwhelmed that of European economies. In this context, the arrival of the new trade commissioner, Peter Mendelssohn, brought a new point of view on bilateral FTAs. He argued that wisely constructed and ambitious bilateral agreements with carefully chosen partners could create new trade and improve the competitiveness of EU companies in key enlarging markets.

Incorporating new objectives in external trade policy, the European Commission announced a new trade policy in October 2006, later known as 'Global Europe.'[4] The latter emphasizes the role of the EU's external trade policy which contributes to EU's competitiveness in foreign markets. Considering that it is hard to deal with investment, public procurement, competition and intellectual property rights in the WTO, negotiating comprehensive FTAs with like-minded countries was regarded as the second best option in realistic terms. In order to select FTA partners, the European Commission proposed the key economic criteria: 1) market potential (economic size and growth); 2) level of protection against EU exports (tariffs and non-tariff barriers); and 3) potential partners' FTA negotiations with EU competitors (potential discriminatory impact on European firms). On the basis of these principles, the European Commission identified ASEAN, Korea and MERCOSUR as priorities.

In addition to using fully economic criteria for selecting FTA partners, Global Europe is notable in several aspects. First, it aims for ambitious and high-level FTAs. New competition-driven FTAs aim to be comprehensive and ambitious in coverage, aiming at the highest possible degree of trade liberalization including far-reaching liberalization of services and investment. Second, ongoing or scheduled FTA negotiations with EU's competitors (implicitly the United States) were also taken into account. Third, the new FTAs explicitly focus on tackling non-tariff barriers through regulatory convergence and contain strong trade facilitation provisions, intellectual property rights and competition. This means that the FTA model that the Commission wanted to construct was deep integration, which seeks to harmonize trade-affecting rules. The objectives of the EU's FTA policy corresponded to what Korea had been seeking for its FTA roadmap.

Negotiating Korea-EU FTA

Negotiation Process

Official Korea-EU FTA negotiations were launched in May 2007 after a series of preparatory meetings held the previous year. It took over two years with eight rounds of negotiation and many technical meetings on the side to finalize the deal on 15 October 2009. By this time, Korea had already finished FTA negotiations with the U.S. and signed the KORUS FTA in June 2007. This allowed Korean trade negotiators to use technical know-how obtained in KORUS FTA negotiations as an example of an advanced FTA. In that sense, the KORUS FTA provided a partial template for the Korea-EU FTA. The EU sought a comprehensive and advanced FTA with Korea, which was its most economically-developed bilateral FTA partner to date. Accordingly, the Korea-EU FTA is the most comprehensive FTA ever negotiated by the EU. Import duties are eliminated on nearly all products (97.3 percent of Korean products for the EU market by number of items) and the service market is liberalized further than the KORUS FTA (KORUS Plus). Composed of 15 chapters, the FTA includes provisions on investments (termed as establishment due to the Commission's mandate in trade negotiation) both in services and industrial sectors, provisions on intellectual property and competition rules. The Korea-EU FTA is also a pioneering case in that it aims at reducing non-tariff barriers and promoting a future dialogue in industrial regulation. During the preparatory and implementation period, Korea changed many parts of its domestic laws in accordance with implementing Korea-U.S. and Korea-EU FTAs. Most of the revisions concern service sectors and intellectual property.[5]

Diverging Concerns Between Korea and the EU

Two issues delayed the finalization of overall negotiation to the end: 1) the duty draw back system and 2) rules of origin. Korea and the EU showed a very clear divergence on the duty drawback system (DDS) from the beginning. From Korea's point of view, the DDS is a crucial support system, especially for small and medium enterprises (SMEs), that rely heavily on outsourcing to China and Southeast Asia for intermediate goods. Without DDS, any kind of FTA would not bring about tangible economic benefits to Korean firms. It seems that European negotiators sufficiently realized that the DDS is important for the Korean government not only for economic background, but also for political reasons. In order to gain ground from Korean exporting firms, it was necessary for the Korean government to maintain the DDS which dated back to 1964 in the Korean customs system. The problem is that the EU did not have precedent to include the DDS in the previous FTA with third countries (i.e. Chile, Mexico and South Africa). The reason for not including DDS in FTAs can be found in the trade structure of European countries which rely mainly on intra-European trade for supply of intermediate products. More developed Western European firms have taken advantage of the European enlargement toward Eastern Europe. As a result, they tend to rely less on outsourcing out of the EU, and the DDS is less important for them.

However, the relative indifference of the European Commission on the DDS turned to be its preoccupation, as major industrial associations—especially the automobile association—showed their concerns about Korea's DDS and its positive effect on price competitiveness of Korean products. The European Automobile Manufacturers' Association (ACEA) strongly opposed Korea's intention to include the DDS in the Korea-EU FTA.[6] The ACEA argued that approving the DDS in the framework of the Korea-EU FTA would offer a disproportionate competitive advantage to the Korean auto industry when exporting to the EU. It insisted that this would set a precedent for other scheduled EU FTAs. In finalizing the negotiations, Korea and the EU reached a compromise. In the final deal, the EU agreed to allow Korea to maintain the current DDS (on average 8 percent) on Korea's exports to the EU for five years from FTA enforcement. When Korea's imports of intermediate goods increase rapidly after the five-year grace period, EU can limit DDS to five percent.[7] Setting a threshold for local content in the rules of origin was also an issue for both parties. As for the DDS case, the EU had precedent which served as a principle; the EU used to set a percentage of the locally produced contents in a final product to 60 percent in the previous FTAs with Chile, Mexico and South Africa. This meant that in order to be qualified as "Made in Korea," Korean-produced content should exceed 60 percent of total value of the products concerned. Korea's initial proposal for local content share was 35 percent, which was applied in the KORUS FTA. In the final deal, EU agreed on reducing threshold for local content to 45 percent.

After more than two years of negotiations, Korea and the EU signed the deal on October 6, 2010 during Korea's presidential visit to Brussels for the 8th Asia-Europe Meeting (ASEM) summit. The agreement was approved on February 17, 2011 by the European Parliament. Korea's National Assembly ratified it on May 5, 2011. With this, all necessary legal procedures have been completed and the FTA entered into effect on July 1, 2011.

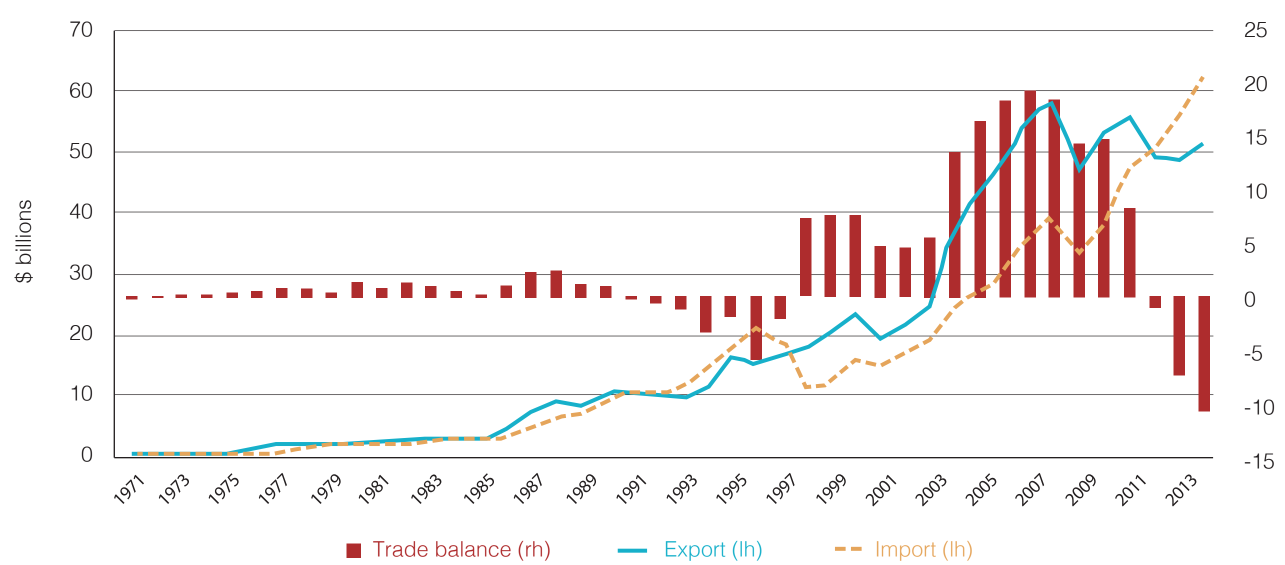
Three Years of the Korea-EU FTA

Trade Flow Between Korea and the EU After the Global Financial Crisis

In the 2000s, trade between Korea and the EU increased considerably. Korea's exports to the EU soared from $39.2 billion in 2000 to $98.4 billion in 2008. Imports from the EU showed a similar increase from $23.4 billion to $58.4 billion. In this context, the possibility of FTA implementation raised the prospects for more exports to the EU. Various studies suggest that the Korea-EU FTA will contribute to increasing Korea's exports to the EU as well as Korea's GDP. According to KIEP (2010), the FTA is expected to increase Korea's exports to the EU by $2.5 billion per year and, as a result, Korea's GDP will increase by 0.1 percent in the short term and by 5.6 percent in the long term.[8] Decreux, Milner and Péridy (2010) provides a similar estimation, stating that Korea's export to the EU will increase by up to 5.5 percent following the implementation of this FTA.[9]

While Korea's trade surplus vis-à-vis the EU reached a record level of over $19 billion in 2007, it has been gradually decreasing. Korea's imports from the EU increased by 21.3 percent per year from 2009-2011, while its exports to the EU increased only at an annual rate of 9.3 percent in the same period. The reason for the difference between export and import growth rates is the slowdown of EU's economic growth, which decelerated import demand, and the increase

Figure 1 Korea's Exports and Imports with the EU (in $ billions)



Source: Korea International Trade Association (KITA).

Table 1 Korea's Exports to its Trade Partner Before and After Korea-EU FTA

	Exports ($1 billion)				Change (%)			
	1 year before	1st year	2nd year	3rd year	1st year	2nd year	3rd year	3 years
EU	57.9	50.8	48.4	47.3	-12.3	-4.7	7.9	-10.4
China	125.6	133.2	140.5	134.5	6.1	5.5	4.2	17.6
USA	54.2	59.1	59.2	58.4	9.1	0.2	21.4	32.8
ASEAN	62.2	75.5	82.9	78.0	21.3	9.9	2.7	38.3
Japan	34.3	40.1	36.6	31.2	16.8	-8.8	-7.5	0.8
Total	**518.7**	**556.6**	**549.4**	**518.9**	**7.3**	**-1.3**	**3.2**	**10.0**

Note: 1) 1 year before: July 2010 to June 2011, 2) 1st year: July 2011 to June 2012, 3) 2nd year: July 2012 to June 2013, 4) 3rd year: July 2013 to June 2014, 5) 3 years: change in exports from 1 year before (July 2010 to June 2011) and the 3rd year (July 2013 to June 2014).

Source: Author's calculation based on data from KITA.

of imports into Korea from the EU due to Korea's rapid economic recovery. In 2011, Korea recorded several monthly trade deficits with the EU, and in 2012 Korea recorded a $1 billion trade deficit with the EU for the first time since 1998. The deficit expanded further to $7.37 billion in 2013 and $10.7 billion in 2014.

Three Years of the Korea-EU FTA

Korea's exports to the EU, which had been recovering after the global financial crisis, began to experience a decrease in the latter half of 2011. For the first year of the FTA with the EU, Korea's exports to the EU decreased 12.3 percent compared to the previous year. This result is an exception, given Korea's overall exports to the world increased by 7.3 percent in the same period, as shown in Table 1. From Korea's point of view, this outcome based on trade statistics is rather disappointing as most of the previous studies predicted a substantial increase in exports. Moreover, this figure contrasts with Korea's considerable increase in exports to the U.S. after the KORUS FTA. For the second year, Korea's exports to the EU once again fell by 4.7 percent, while it rebounded for the third year, largely due to the base effect.

In contrast, Korea's imports from the EU increased by 13.1 percent for the first year of the FTA. Given that Korea's overall imports from the world increased by 10.6 percent in the same period, the increase in imports from the EU is in accordance with the overall trend. However, imports from the EU also increased for a second year while Korea's overall imports reduced by 3.5 percent. During three years of the FTA implementation period, imports from the EU increased by almost 40 percent and the trade balance turned from a surplus of $14.5 billion to a deficit of $8.4 billion. It is clear that the FTA exerted a positive influence on Korea's import through tariff-cut effect, given that the growth rate of imports from the EU was four times larger than Korea's overall import growth. However, a question remains regarding the fall in exports to the EU under the 'FTA effect.' In order to understand this change in trade between Korea and EU, it is necessary to review the economic situation and trade flow in more detail.

First, we can observe a stark contrast between Korea's exports to the EU and other regions. Exports to the EU have been decreasing despite the FTA, while its exports to other trade partners have considerably increased. Over the three years since the FTA came into effect, Korea's exports to the EU fell by more than 10 percent. On the other hand, its exports to the U.S., China and the ASEAN countries increased by 21-36 percent during the same period. The answer to such a difference can be found from a comparative view on exports of other Asian countries to the EU. According to trade data from Eurostat, most East Asian exporting countries – China, Japan and Taiwan – have experienced a sharper decline in their exports to the EU than Korea. While China's exports to the EU decreased by 5.6 percent, Japan and Taiwan's exports to the EU dropped by 13 and 22 percent respectively. Given the continued depreciation of the Japanese yen from late 2012, it is intriguing to see that Japanese exports to the EU have seen the most visible decrease. It is noteworthy that all East Asian economies experienced a decrease in exports to the EU. They have common features in that they are specialized in exports in manufacturing sectors. The sharp fall in domestic demand in the EU has exerted undoubtedly a very negative influence on exports to the EU of East Asian countries with a high export share in manufacturing industries. In other words, the less-than-expected performance in Korea's exports to Europe should be attributed to weak demand in the EU from around

Table 2	Korea's Imports from its Trade Partner Before and After Korea-EU FTA							
	Imports ($1 billion)				Change (%)			
	1 year before	1st year	2nd year	3rd year	1st year	2nd year	3rd year	3 years
EU	43.4	49.1	53.0	54.7	13.1	8.0	12.5	39.4
China	81.0	83.8	81.3	78.4	3.4	-2.9	4.7	6.6
USA	42.4	45.7	40.8	40.0	7.8	-10.7	6.5	3.9
ASEAN	48.8	53.5	51.7	49.5	9.7	-3.4	4.3	11.4
Japan	67.6	66.8	62.2	51.9	-1.2	-6.9	-9.7	-15.5
Total	**479.7**	**530.3**	**511.0**	**479.9**	**10.5**	**-3.5**	**1.8**	**10.4**

Note: 1) 1 year before: July 2010 to June 2011, 2) 1st year: July 2011 to June 2012, 3) 2nd year: July 2012 to June 2013, 4) 3rd year: July 2013 to June 2014, 5) 3 years: change in imports from 1 year before (July 2010 to June 2011) and the 3rd year (July 2013 to June 2014).

Source: Author's calculation based on data from KITA.

2008. Indeed, the decline in exports to the EU was common among the exporting countries in Asia.

Second, the fall in exports is salient in ships and electronics, which are Korea's most important export items. For example, ship exports accounted for 28 percent of Korea's total exports to the EU in 2011. However, its export amount fell by more than 60 percent since the implementation of the FTA. Exports of cellular phones, LCDs and semi-conductors were reduced by 15-52 percent. These products are marked either by general European import market contraction, due to the economic recession, or by relocation of Korean firms to Southeast Asia in order to cut production cost. Because Korean exports to the EU are highly concentrated in these few sectors, their fall creates a more statistically important impact on change in overall exports to the EU. On the other hand, Korea's exports increased for manufacturing items—such as refined oil, automobiles, and chemical products —for which tariff cut was quite important.

Third, Korea's imports from the EU increased considerably, which had a more important impact on change in trade balance than the decrease in exports. Imports from the EU increased by almost 40 percent over three years. This figure is outstanding, given that Korea's total imports only increased by 10 percent during the same period. At the sectorial level, an increase in imports from the EU is identified over a wide range of manufacturing products, from intermediates such as crude oil and refined petrol to machinery, automobiles and luxury items. For instance Korea's import of both crude and refined oil from the EU (Brent oil) was negligible before the FTA, but its import soared and accounted for 17.2 percent of Korea's total import from the EU. Instead, imports from OPEC countries fell, which means the FTA created a trade diversion effect from Korea's main oil resource to the EU – largely the UK. Some imports from Japan in machinery and industrial equipment were replaced by European products.

Fourth, the weakening value of the euro (since mid-2011) exerted a positive influence on EU's exports in that European products are becoming cheaper outside of Europe. The reasons for the weak euro can be explained by the decline of confidence and economic recession in the Eurozone and the lowest key interest rate since the introduction of the euro in 1999. As a consequence, the trade balance of crisis-affected European countries has considerably improved and Germany recorded its largest ever trade surplus. It is expected that the euro will remain weak while the European Central Bank considers an expansionary monetary policy. This will create a favorable trade environment for European exporters.

Korea's exports to the EU turned to positive growth in the third year of the FTA, mainly due to the base effect. As European economies start getting out of the recession, it is likely that Korea's exports to the EU will increase. However, as the EU is negotiating FTAs with Japan and members of ASEAN, Korea's unique status as EU's FTA partner in East Asia will become obsolete. All the more, Korean firms' relocation will be more salient, as they try to create supply chains in developing countries. In this context, the role of the FTA in promoting export in statistic terms will meet its limit and a more comprehensive approach will be required to make full use of the FTA.

Conclusion

Conventionally, FTAs focus on reducing tariff barriers. However, the role of tariff barriers in trade has become less important, as developed countries have already lowered their tariffs on industrial goods. As more FTAs will be implemented, issues of trade negotiation have been shifting from tariff liberalization to harmonization and mutual recognition of different regulations. During the negotiation of the Korea-EU FTA, different standards between Korea and the EU were highlighted, particularly regulations on the safety certificate procedures in electric/electronics and product standards for automobiles. The FTA states that both parties set regular committees on how to reduce trade-impeding regulatory barriers. It is still hard to expect that Korea and the EU can complete a free trade framework equivalent to that of the European Economic Area where most of the trade-related regulations are highly harmonized and mutually recognized. However, as trade and investment relations between the two parties are strengthened by the FTA, there will be more pressure toward tackling non-tariff barrier issues. What we will see in the next few years will be policy efforts to coordinate business practice as well as "regulatory convergence" between Korea and the EU. This will certainly require more time and involve more stakeholders, not only government officials, but also businesses.

Technology cooperation can be another issue in the post-FTA era. For example, Korea and the EU can create and activate international technology transfer mechanisms both by public and private initiatives. Small and medium enterprises (SMEs) experience a number of hardships in the course of doing business, starting from finding technology in need, as well as financing. In some cases, it is impossible for SMEs to independently introduce, apply, and spread new technology. As institutional cooperation frames have been consolidated by the FTA and its associated arrangements, it will be more possible to promote cooperation between private firms. Trade associations can find a more important role in this regard.

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7 The Singapore-EU FTA initialed in late 2013 excludes all kinds of drawback of duties for bilateral trade between Singapore and the EU. Given that the FTA with Singapore will work as an undoubted template for more FTAs with ASEAN members, it means that the EU does not want to include the DDS in its FTAs in the future.

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130 YEARS BETWEEN KOREA AND ITALY: EVALUATION AND PROSPECT

By Oh Tae Hyun

Abstract

Last year was a special year for Korea and Italy as it marked the 130th anniversary of the Korean-Italian diplomatic relationship. Today, Korea and Italy share similar economic features including competitiveness and global companies. Their relationship has grown in the last few decades with the bilateral volume of trade between Italy and Korea exceeding $1 billion in 1987 and expanding to $8.5 billion in 2013. However, despite the growth in bilateral trade there is still room for the economic relationship to expand as the performance of investments between Korea and Italy have not been as strong as their economic size and trade volume would indicate.

Introduction

In October 2014, President Park Geun-hye visited Milan, Italy to attend the Asia-Europe Meeting (ASEM). Even though the ASEM summit was the main reason for the official visit to Italy, 2014 was a special year for Korea (or ROK, Republic of Korea) and Italy, the 130th anniversary of the Korean-Italian diplomatic relationship. Following ASEM, President Park held two official summits with Italian President Giorgio Napolitano and Prime Minister Matteo Renzi. Leaders of both countries held extensive discussions on ways to enhance bilateral substantive cooperation in expanding trade and investments, recent developments on the Korean Peninsula, and cooperation efforts on regional and international issues. After the summits, the two leaders signed a total of 17 agreements covering a wide range of areas, including the economy, culture, fashion, and IT.[1] In particular, President Park emphasized cooperative measures for creative industries, as well as for science, defense, and the arts.[2] They also declared that the Korea-EU FTA could have a positive impact on bilateral trade and reaffirmed their commitment to its full implementation.

With 130 years of diplomatic relations, both Korea and Italy have similar economic features including competitiveness and global companies. First, Korea is one of the most resilient and competitive countries in Asia and the 15th biggest economy in terms of GDP in 2013, and Italy ranks as the 9th largest economy. Second, in terms of trade, both Korea and Italy are leading trading countries despite having few natural resources. Korea is the 12th largest exporter and the 14th largest importer in the world, whereas Italy ranks 8th in exports and 7th in imports. Third, both countries have globally competitive companies, which are reflected in the *Global 500* published by Fortune. Among the world's 500 companies in 2014, both Korea and Italy have seven companies each. In terms of market values, Korean companies have $392,661 million and Italian companies have $341,058 million. And Forbes' *Global 2000* listed 52 Korean companies and 30 Italian companies among the world's 2000 leading companies in 2014. However, there are some differentiating factors between Korea and Italy. Among them, small and medium-sized enterprises (SMEs) are the main pivot of the Italian economy, which makes up 99.9 percent of its firms, 80 percent of its employment and 67 percent of its value added among the highest proportions in any OECD countries.[3]

This article will explore the 130-year diplomatic history between Korea and Italy, beginning with a focus on trade, investments, and political issues. The second section describes and suggests measures to enhance cooperation in economy, politics, and culture.

Bilateral History between Korea and Italy

Overview of Diplomatic Relations Between Korea and Italy

Official bilateral relations between Italy and Korea date back to 1884, when the Chosun Dynasty and Italy signed the *Treaty of Friendship, Commerce, and Navigation between Korea and Italy*. Substantive relations between Korea and Italy have been remarkable since the Korean War broke out in 1950. During the Korean War (1950-1953), Italy helped the Korean people by sending humanitarian aid to the field hospitals, even though Italy was not a member of United Nations and had difficulty recovering from World War II. In 1956, the two countries reestablished diplomatic relations through embassies, instead of legations. Since then, the two countries have built and maintained a high level of bilateral cooperation. In 1984, they celebrated the 100th anniversary of diplomatic relations by exchanging messages between the two countries' leaders and by holding various commemorative events. Despite their long diplomatic history, the first state visit of Korea to Italy was in 2000 by President Kim Dae-jung, and the first state visit of Italy to Korea was in 2007 by Prime Minister Romano Prodi.

Furthermore, Italy has played an important role in bringing peace and stability to the Korean Peninsula as the first G7 country to establish diplomatic ties with North Korea in 2000 after the end of the Cold War. Italy took this initiative, which was carried out in close consultation with the ROK government, to support the ROK's policy of dialogue. They reiterated that Italy and the European Union strongly support the engagement policy South Korea has adopted vis-a-vis North Korea.

Trends in Economic Relations between Korea and Italy

Key Features of Both Countries' Economies

According to *The Global Competitiveness Report 2014-2015* released by the World Bank, Korea ranks 26th and Italy's ranking is 49th. Korea has comparative strengths in the macroeconomic environment, market side and innovation compared to the average, while it shows less competitiveness on institutions, labor market efficiency, and financial market development (Figure 1). On the other hand, Italy shows competitiveness on market size only, and is less competitive on other indicators. It is estimated that without additional policies and reforms to address structural obstacles, Italy's growth may remain sluggish over the near term (Figure 2).[4]

Recent Features of the Korean Economy

For decades, Korea was a model for industrializing countries with a combination of a relatively free market, preindustrial development policies, and an outward orientation.[5] In particular, high-tech, innovative goods such as semiconductors and mobile phones, and manufactured goods like shipbuilding and vehicles, are competitive compared with other countries. During the last few decades, an export-driven economy has been the growth engine for Korea. However, the Korean economy has had difficulties with the competitiveness gap between large enterprises and small and medium enterprises (SMEs).[6] In addition, economic growth has slowed with the decline of employment, and the productivity gap has widened between manufacturing and services. To address structural challenges, President Park has emphasized the importance of the creative economy and innovation for the future of Korea.[7] In the *Three-year Plan for Economic Innovation*—with goals of 4 percent economic growth, 70 percent employment, and $40,000 per capita income—President Park highlighted tackling public sector reforms, righting ill practices rampant in our society, boosting domestic demand through promoting Korea's long-underperforming SMEs and fostering a creative economy.[8] In order to boost Korea's growth, the three-year plan suggests three strategies and nine areas of focus.

Strategy 1: Fair and efficient economy

a. Reform the public sector on the basis of efficiency

b. Reform the private sector on the basis of fair practices

c. Strengthen social safety nets

Strategy 2: Growth through innovation

a. Promote a creative economy

b. Invest in the future

c. Develop overseas markets

Strategy 3: Balance between exports and domestic consumption

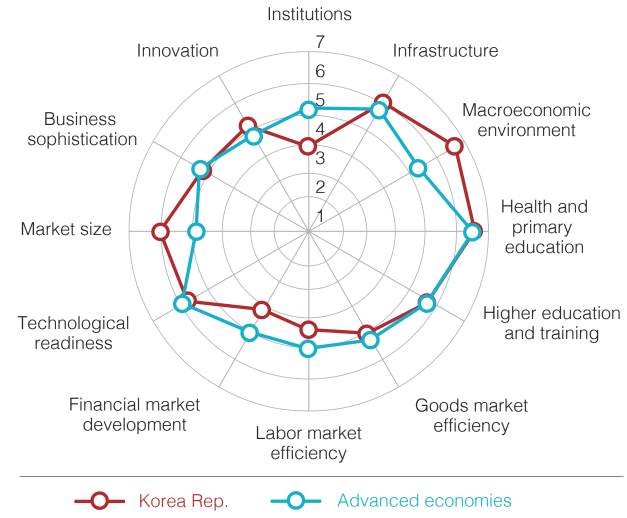
a. Boost investment

b. Stimulate domestic consumption

c. Increase female and youth employment

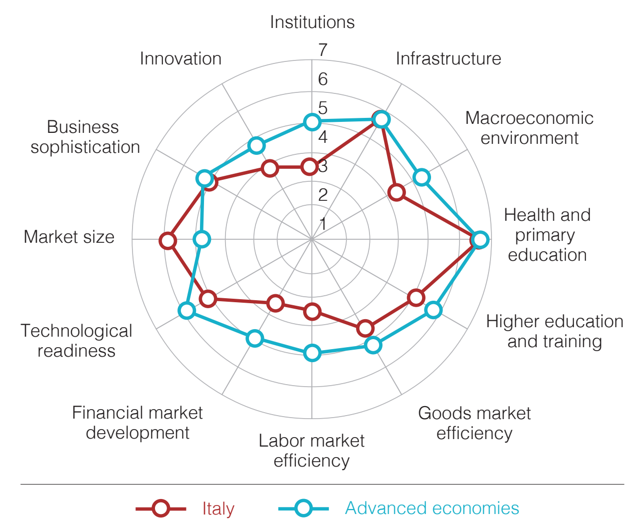
As the creative economy is one of the core pillars for implementing the *Three-year Plan for Economic Innovation*, President Park presented her vision of it at a business forum in Milan, cohosted by businessmen from Korea and Italy. In other words, bilateral cooperation between Korea and Italy could enhance the foundation of the creative economy for Korea, while also supporting the Italian economy.

Figure 1 Korea's Stage of Development



Source: World Bank (2014), p. 234.

Figure 2 Italy's Stage of Development



Source: World Bank (2014), p. 222.

Recent Features of the Italian Economy

The third largest country in the Eurozone, Italy has been well known for the competitiveness of its SMEs. In particular, there are many competitive family-based companies which have succeeded for hundreds of years. SMEs in Italy comprise 99 percent of the country's industrial forces, and

Table 1 Major Trade Goods Between Korea and Italy (2013) (Unit: $ million, MTI 4-digit)

	Exports from Korea to Italy			Imports from Italy to Korea		
	Code	Name	Value	Code	Name	Value
1	7411	Passenger car	453	5132	Leather bags	420
2	2140	Synthetic resin	385	7512	Valve	346
3	8121	Wireless phone	209	1334	Naphtha	346
4	7461	Vessel	149	2262	Pharmaceuticals	298
5	6132	Hot rolled sheet and strip	144	4412	Knit fabric garments	196
6	6133	Cold rolled steel and strip	103	7111	Prime mover	164
7	3203	Tires	80	5129	Other footwear	139
8	7420	Parts of automobile	80	6171	Casting, forged steel	120
9	7231	Machine tools for cutting metal	78	7112	Pump	108
10	4360	Knitted fabrics	53	9411	Spectacles	103
Top 10	Value	1,734 (55.8%)		Value	2,240 (41.6%)	
Total	Value	3,126 (100%)		Value	5,383 (100%)	

Source: KITA (www.kita.net, accessed 2 Dec 2014).

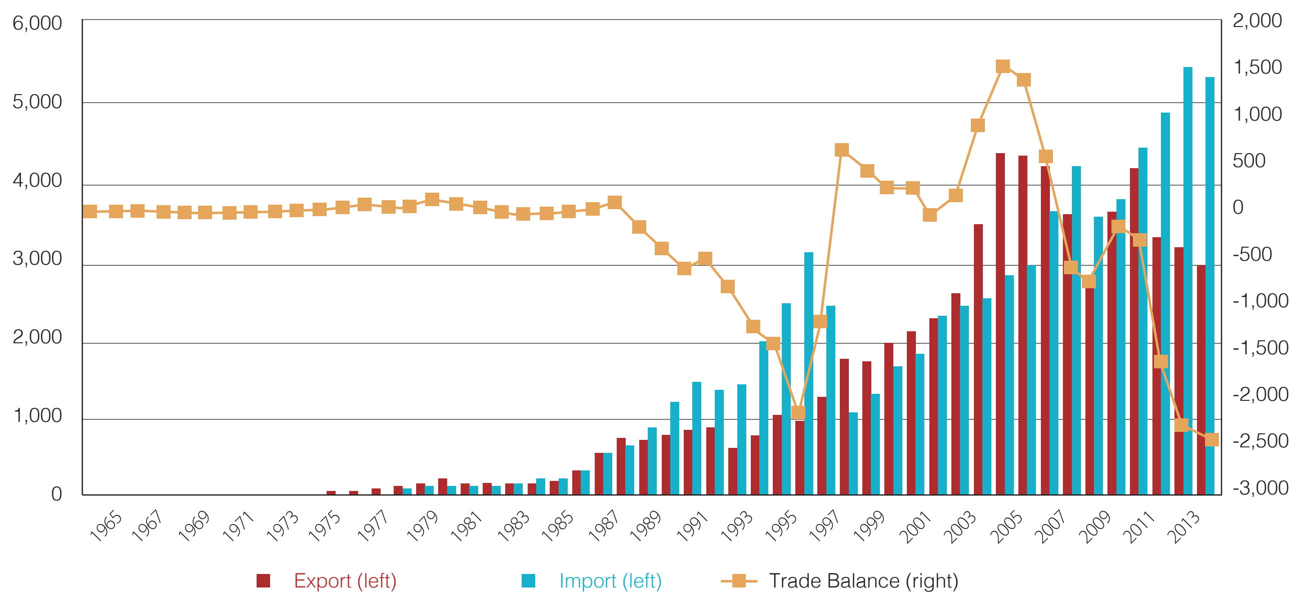
produce 65 percent of the country's exports and account for 80 percent of the country's employment.[9] Italy has remained the world's top ranking exporter in textiles, clothing, and leather goods.[10] Also, Italian competitiveness is evident in the ranking of Italian brands. According to FutureBrand Index 2014, Italy ranks 5th in the world after the United States, France, Germany, and Japan. In terms of industry sectors, Italy records a high level on Food & Beverage (2nd), Fashion (2nd), Luxury (3rd), Automotive (4th), Personal Care & Beauty (5th), and Electronic goods (10th). Korea ranks 10th in the world, with a high level only in Electronic goods (4th) and Automotive (8th).[11] The Italian economy, however, has gone through difficult times since the European sovereign crisis in 2010.[12] In particular, the Italian economy as a whole may have faced difficulties integrating and exploiting new technologies to boost performance as well as a broad range of structural and administrative issues.[13] Prime Minister Matteo Renzi wanted to stimulate growth, which is possible only if Italy's economy regains its competitiveness. Therefore, when the Italian government suggested their G20 Growth Strategies in 2014, Italy tried to deal with some reforms to address the inefficient governance system in spite of important achievements. According to the IMF, Italy has to streamline unnecessary regulations to reduce and red tape to recover their competitiveness. In fact, Italian economy has been estimated to lose its competitiveness on the global market over the last decades. The SMEs-centered economy of Italy has some challenges to deal with.

Trade and Investments between Korea and Italy

Trends in Trade Between Korea and Italy

The bilateral volume of trade between Italy and Korea exceeded about $1 billion in 1987, and amounted to $8.5 billion in 2013 (Figure 3). In 2013, Italy ranked the 31st destination of Korean exports and the 22nd of Korean imports. Among EU members, Italy is Korea's 5th largest trade partner, following Germany, Netherland, UK, and France. Bilateral trade volume between Korea and Italy remains at a low level compared to the magnitude of their total foreign trade. Korea's exports to Italy, which had been experiencing ups and downs after the global financial crisis and the European sovereign crisis, have decreased since 2011. This decrease seems to be natural given Korea's overall exports to the EU shrank by 7.3 percent in the same period. This is because major export goods from Korea to Europe are impacted by the economic situation. In contrast, Korea's imports from Italy have increased even though there was once a sharp drop in 2009. In this context, the reason why Korea's trade deficit vis-à-vis Italy has widened is that the economic recession in Italy decelerated import demand because of the European sovereign crisis and economic recession. Even though trade size could be high, it can increase to better reflect the potentialities of the two economies given the economic size of the two countries. Korea and Italy must, therefore, work to increase bilateral trade through export promotion and

Figure 3 Trade Balance Between Korea and Italy (Unit: $ million)



Source: KITA (www.kita.net, accessed 2 Dec 2014).

liberalization of the remaining hurdles. In terms of goods, major exports good from Korea to Italy are passenger cars, synthesis resin, wireless phones, vessels, and hot rolled sheet, while imports from Italy are leather bags, valves, naphtha, and pharmaceuticals (Table 1). As seen in Table 1, Korea's top 10 exports to Italy account for 55.8 percent and Korea's top 10 imports from Italy are 41.6 percent. This shows that Korea should take active measures to diversify its goods and global markets.

Trends in Foreign Direct Investment Between Korea and Italy

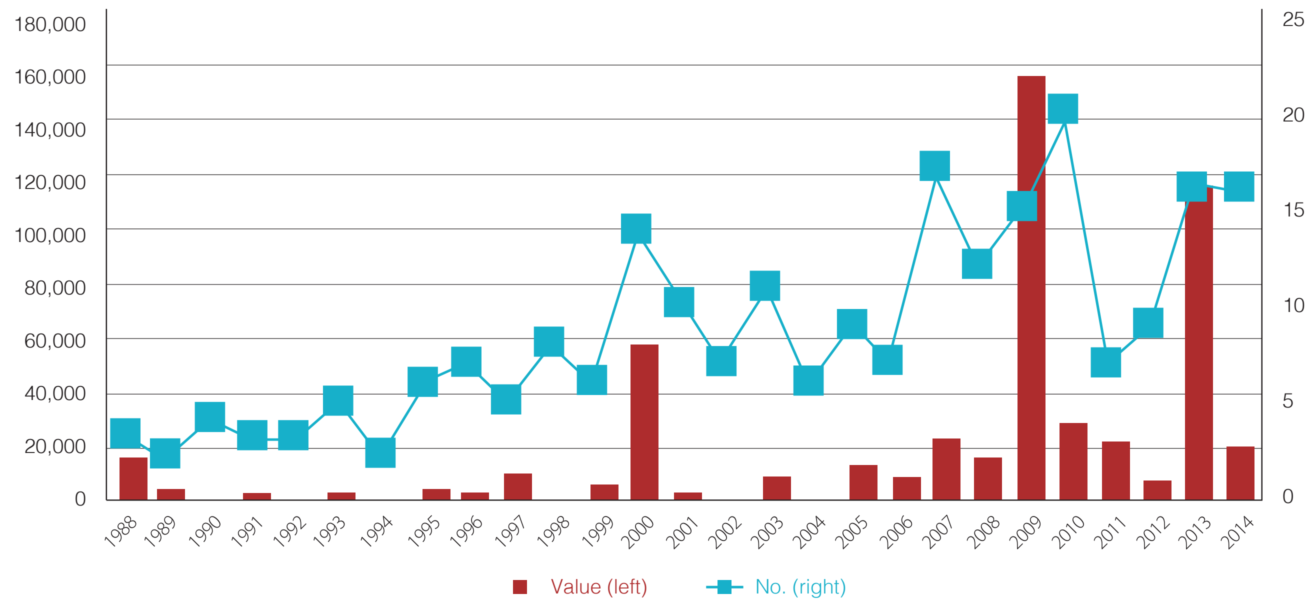
Among useful and efficient ways to increase trade is to encourage investments in both directions. However, the performances of investments between Korea and Italy have not been as strong as their economic size and trade volume. So it leaves much room for improvement. In terms of Foreign Direct Investment (FDI) inflows from Italy to Korea from 1962-2014, Italy's investment accounts for 0.2 percent ($535 million) of the total inward investments to Korea, ranking 29th in the world and 12th among the EU member countries (Figure 4). At the sector level, Italy's FDI to Korea is concentrated in the areas of accommodation and food service activities (27.9 percent) for services, and machinery and equipment (27.1 percent) for manufacturing. Trends of Italian investment to Korea have shown variations. FDI from Korea to Italy records 0.15 percent ($569 million) ratio of FDI stocks during the period of 1968-2014, which means that Italy is the 54th country for Korea's FDI (Figure 5). At the sector level, FDI outflows from Korea to Italy were mainly directed toward retail and wholesale (62.5 percent), manufacturing (16.9 percent), and financial and insurance activities (11.5 percent).

Major Cooperation Issues Between Korea and Italy for the Future

Economic Cooperation: SMEs and Creative Economy Partnership

"If the two nations could collaborate with each other's strength through industrial and technological cooperation, creative ideas could become manufactured goods targeting the global market," President Park said at a business forum in Milan on October 2014. Korea and Italy signed a series of memorandums of understanding to boost cooperation in a wide range of issues, including fashion, design, and information technology. Cooperation, competition and creativity between Italian SMEs and Korean SMEs could lead to a new era of the global market beyond domestic and regional markets. As President Park mentioned, Italian SMEs have been well known for their longevity and competitiveness based on Italian brand power. Also, Korea

Figure 4 FDI Inflows from Italy to Korea (Unit: $ thousands)



Source: MOTIE (www.motie.go.kr, accessed December 26, 2014).

has obvious strengths in manufacturing and IT technologies. According to the OECD, Korea's gross domestic expenditure on R&D as a percentage of GDP was 4.039 in 2012, the 2nd among OECD countries, while that of Italy is 1.266.[14] Therefore the combination of Italy's brand and Korea's technology can benefit companies in both countries. In addition, the automobile industry is an area where Korea and Italy can cooperate by integrating their comparative advantages on IT and automobile production. As a result of the summit, 17 agreements—covering the economy, culture, fashion, and IT—will be implemented by a high-level cooperation committee.

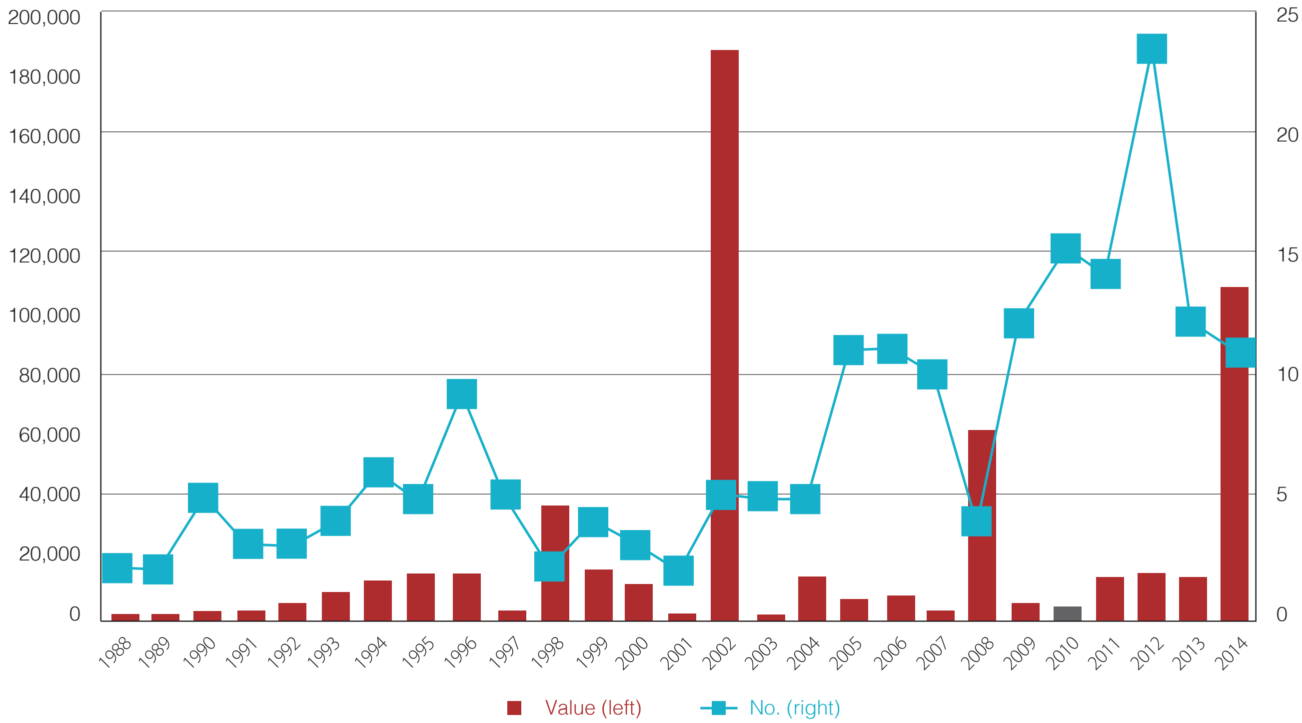
Political Cooperation

Throughout the diplomatic history of Korea and Italy, Italian high-level politicians have consistently tried to support the Korean government's policy toward North Korea. The Italian Minister of Foreign Affairs, Lamberto Dini, officially visited North Korea in March 2000. It was the first visit by a G-7 minister to Pyongyang. On that occasion, Minister Dini delivered to the North Korean authorities the clear message that "in this era of globalization, no country can develop in isolation and no one can guarantee his own security without taking care of the concerns of others. In particular, peace and security on the Korean Peninsula and in the region are fundamental concerns of the international community. Italy advocates a solution through a direct dialogue between the North and the South."[15] During the 2014 Summit of Korea and Italy, leaders of the two countries shared a vision on their political stance on North Korea and commitment to bilateral support, which will pave the path for political cooperation on the Korean Peninsula in the future. Also, Korea and Italy will cooperate on other international issues, such as UN reform and the G20 agenda, based on their shared understanding.

Cultural Cooperation

Korea and Italy signed a Cultural Agreement between the two countries to strengthen relations and mutual understanding. A positive relationship between the two countries must be based on the knowledge of their respective cultures. During the 2014 summit, the Korean Ministry of Culture, Sports and Tourism and Ministry of Italy's Heritage, Cultural Activity and Tourism shared their ideas on some measures to cooperate on preserving and restoring cultural assets, as well as on cultural and tourism exchanges and on policies to improve tourism between both countries.[16] As both countries have many of historic assets, ranging from buildings and sculptures to paintings, human resources and technologies concerning the conservation and restoration of cultural legacies are very important. Therefore more exchanges of cultural activities as well as of policies on tourism will be beneficial for the two countries as well as for the next generation.

Figure 5 FDI Outflows from Korea to Italy (Unit: $ thousands)



Source: Korea Exim Bank (www.koreaexim.go.kr, accessed December 26, 2014).

Conclusion

Korea's and Italy's economic performances have differed since the global financial crisis. The Korean economy has been more resilient and a model for other emerging countries, while Italy has undergone more reforms designed to restore competitiveness under the suggestion of the EU Commission and IMF. As we can see in the summit agenda, Korea and Italy share common interests: to penetrate the global market together through cooperation between the two countries' companies. In other words, the summit of Korea and Italy has shown win-win strategies for a constructive future. Of course, the economic relations between Korea and Italy still have a strong growth potential, which could be accelerated by bilateral investment. In 2010, Chatham House published a paper entitled, *The 'Marco Polo' Effect: Chinese FDI in Italy,* which investigated the motivations driving Chinese outward investment in Italy. The report delved into a dramatic increase of Chinese FDI to Italy, naming the situation the "Marco Polo Effect."[17] However, Korean businesses seem to focus on opening new markets rather than increasing direct investment. These business patterns raise the question of why Korean firms fail to sufficiently take into account investments in Italy since the Korea-EU FTA established the foundation for direct investment? Korean companies need to change the way they do business, and the 2014 state visit of Korea to Italy has reinvigorated economic bilateral ties, and boosted other expressions of cooperation between Korea and Italy. The 130th anniversary of relations between Korea and Italy could be the new starting point for the future.

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1 President Park and Prime Minister Renzi signed a total of 17 agreements covering a wide range of areas, including economy, culture, fashion and IT.

2 "Republic of Italy-Republic of Korea Joint Press Statement on the occasion of President Park Geun-hye's official visit to Italy." Briefing by the Office of the President, Republic of Korea (October 18, 2014).

3 *OECD Studies on SMEs and Entrepreneurship Italy: Key Issues and Policies* (OECD, 2014): p. 15.

4 *The Global Competitiveness Report 2014-2015* (World Bank, 2014).

5 *Country Profile: Republic of Korea* (Global Insight, 2014); p. 1.

6 *Article IV: Republic of Korea* (International Monetary Fund [IMF], 2014).

7 The term of "Creative Economy" means a process of creating new jobs and industries through converging science, technology, culture and industry in new ways, and by fostering the blossoming of creativity in the very borders that were once permeated by barriers. Also, the concept is usually discussed in terms of meshing existing sectors with information and communication technologies (ICT).

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[9] *Country Profile: Italy* (Global Insight, 2014).

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[11] *"Made in: The Value of Country of Origin for future brands,"* FutureBrand (2014).

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[14] *The 2014 Edition of Research and Development* (OECD, 2014).

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[16] Korean Ministry of Culture, Sports and Tourism (www.korea.net, accessed December 12, 2014).

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2014: 130 Years of Diplomatic Relations Between Korea and Italy

By Angelo Gioe

Abstract

2014 marked the 130th anniversary of diplomatic relations between Italy and Korea. This paper provides a historical overview of the relations between the two countries and gives two examples of Italian events that were organized to celebrate the special occasion.

The Treaty of Friendship Between Italy and Korea

On June 26, 1884 (the 493rd year of the Kingdom of Joseon and the 10th year of Guangxu, China), Kim Byeong-si and Ferdinando De Luca, both extraordinary plenipotentiary ministers, signed the *Treaty of Friendship, Commerce, and Navigation between Italy and Korea at Hanyang* (present day Seoul). The treaty was prepared in three languages – Chinese, Italian, and English – and accompanied by three copies of the *Regulations for the Exercise of Trade between Italy and Korea; Import Tariffs, Export Tariffs; and Regulations for Import and Export Tariffs*. On July 24, 1886, Federico Graviosa, the commander of the Italian Navy, and extraordinary envoy Seo Sang-woo exchanged ratifications at Hanyang. The relations were interrupted as a result of the Japan-Korea Treaty of 1905 (also known as the Eulsa Treaty of Japan-Korea Protectorate Treaty) following the Japanese victory over the Russians, which cancelled the diplomatic power of Korea and evacuated foreign legations.

The First Contacts Between Italy and Korea

The similarities between the two countries (Italy is located from 47 N to 36 N and Korea from 43 N to 33 N, both are peninsulas that stretch into the sea with an island in the south, and their territories are mostly mountainous) were detected by Daniello Bartoli in his book *Japan* in 1660, where Korea is defined as “a land rich and strong” and comparable to Italy in terms of climate, geography, and character of the inhabitants.

Marco Polo was the first Westerner to note the existence of Korea, known as Goryeo, but the real contribution to his knowledge comes from the Jesuits who worked in Japan during the invasion of Toyotomi Hideyoshi. Some of the Jesuits followed the Japanese commanders; for example, the Portuguese Gregorio de Cespedes sent “valuable information about Korea to the Society of Jesus.” Right around the time of this war, Francesco Carletti, a Florentine merchant and traveler, paid ransom for five Korean prisoners while he was in Japan in 1597 and released all but one in Goa. The fifth one, who had learned Italian the quickest, took the name of Antonio Corea through baptism and he and Carletti arrived in Florence in 1606. Corea spent time in Rome in 1610 and then settled in Albi where he died in 1626. This fact moved Europe, and the young man was probably the person painted in the work of Rubens entitled “Man Wearing Hanbok,” which was later sold at Sotheby’s auction house in 1983 for the then record price of £324,000.

The work of missionaries was also valid the other way around, causing widespread news about Italy. The work of Ricci, the bearer of the highest developments achieved by the Renaissance in different fields of knowledge, played an important role in Korea. Geographical maps and books of the West (i.e. *il De deo vera doctrina by Ricci*) were introduced by Yi Sung-wan and Heo Kyun between the late sixteenth and early seventeenth centuries and then until the eighteenth century by other figures such as Chusa Kim Jeong-hui, Jeong Du-won, Yi Yi-myeong, and Yi Sung-hun. This Western science (*sohak*) served the thinkers of *silhak* (practical learning), which was a real and appropriate Asian enlightenment movement before its time for its strong will to reform.

The Resumption of Diplomatic Relations

Korea resumed diplomatic relations with the outside world when it was internationally recognized as an independent government. Relations with Italy resumed in November 24, 1956, the Italian ligation was reestablished in Korea in December 1957, and it was elevated to an Embassy in 1959.

A friendly relationship with Italy was already present in 1951 during the Korean War when Italy answered the call of the International Red Cross to help the wounded. They sent the 68th Red Cross Italian hospital medical unit to the port of Busan in November 1951 and operated until January 1955. During this time they admitted 7,250 people to the hospital, treated 222,885 outpatients, conducted 3,297 operations, provided 1,155 dental benefits, conducted 8,444 pathological examinations, and took 17,115 x-rays. Their assistance won acclaim and awards from the Korean, American, and Chinese governments. The year 2014 marked the 130th anniversary of this special friendship, which was announced during the bilateral summit between South Korean President Park Geun-hye and the then Prime Minister Enrico Letta as part of the G20 summit meeting on September 5, 2013.

Economic relationships between Italy and Korea would not really take off until the late 1980s. Two-way trade between Italy and Korea did not surpass $1 billion until 1987, and reached over $8.5 billion in 2013. The trade flow structure might be surprising considering that the largest Italian export to Korea is in machinery. As for Korean exports to Italy, the most important sectors are cars, plastic, steel and electric devices. While the two countries have experienced constant growth and outstanding performance, large investment improvements could be achieved. Korea is only the 54th largest source of foreign direct investment in Italy, while Italy is the 29th largest investor in Korea.

Celebrations in the Cultural Profile

Culture, as a set of experiences shared by members of a society, lends itself to enhancing friendly relations between two countries. It not only brings people together through better knowledge of each other, but is also an essential element of personal and group identity formation helpful to draw upon to meet contemporary challenges.

Working in cultural events develops and produces ideas, books, materials, networks, practices, and experiments to engage in a possible future and disengage homologation (a present-day risk). Culture is a place of independence and a tool for independence, a space to experiment with forms of productive culture cooperation of freedom.

Italian Cultural Events in Korea in 2014

The construction of a cultural program, especially during a year of celebration, must not only attempt to showcase the best of a country's culture with as much breadth and depth as possible, but must also try and meet the frontier and consolidated state of culture of the host country.

In Korea, these cultural areas appear to be design, music, and especially contemporary art within which Koreans move with the same spirit as when they produce automobiles and electronics. The Korean art scene of the last 25 years has been rich and dynamic. For 10 years now, it has received great attention within the global art scene with a growing number of museums, galleries, biennials, and triennials interested in presenting Korean art in both the East and West.

It has been growing vigorously since the democratic transition of the country and the 1988 Olympic Games, which represented a profound change in the social and political landscape. Subsequent growth has transformed Korean society and culture in general. In order to quickly retrace the most important steps in the growth of art in Korea from the 90s to the present day, it is worth mentioning the Whitney Biennale, which was held in Seoul after New York, allowing many artists to participate in an international debate for the first time. This was followed by the opening of the Gwangju Biennale and the Korean permanent pavilion at the Venice Biennale in 1995, the Busan Biennale in 1998, the birth of many private museums (Artsonje Center, Rodin Gallery, now Plateau), and the growth of alternative spaces such as Ssamzie Space, Project Space Sarubia, Alternative Space Loop—non-commercial places which were important in the discovery of new talent. Do Ho Suh and Lee Bul, just to name two artists, well represent the internalization of Korean contemporary art and its assumption of a global reputation. Of great final interest, overseas Koreans are being presented through contemporary art projects such as *Who is Alice* and *K-eye*.

In 2014, there have been many Italian cultural events of great depth and breadth, touching various fields of knowledge from a major exhibition dedicated to Giorgio Morandi, one of jewelry created by industrial designers, and Verdi's Aida with the original set edition of Franco Zeffirelli and Lila De Nobili's 1963 production at the Teatro Alla Scala in Milan. Since contemporary art is a fundamental element which complements the image of an advanced country, I wish to draw attention to the two exhibitions of *We Have Never Been Modern and Craftsmen Designers Makers*.

We Have Never Been Modern, Contemporary Italian Art Exhibition Curated by Angelo Gioè and Maria Rosa Sossai

What is the era of modernity? Who can be called modern? What do we associate with this term when we talk about art? These are questions that the title of the exhibition, *We Have Never Been Modern*, may well prompt Korean visitors to ask themselves. Though legitimate, they envision no exhaustive or definitive answer because the modern era, as a historical and aesthetic fact, is a fluid period with no specific boundaries. Its source and the precise sea into which it flows are both unknown. It is a transitory period destined to end in the contemporary, a term that helps us to marshal the stages of industrialized western culture within a highly precarious framework but differs in presence and duration in relation to the fields of study in which it is used. Is it the *modernité* of the metropolis of which the French poet Baudelaire spoke in the second half of the nineteenth century in *Le peintre de la vie moderne*? Or was it born with the development of western rationalism and the ensuing rational organization of work and society, as Max Weber suggests? Does *modern* mark the end of the Middle Ages, as it does for European historians, or the new order born out of "what has always been," as Walter Benjamin maintains, introducing an idea that has run through the history of western philosophy?

Modernity appears to be a far more slippery idea of time than those preceding it, and this elusive quality was indeed one of the elements that led us to choose the title of the exhibition held by the Italian Institute of Culture in Seoul at the SongEun ArtSpace. Another is connected with Italy's laborious progress in the twentieth century towards an authentic modernity that has never been fully attained: perhaps because of the historical discontinuity of Fascism and its consequences; perhaps because of the rapid change in the Italian cultural and social identity during the period of economic recovery and the attendant swift adoption of the lifestyles of societies more highly evolved in terms of democracy, industrialization, and consumption.

On contacting Maria Rosa Sossai with a view to joint curate this exhibition project at the SongEun ArtSpace in Seoul, I was concerned from the outset to define the cultural aims that I had identified in this event as Director of the Italian Cultural Institute in Seoul, namely to promote Italian contemporary art in South Korea and to plan and organize a show capable of gathering together a large number of works so as to illustrate the qualitative level attained by Italian artists despite their deep diversity in form and results.

These two aims took concrete shape through an interesting process of investigation and comparison. While the selection of artists to take part in *We Have Never Been Modern* inevitably reflects the curators' tastes and values, it also unquestionably captures the vivacity of the Italian art scene, the richness of its cultural points of reference, and the recognition that Italian artists have obtained in recent years at the national and international level. Eleven of the 22 artists featured are women, and this too is a precise indication of growth in artistic sensibility in Italy and the ever-greater move away from discrimination in art criticism.

In *The Poet and Time*, a collection of essays from the period 1926–33, the Russian poet Marina Tsvetaeva wrote that the contemporary period was not the whole of her time. She added, however, that poets always come to "serve" their time, involuntarily but inevitably. They cannot do otherwise, as serving one's time means obeying an order out of desperation. We have only "this precise minute of the century" in our hands, "only this measure of weight." For those of us that have no hope of the heavenly kingdom, there is only "the earthly kingdom" and its time. Time is always moving on—as we are with it—but "going nowhere": movement for its own sake that we have divided up into names and numbers for convenience of historical definition. The century of today—the twenty-first—is juxtaposed with the century of yesterday, the twentieth. We call the time we obey today *contemporary*; we can call the time we obeyed yesterday *modern* or the *century of modernity*.

If true modernity has never been attained in Italy, the title of the exhibition in Seoul, *We Have Never Been Modern,* is closely concerned with the state of things in Italian society and art over the last few decades. It does not "serve" its time but focuses a sort of regret over abandonment of the modernity that we failed to understand thoroughly, or perhaps never really wanted.

The exhibition at the SongEun ArtSpace was divided into five stages, each of which deconstructs the idea of modernity and its perennially renewable flow, and bears a subtitle including the names of the artists who enable us with their works to address some crucial nodes of the present, not only in Italy but also at the broader international level.

The first stage, **Disinventing Modernity (Francesco Arena, Elisabetta Benassi, Rossella Biscotti, Valerio Rocco Orlando, and Alberto Tadiello)**, hooks up with the title of the exhibition but from a later vantage point. Modernity is over and it is now our task to reread it. It must be "disinvented" by reassessing spaces, objects, items, and documents of the twentieth century so as to represent them in the new iconology of an unended modernity.

The title of the second, **Plurality of Worlds (Giorgio Andreatta Calò, Piero Golia, Giulia Piscitelli, Paola Pivi and Luca Trevisani)**, again pinpoints one of the central themes of contemporaneity: the overall expansion of a "globalizing" idea of the planet that artists, though subjected to the pressure of reality, experience in the autonomy of their cultural and existential life, engendering a sort of artistic nomadism that can hardly be limited to the boundaries of a national identity.

The third presents a more complex title, **Parallel Cosmograms (Meris Angioletti, Tomaso De Luca, Chiara Fumai and Nico Vascellari)**, laden with meaning in the field of graphic and iconographic symbolism, as sort of synthesis bringing metaphysical concepts, dreamlike visions and objectual images together on parallel pathways, artistic sensibilities concentrated above all on the impact of signs on reality.

The terms brought into play in the title of the fourth thematic stage, **Politics of Nature (Ettore Favini, Margherita Moscardini, Adrian Paci and Moira Ricci)**, are conceptual spaces hard to reconcile, the former being theoretical and philosophical while the latter bears a whole range of existential meanings. This semantic gap prompts us to consider the many forking paths that art can create within the two central nuclei of being, reason, and pathos.

In the fifth and last stage, **Thinking the Present (Francesca Grilli, Adelita Husni-Bey, Marinella Senatore and Diego Tonus)**, presents the historical time in that of the creation of the work of art in direct relation to the present or to what the fleeting *hic et nunc* can draw here from the historical data of the past, a handover or a legacy capable of conferring substance and meaning.

Overall consideration of the works shown in Seoul reveals a common factor that regards not so much the exploratory spirit of the 22 artists presented as a certain effort of imaginative curiosity that relates the reality of the artistic object exhibited to a now historicized political and social reality that is never forgotten and with which links are maintained. Rather than nostalgic attachment to the past or – worse still – incapacity to interpret the present, this reflects a form of intolerance or annoyance with the anonymous flowering of *topicality*, a temporal subspecies that is severed from before and leaves no traces of itself in the after.

The "re-presentation" of modernity considers the effort of a cultural and historical phenomenon that is constantly called into question and never completely abandoned. We have never been modern because we have too much weight on our backs and modernity is an elusive era that slips from our grasp, as if a heavy boat were being hauled from the quay of the present towards the pier where it cannot dock.

Craftsmen Designers and Makers, Curated by Francesca Veronesi

This exhibition explored the relationship between craftsmen, designers, and makers – that is, design, traditional crafts, and manufacturing and the new opportunities opened up by participatory design culture, the availability of digital fabrication technologies, and creative international collaborations between designers, craftsmen, manufacturers, and digital communities. Through a combination of the creative and entrepreneurial capital of Italy, the exhibition maps the increasingly more complex forms of connectedness that are fostering new collaborations, supporting innovation, and enabling knowledge exchange between designers, craftsmen, makers, brands, and communities and provides the opportunity to discover the similar elements shared by tradition and innovation. By utilizing 3D printers, robots, crafts, and sustainable digital design, the know-how handed down from generation to generation can make a quantum leap and become a new form of work. "Makers" are those who design and manufacture goods in both shared physical and virtual spaces by using group-work methods and digital instruments. The use of digital production technologies of hardware and software as well as services based on social media and the adoption of a position of shared knowledge are other characteristics of makers, who could also be described as technological hobbyists of the twenty-first century and the bearers of the do-it-yourself (DIY) philosophy. The DIY philosophy and open design culture is enabling new forms of social agency and shared knowledge about how things are made and the possibility to manipulate, reproduce, and remix existing design. The results are sustainable methods and experimentation with new approaches to low-cost production, and a new wave of artisanal works is re-claiming the appraisal of crafts and applied research as a vehicle of knowledge preservation and driver of innovation. A maker puts into question the foundations of society by freeing himself from the role of a mere consumer and moreover taking in hand reality in order to deconstruct and reconstruct it in accordance with his own daily needs. Therefore, as crafts and digital manufacture fertilize one another, the distinction between practitioners, professionals, and amateurs is becoming increasingly blurred. The exhibition explored boundaries between open design culture, crafts, and luxury manufacturing and how intangible and informal knowledge is passed on and shared around the culture of design and making, through the democratization and distribution of tools of invention and production. It addressed a broad range of themes from international talent support schemes, open wear fabrication laboratories, educational and community driven knowledge transfer platforms, to the understanding of the role of designers as innovators, forethinkers and interpreters of the material and intangible heritage of a locale, and research-led collaborations on future textiles and material innovation. It explored the role of makers as contemporary craftsmen and current challenges and opportunities hacking the contemporary fashion industry in ways that strive to be experimental, performative, and participatory.

Conclusion

The set of events held in 2014 to celebrate the anniversary of the two nations had as its primary objective to present the foundation of the constituents of culture—such as the system of knowledge, opinions, beliefs, customs, and behaviors—that characterize Italy on a large scale. The presentation of Italian events in Korea and Korean events in Italy has strengthened mutual knowledge. To paraphrase Proust, it could be said that every cultural event is a journey into the world of others that allows you to have new eyes. Knowing how to observe what is happening in another country allows better understanding of ourselves, and broadens horizons, enabling rich, new combinations of unique experiences. Interculturalism, without a doubt, seems to be the main ingredient to eliminate racism and promote feelings of peace in a process of understanding and cooperation and the best way to celebrate friendship between two countries.

Angelo Gioe is the Director of the Italian Cultural Institute in Seoul.

130TH ANNIVERSARY OF KOREA'S ECONOMIC RELATIONS WITH RUSSIA

By Jeong Yeo-cheon

Abstract

The beginning of Korea-Russia economic relations go back 130 years, however, for most of the last century, the relationship between Korea and Russia has been curtailed due to historical events. It was not until the early 1990s that South Korea and Russia established new diplomatic ties and resumed normal economic interaction.

Over the last 20 years, South Korean and Russian economic relations have vitalized rapidly. Russia is currently South Korea's tenth trading partner, and is becoming increasingly important as an importer of automobiles and an exporter of energy resources. As large-scale direct investments of Korean companies into Russia have increased since the mid-2000s, the fields of economic cooperation between the two nations have become more diverse.

There is a strong synergy between South Korea, with its powerful manufacturing industry, and Russia, which has abundant natural resources. Another possible factor accelerating economic relations between the two nations is the Russian government's pursuit to develop the Far East, and the Korean government's goal of a tighter connection with the Eurasian continent. If North Korea's peaceful participation is made possible, the economic relations of Korea and Russia will progress even more rapidly.

Introduction

Today, many people regard the 'Friendship and Trade Agreement' between the Joseon Dynasty and the Russian Empire contracted in 1884 as the starting point of official diplomatic relations between Korea and Russia. It is not a simple task to summarize the 130-year relationship between the two nations, especially because of the enormous changes in national systems and territories that occurred in each nation during this time.

In this chapter, the author will focus on the economic relations between Korea and Russia from South Korea's current point of view. The author will first summarize a century of events, from the establishment of diplomatic ties between the Joseon Dynasty and the Russian Empire in 1884, to the early 1990s when new diplomatic relations were established. The new relations between South Korea and Russia (Russian Federation) were based on a diplomatic treaty agreed to by the Soviet Union and South Korea in 1990, which was a complete departure from the 19th century 'Friendship and Trade Agreement.' Thus, the new era of economic relations is impossible to compare with the former one. The author will then focus on the development of economic relations between South Korea and Russia from 1990 to present; the distinctions of Russia as a partner of economic relations with Korea; and the prospect of future economic relations between the two nations. Relations between North Korea and Russia will also be mentioned.

Historical Background of Korea-Russia Economic Relations

Being the only nation on the Korean Peninsula in 1884, the Joseon Dynasty's first diplomatic relationship with the Russian Empire occurred in the context of the competitive entries of Europe's imperial powers[1] into Northeast Asia. The Joseon Dynasty had few international exchanges except with China (the Ming and the Qing Dynasties) and Japan since its foundation in the late 14th century.[2] In the late 19th century, however, the Joseon Dynasty established modern diplomatic relations with Europe's imperial powers, including the Russian Empire. As shown in the title of the first diplomatic treaty, the 'Friendship and Trade Agreement,' economics were was an important issue within the amity between the Joseon Dynasty and Europe's imperial powers. Core issues included obtaining the right to exploit goldmines, construct railroads, and open harbors for international trade. However, in 1910, 20 years after establishing diplomatic ties with the West, the Joseon Dynasty was forcefully annexed by Japan and remained as a colony until Japan was defeated in World War II. During this period, it was impossible for Korea to establish any independent relations with foreign countries, including Russia.

With the end of World War II, the Cold War structure began to form and in 1948, Korea became divided into South Korea and North Korea. South Korea belonged to the so-called Western bloc, led by the United States, and pursued anti-Communism policies which disapproved of diplomatic relations and private contacts with the Communist bloc, including the Soviet Union. This status continued until the mid-1980s when the Cold War structure collapsed with the USSR operating policy of reformation internally and open-door policy externally. Therefore, South Korean-Russian economic relations essentially did not exist between 1910-1980s. In contrast, for North Korea, Russia (the Soviet Union at that time) was not only their most important partner country, but also their strongest patron and socialist advocate. The primary industrial facilities of North Korea were constructed through technical, material, and financial support from the Soviet Union. Almost half of North Korea's foreign trade in the early 1990s was with the Soviet Union,[3] which illustrates the economic importance of the Soviet Union to North Korea.

South Korea sought to improve relations with the Soviet Union from the mid-1980s, during the Soviet Union's reform and open-policy era, and established official diplomatic relations in 1990. During this time, trade between South Korea and the Soviet Union grew, culminating in a trade volume exceeding $1 billion in 1991, the last year of the Soviet Union. South Korea extended an Economic Cooperation Loan to the Soviet Union to support the expansion of trade and, as a political bonus, to form the beginning of an amiable relationship between the two nations. After a discharge of $1.47 billion, however, the loan was suspended due to the extinction of the USSR.[4]

The Progression and Present Conditions of South Korea-Russia Economic Relations

The Progression of South Korea-Russia Economic Relations during and after the 1990s

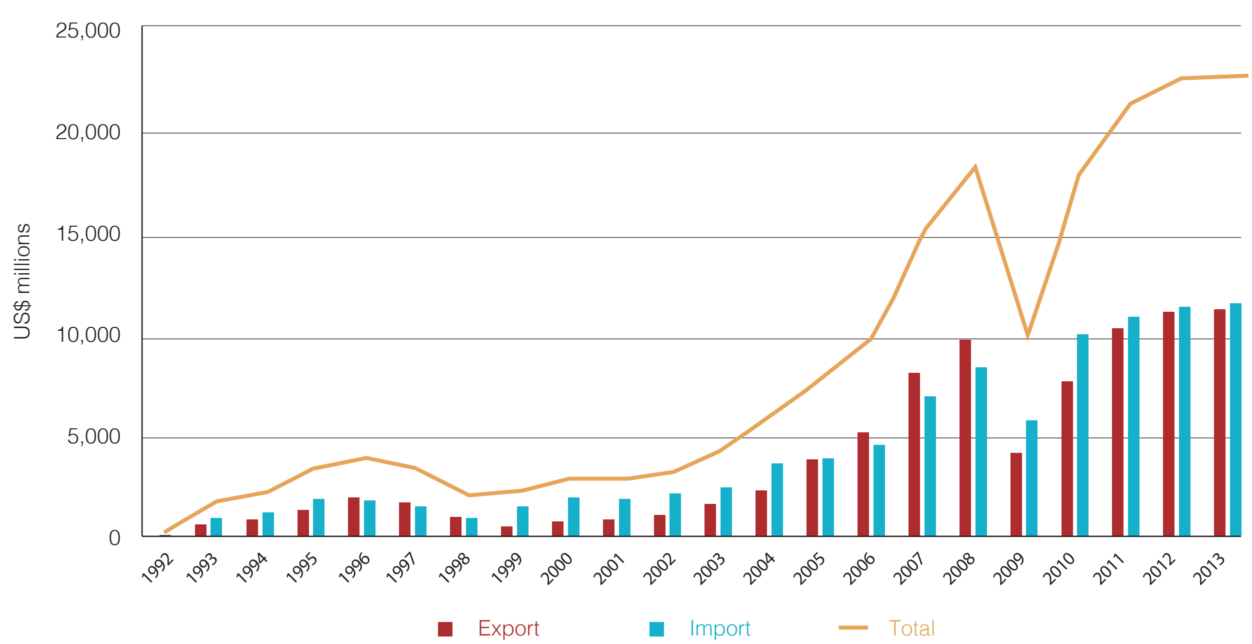
Near the end of 1991, after the extinction of the Soviet Union, all official South Korea-USSR relations became South Korea-Russia (the Russian Federation) ones. Almost 70 years of complete severance in diplomatic relations had ended and new ties were established, making it possible for people to travel freely. In the first stage, trade between South Korea and Russia expanded to $3 billion in the mid-1990s. During the first decade of Korea-Russia economic relations, trade mainly settled into Korean exports of electric home appliances (color TVs and refrigerators), and Korean imports of raw materials (steel, metal goods, and wood) from Russia. At that time, Russia had just begun opening its market, so awareness of Western products was limited, making entry of South Korean consumer goods easy. In addition, abundant and cheap Russian natural resources and raw materials found Korean sales channels relatively rapidly. As South Korea-Russia trade grew quickly in the 1990s, the early stage of their interaction, other economic relations stalled in the investigation phase. For example, even though Korean companies had made various attempts at direct investment in Russia before the treaty of amity with the USSR, it only resulted in a few small investments. This was partly caused by post-Soviet Russia's unstable social circumstances and institutional chaos after its implementation of radical reform. However, the main reason was the lack of information and knowledge that South Korean companies had about Russia's domestic market and the Russian people, which made it difficult to carry out bold investments. After the establishment of formal diplomatic ties, the governments of the two countries signed an agreement related to customs and reciprocal protection of investments to prepare a systematic ground for activating interactive economic relations, and directly led discussions about economic cooperation projects in terms of national policy. Plans for building exclusive industrial complexes for South Korean companies in the Russian Far East, and setting a joint project on the development of natural gas field in East Siberia's Sakha Republic,[5] were discussed, but none of them came to fruition at that time.

Economic exchanges between South Korea and Russia grew constantly from the early 1990s, apart from sharp dips due to the economic crises originating in Korea (1997) and Russia (1998). However, in the 2000s, economic relations between the two countries started to enter a full-blown growth stage, as Russia's economic situation took a favorable turn and entered a long-term booming stage. The trade volume between South Korea and Russia exceeded $10 billion in 2007 and $20 billion in 2011.

During the 2000s, traded products between the two countries also changed significantly. Korean automobile machinery exports to Russia increased drastically to over 60 percent of entire exports in the late 2000s.[6] Russia's export items to Korea also changed. In the late 1990s, Sakhalin Island began exporting crude oil and crude oil processed products, which became Russia's principal trade items. In the stabilization of society and economic prosperity during the Putin administration (2000), direct investments of South Korean companies in Russia also started to increase. In particular, after the mid-2000s, South Korean companies carried out investments that built large-scale hotels and manufacturing plants for automobiles and electronic products, so that Korean direct investments to Russia exceeded $2 billion.

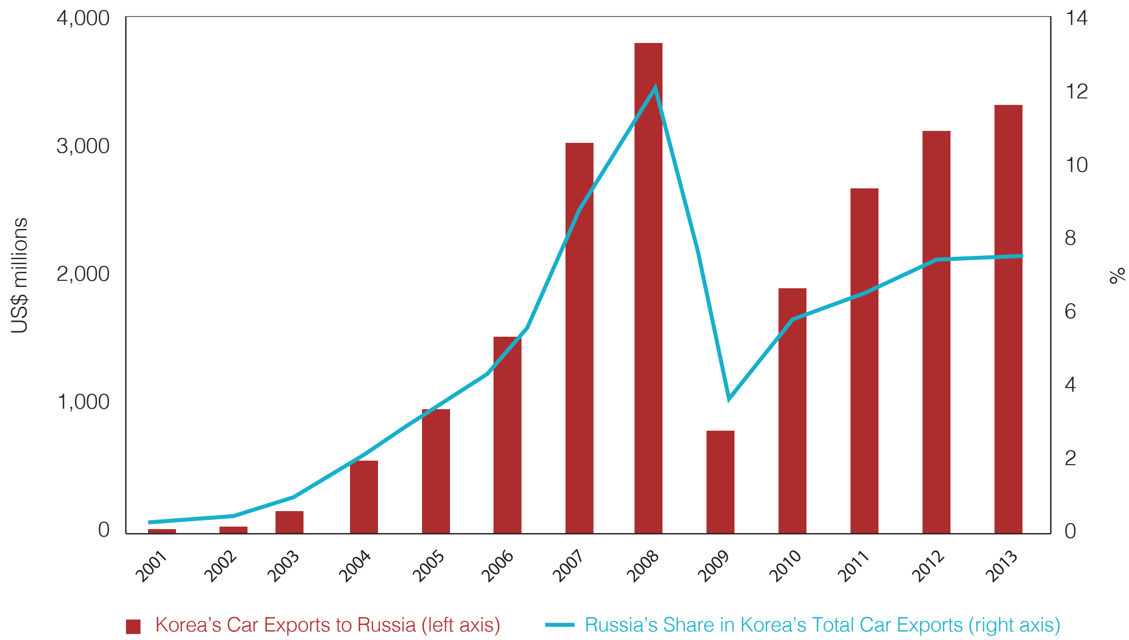
Entering the 2000s, South Korea-Russia interaction increased and economic relations diversified. The combination of Korea's capital, technology, and business know-how with Russia's production achieved remarkable successes in several fields. In this period, the Korean and Russian governments discussed linking the Trans-Siberian Railroad (TSR) and the

Figure 1 Annual Changes of Korea's Export to and Import from Russia (1992-2013)



Source: Korea International Trade Association, Trade Statistics, http://stat.kita.net/stat/kts/ctr/CtrTotalImpExpDetailPopup.screen.

Figure 2 Growth of Korea's Car Exports to Russia in 2000s



Source: Korea International Trade Association, Trade Statistics: http://stat.kita.net/stat/kts/pum/PumCtrImpExpList.screen.

Trans-Korean Railroad (TKR), making natural gas pipelines traversing from the Russian Far East to the Korean Peninsula. Although both projects failed due to lack of cooperation with North Korea, they still hold an important position in the current list of South Korea-Russia economic cooperation. Farming was a new form of investment in Russia tried by South Korean private enterprises during this time. In the mid-2000s, when crop prices throughout the world were on the rise, several South Korean companies leased and managed large-scale farms in the Russian Far East. In addition, the Russians collaborated with the South Koreans to develop a satellite rocket for the first time in South Korea, demonstrating the diversity of their economic relations. This project, started in 2004 from the agreement between the two governments and processed by South Korean and Russian research institutes, paid off in early 2013 with a successful satellite launch in South Korea.

The Position and Distinctions of Russia as a Partner of Economic Relations with South Korea

Economic relations between South Korea and Russia have expanded enormously in many fields during the 20 years following the establishment of diplomatic ties after their 70-year hiatus. Consequently, Russia's status as a partner of economic relations with South Korea has risen significantly. Today, Russia is ranked tenth of South Korea's trading partners, contributing 2.3 percent of the entire trade volume of South Korea. As South Korea's automobile business rapidly grew in the Russian market during the 2000s, Russia became the second import destination of South Korean cars, just behind the United States.

Today, crude oil makes up 40 percent of South Korea's imports from Russia. As a result, Russian crude oil's portion of total crude oil imports in South Korea expanded to approximately five percent. As South Korea began importing liquefied natural gas (LNG) from Russia in 2009, South Korean dependency on Russian energy resources became even higher. For the last 20 years, the trade volume between South Korea and Russia has been balanced in general, and recently, imports of Russian products to South Korea have been marginally higher than exports from South Korea to Russia.

Until recently, the accumulated amount of direct investment of South Korean companies in Russia, over $2 billion, had been less than one percent of South Korea's entire overseas direct investment. Considering this figure, investment relations had not been as active as trade relations during this same time period. It was after the mid-2000s when direct investments of South Korean companies in Russia rapidly increased, although this was not strictly a Korean phenomenon since

Russia was becoming a global host country.[8] While other countries concentrated on investing in material resources in Russia, South Korean companies invested in local production and the sale of processed goods, including automobiles. The fact that investment relations between the two countries still consist mainly of South Korea's investments in Russia,[9] but not Russia's in Korea, confirms that South Korea-Russia investment relations are not yet active. Even though Russia has become one of the most primary overseas direct investment candidates in the world, its investments are still biased mainly in the former Soviet countries and regions of Europe. Only recently has Russia begun investing in Asian countries such as China and Vietnam, and is expected to increase direct investments in Korea in the future.

Today, there are various discussions underway about economic cooperation projects between South Korea and Russia which are not yet developed enough to be specific investment projects. For instance, the two countries have discussed plans to jointly develop and utilize underground resources such as oil, natural gas, and coal; develop agriculture in the Russian Far East; acquire fishery resources; and process forest products. Along with discussions about railway cooperation centered on the Trans-Korean Railway-Trans-Siberian Railway (TKR-TSR) linkage project, the construction of harbors, expressways, powerhouses, and massive mining facilities are also on the South Korea-Russia collaborative business plan. In addition, there has long been discussion about joint construction of a transmission network for exchanging mutual surplus electricity. There are already successful cases of businesses that produce new products which combine Russia's advanced scientific technology and Korea's commercialization techniques. Although the financial costs and benefits of these mutual projects in process are difficult to assess, their very existence highlights the diversity, distinctiveness, and significance of economic relations between South Korea and Russia.

Prospect of Korea-Russia Economic Relations

Considering that South Korea and Russia's current interactive history is only about two decades, it is not hard to forecast that the future will bring more contact between the two countries.[10] Most scholars and commentators agree that their current economic relationship has barely reached its potential. For example, a recent study evaluated that South Korea-Russia trade in the 2000s was only 40-50 percent of a generally expected size based on the economic conditions of the two countries. Since economic relations occur primarily through the interaction of people, economic relations will escalate as experience and knowledge of not only the economy, but also of culture, language, and customs, intensify between both countries. In this regard, the visa-waiver agreement of short-term visitors between South Korea and Russia, which went into effect in early 2014, seems to boost the visit and interaction of citizens and, therefore, the economic relations of the two nations.[11]

South Korea's manufacturing-centered economic structure with absolute scarcity in natural resources and Russia's abundance in natural resources together with her big market provide the basic rationale for a positive forecast of economic relations between the two countries. Another positive element leading to a more profound relationship is the friendliness between the two governments' external economic policies. The South Korean government has been taking a huge interest in Russia's rich natural resources, large market size, and the potential of developing railways and marine transportation networks through the Russian Far East, which is directly connected to the Korean Peninsula and regarded as a crucial platform for Korea to establish a new international transportation system for future imports and exports. That is why the Eurasia Initiative policy of the present South Korean government includes cooperation with Russia. The Putin administration started long before to modify Europe-leaning economic relations and began expanding economic relations with the Asia-Pacific region. The 2012 foundation of the Federal Ministry of the Development of the Far East shows the Putin administration's interest in the economic developments of the Russian Far East and East Siberia as its national project. It appears that the basic aim of international economic policies between South Korea and Russia will remain into the future, and will serve as a key engine for intensifying these economic relations.

To forecast future economic relations between South Korea and Russia, North Korea should be mentioned as an important element and special consideration. For the past 20 years, North Korea has not put any substantial influence on the economic relations between South Korea and Russia. Nonetheless, there have continuously been suggestions of economic cooperation projects between South Korea and Russia which involve—or utilize—North Korea. Quite a few of them were actually attempted, although they did not result in any projects. The chief arguments were to use North Korea's geographical location in the middle of South Korea and the Russian Far East, to apply the long-standing friendly political and diplomatic relationship between North Korea and Russia, or to make use of the special relationship between South Korea and North Korea. Connecting TSR-TKR railroads or constructing pipelines between the Russian Far East and South Korea, as mentioned, are the representative examples of suggested cooperation projects of this kind. Other suggestions included business plans (such as building a transmission network from Russia to the Korean Peninsula), using North Korean workers for South Korea-Russia common development projects in the Russian Far East, and South Korea and Russia's collaborative project for regional development in North Korea. These plans, the so-called 'trilateral economic cooperation between South and North Korea and Russia,' would not only establish infrastructure to propel long-term economic progression using beneficial geographical conditions, but also bolster communication and cooperation between South Korea and North Korea which would have political and security significance by stabilizing the Korean Peninsula. Whichever meaning it takes, the realization of trilateral cooperation is expected to strengthen economic relations between Korea—the whole peninsula including the South and North in this case—and Russia.

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[1] The United States also can be regarded as one of them.

[2] Historical records show that the Joseon Dynasty had official foreign relations with other countries besides China or Japan, such as some tribal countries of Manchuria and the Ryukyu Kingdom (today's Okinawa, a part of Japanese territory). However, this kind of exchange occurred rarely, and even so, was terminated when they were incorporated as parts of China and Japan.

[3] On the other hand, the share of China rarely went beyond 20 percent in North Korea's foreign trade until early 1990s, right before the collapse of the Soviet Union. See Jeong, Yeo-cheon, *Changes and Prospects of Russia's Economic Cooperation with North Korea*, Northern Economic Studies, Vol. 7, pp. 135-152, published by Association of Northern Economic Studies, Seoul, 1996, p. 145. (in Korean)

[4] 'Economic Cooperation Loan' was contracted in early 1991 through an agreement between Seoul and Moscow. It was originally planned as $3 billion.

[5] Sakha Republic is one of the states of the Russian Federation, formerly called Yakutsiya during the USSR days and is famous for its coal and diamond fields.

[6] Visual equipment such as color TVs occupied 30-40 percent of Korea's export products to Russia during the 1990s, but it declined to around 2 percent in the late 2000s.

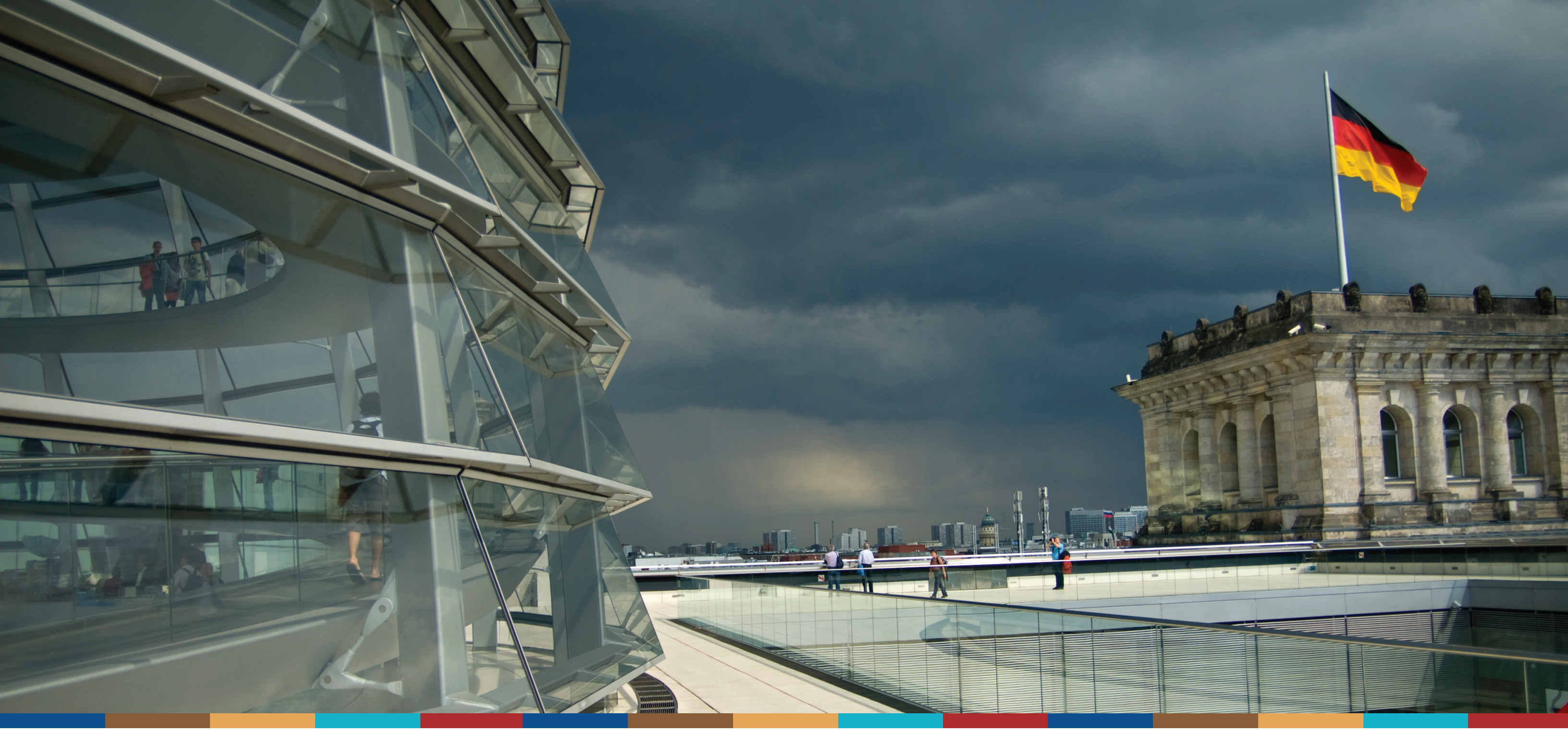
[7] According to official statistics, the trade volume between South Korea and Russia in 2013 is recorded as about $22.6 billion, which is equivalent to about 22 percent of trade volume between South Korea and the U.S. (about $103.5 billion).

[8] In 2006, Russia overtook China as the inflow volume of foreign direct investment (FDI) per capita. D. Tarr/N. Vlochkova, *Russian Trade and Foreign Direct Investment Policy at the Crossroads*, Policy Research Working Paper 5255, The World Bank, p.15.

[9] The accumulated amount of direct investments carried out by Russia in South Korea until recent is not even $100 million.

[10] Jeong, Yeo-cheon, et. al., Korea-Russia Economic Cooperation in the Era of Strategic Partnership, Korea Institute for International Economic Policy, 2010 (Mimeo., in Korean).

[11] See Jeong, Yeo-cheon, Park, Sun-chan, Kang, Bu-gyun, *Economic Impact and Application Plan of the Visa-Free Regime between South Korea and Russian*, Korea Institute for International Economic Policy, Policy References 2013-09 (in Korean).



NORTH KOREA

THE COSTS OF KOREAN UNIFICATION: REALISTIC LESSONS FROM THE GERMAN CASE

By Rudiger Frank

Abstract

German unification is often used as a preview on what is going to happen in Korea. Such a position is rejected in this article. Not only have the costs of German unification been grossly overestimated or misinterpreted, the costs in the Korean case will in many areas be lower than in Germany, and the benefits of unification will be much bigger, which further decreases the net costs. South Korea will, however, experience problems of a structural nature that have not occurred in Germany. The potential role of external partners for shouldering the costs of unification should also not be underestimated in the Korean case, although it will come at a political price. Finally, a highly speculative but not completely unrealistic scenario of unification is briefly presented that would incur almost no unification costs at all.

Introduction

Ever since Germany's unification in 1990, Koreans, mostly from south of the 38th parallel, have been studying that case in the hope to find lessons for their own future. Not only did such comparisons often rest on a shaky methodological foundation,[1] the results, too, were sobering. Most if not all concerned academics, politicians and journalists in the Republic of Korea (ROK, or South Korea) agree that despite the usually undisputed desirability of unification, this process will cost their country huge amounts of money and should thus be approached carefully.

Opinion survey in South Korea seems to confirm this atmosphere of growing skepticism. The number of supporters for a Korean unification dropped from around 64 percent in 2007 to less than 55 percent in 2013. In the same time period, the number of opponents rose from about 15 to 24 percent. For supporters, economic aspects do not seem to play a crucial role; among the reasons why a unification was seen as potentially beneficial, over 40 percent expressed nationalist considerations and 31 percent saw unification as a way to prevent a second Korean War.[2]

Economic fears are not off the mark. The country is sandwiched between a technological leader in Japan with whom it wants to catch up, and a rising China that is breathing down the neck of companies like Samsung or Hyundai on whom the destiny of Korea's economy depends to a large degree. In such an environment, a unification-induced recession, even if it lasts for just a few years and is followed by a strong rebound, could turn out to be a strategic disaster. As a result, unification is commonly welcomed in principle, but usually in combination with warnings that it should happen gradually and slowly.

Such demands for caution are highly justified, but perhaps for the wrong reasons and based on incorrect assumptions. South Korea should not be too worried about gigantic South-North monetary transfers; the real danger lurks elsewhere.

The purpose of this essay is threefold: It will be shown that the data on the costs of German unification need to be understood properly in order not to draw the wrong conclusions; that Korean unification costs will be very different in nature compared to Germany; and that external factors will under certain circumstances turn out to have an impact on the economic and financial side of Korean unification, something that has happened only to a very minor degree in Germany.

Real German Unification Costs Were Not Nearly as High as is Often Assumed

It does not need much explanation to see that the merger of two countries will in all likeliness not come for free. This is even more so when we consider the huge economic gap between South and North Korea (Democratic People's Republic of Korea, or DPRK). Comparative statistics on that issue seem to be a favorite field of research for South Korean scholars. Data are easily available from a wide range of institutions such as the Bank of Korea, the Ministry of Unification and private think tanks. One example is Lee Bu-hyoung at the Hyundai Research Institute who dramatically explains that North Korea is no less than 40 years behind South Korea in terms of economic development.[3] Numbers for nominal GDP per capita in 2013 are $854 in the North versus $23,838 in the South. While the expressiveness of the GDP as such, as well as the reliability of estimates on North Korea's macroeconomic data can be disputed, hardly anyone would disagree that the gap is huge and thus the costs of catching up quickly will be enormous.

The German example is often cited as proof of such an assessment, but perhaps supporters of the above argument need to look for better evidence.

Transfers from West Germany to East Germany (German Democratic Republic, or GDR) between 1990 and 2005 in the context of the so-called "Solidarpakt I" amounted to about 1.4 trillion Deutschmarks, or 700 billion Euros.[4] This is an impressive amount, but how much of it was "lost" in the sense of a unilateral, unidirectional transfer that ended up in the East? Not much, if we take a closer look.

Huge sums went into infrastructure development such as the renovation or installation of telecommunications lines or the rehabilitation of highways. But when driving past the construction sites, there were adverts by companies such as Hochtief, Zueblin, Max Boegl, Heilit und Woerner, Bilfinger und Berger, Teerbau, Phillip Holzmann and others. These were, except Strabag from Austria, West German companies, for whom the "Eastern Reconstruction"[5] meant nothing less but an unprecedented expansion in demand. Most of the money, except for wages paid to local workers, went promptly back to West Germany where they had their head offices and their employees, and where they paid their taxes.

Much was invested into building modern state institutions in East Germany, such as fiscal authorities, police, federal and provincial governments, and so forth. But even as of 2014, very often West German dialects are heard when executives and top bureaucrats appear on TV. Kurt Biedenkopf as the long-time leader of the federal state of Saxony is just one prominent example out of many. While at the lower levels of the administration, East Germans were hired, the number of West Germans in higher levels was considerable, especially in the first years after unification.[6] In other words, the transfers to the East in the form of wages and other funds for institution-building went straight back to West Germany, too.

A key component of unification-related transfers were social benefits for health insurance, pension and unemployment benefits.[7] Those went straight to the East Germans. So far, so good, but what did they do with this money? Economists know that the rate of so-called autonomous consumption, that is, the percentage of their income that people spend more or less necessarily on food, housing and clothes, is particularly high in the lowest income brackets. Receivers of social benefits are by definition among the poorest; they thus spend most of their income immediately. But on what did they spend it in post-1990 East Germany? Private possession of apartment buildings was uncommon in that formerly state-owned socialist economy. After 1990, investors with the appropriate understanding of the market were able to acquire apartment buildings from the "Treuhand"[8] or the communes. Most of these investors inevitably came from West Germany, because hardly anybody in the East had accumulated the necessary resources or was risk-taking enough to buy on credit. Therefore, when receivers of social benefits paid their rent, the money usually went west.

The same is true for food. After 1990, even locally produced staple food temporarily disappeared from the supermarkets in East Germany; people were unwilling to spend the only recently acquired hard Deutschmark for products that they had previously bought for their own unpopular currency. Needless to say that the supermarket chains like Kaiser's, Spar, Aldi, Lidl were all West German. They had taken over the former East German food store chains Konsum and HO. Thus, money spent on foodstuff went to the West as well.

This exercise can be repeated for textiles, consumer electronics and of course the German's favorite – cars. Mercedes, BMW, Audi, VW and Opel quickly replaced the East German Trabant and Wartburg. Even Japanese, French and Italian cars were imported through dealers located in West Germany.

Last but not least, receivers of direct and indirect transfers were taxed. Income tax on wages and value added tax on consumption (between seven and 16 percent) flowed straight back into the unified German federal budget.

If seem from this perspective, German unification and the massive transfers that resulted from it were nothing less but a gigantic economic stimulus package for the West German economy. They secured employment in the West and increased incomes there. At this point, it is necessary to emphasize that the transfers were very welcome in the East and are still seen there by many with a sense of deep appreciation. Occasional accusations of colonization are as incorrect as they are unfair. However, it is important to understand that a large proportion of the transfers was not unilateral, but circular. In fact, if such a scheme would be repeated today, Brussels would very likely intervene out of concerns of an inappropriate subsidy for the West German industry. Back in the years after 1990, however, the extraordinary circumstances of German unification seem to have justified almost anything.

From that perspective, South Korea's industry should be looking forward to a unification. Provided that things work the same way as they did in Germany, unification will result in a massive business activity support program for South Korean companies. This is at least what those analysts should believe who expect a Korean unification to proceed along the German lines. It is very unlikely that this will be the case, however; but more on that later.

The above argument – that most of the transfers in reality flowed back to where they came from – needs to be supplemented by a consideration of the actual necessity of such transfers. It is hard to dispute the fact that North Korea's infrastructure is in dire need of expansion and rehabilitation. But the expectation of massive flows of funds for social security spending is less realistic. In the years 1990 to 2014, not less than 60 to 65 percent of all German transfers were made for social benefits, and among them, pensions took the lions share[9]. In 2012, about 30 percent of the German state budget was spent on pensions.[10] But the situation in South Korea is very different. In 2014, the state spent 0.26 percent of its budget on pensions who received a maximum of $83 per month.[11] The real situation is of course more complex, as many South Koreans receive a pension from their former employers or from private insurance companies. But regarding the state's expenses, we cannot avoid noting that the level of social security in South Korea, which would become the standard in case of a sudden German-style unification, is worlds apart from the West German standard that was to be installed in East Germany.

Korean Unification Costs will be Different in Nature

This leads us to the question of unification costs in Korea. The National Assembly Budget Office (2015) estimates that the total unification cost for the 45 years from 2016 to 2060 will amount to 10,428 trillion won at current prices (about $9.2 trillion).[12]

It is not just that the German transfers are overstated; there are many reasons to believe that the actual costs in the Korean case will be lower. Social security is just one example. The crucial yardstick here is the South Korean standard – and knowledge thereof as well as promises made by politicians. We should not forget that East Germans had for decades lived with regular, that is, daily, consummation of West German TV and radio. This included more or less subtle propagandistic messages to the effect how plentiful life was in the West, and how similar the standard of living of the East Germans would become if they only got rid of Soviet occupation and Communist oppression and joined their brothers and sisters to the West. Such general propaganda was supplemented and supported by many individual experiences, be it the jealous observation of thousands of West German cars on East German highways, the frequent visits by West German relatives, the millions of parcels that were sent East for Christmas and other holidays, or the infamous hard currency stores "Intershop".

After the peaceful revolution of 1989, West German politicians intensified their campaign to appeal to the materialistic desires of East Germans. The formula, most prominently spread by Chancellor Helmut Kohl and his Christian Democrats, was simple: If East Germans wanted exotic fruits, fashionable brand clothes, high-quality cars and travel to tropical islands, they needed the hard Deutschmark. The only way to get it was fast unification. This won the Christian Democrats the March 1990 election in East Germany. The promised currency conversion came in July, even a few months before formal unification in October 1990, and at an economically unrealistic, but politically inevitable rate of 1:1 or 1:2 for most funds.

This is not the place to debate the justification of that decision. What is more important is to understand how deliberately inflated and fanned East German expectations became a push factor to guide economic policy decisions related to German unification. So far, it is fair to say that North Koreans do not have the same high expectations, despite DVDs and USB sticks with South Korean soap operas that find their way via the semi-permeable Chinese border. As long as this stays that way, Korean politicians will be faced with much less costly pressure to elevate the standard of living in North Korea instantly up to the actual or imaginary South Korean standard.

Another point regarding costs is that net costs matter, that is, the difference between costs and benefits of unification. The much-criticized trust agency Treuhand finalized the privatization of East Germany's state owned assets with a deficit.[13] East Germany was the richest country of the socialist camp – if it was worth so little on the flea market, what could reasonably be expected from North Korea? The fact that the material value of East Germany turned out to be so low, if not to say negative, after unification should perhaps be seen as an anomaly rather than normality. In the Korean case, the benefits of unification will not only be of ideational value.

One important reason to think so is the fact that the painful adjustment of foreign trade to a rapidly and profoundly changing environment, which happened in parallel to German unification, has already been completed by North Korea. The effects of a conversion of foreign trade from preferential barter trade agreements with partners susceptible to political blackmail, to regular trade relations in hard currency and at world market prices are known as the "arduous march" or the great famine of the mid-1990s. But as dreadful as it was, this transition has been completed and will not have to be repeated in case of Korean unification. North Korea's trade will survive a systemic change because it is already being conducted according to the rules of the game in a market economy. If we consider that the wave of bankruptcies of East German companies after unification, along with an exploding unemployment rate and the resulting need for social security transfers, had not only to do with the chronic inefficiency of socialist enterprises, but also with the sudden vaporization of their foreign trade connections, then there is room for optimism that the unification-induced economic downturn in Korea will be less severe.

Regarding assets that North Korea will add to the then joint Korean household, the prospects are also much better than in Germany. While most of North Korea's production facilities might indeed turn out to be a liability, there are also strengths that East Germany did not have. One of them concerns mineral resources. East Germany had very little except potassium salt and lignite, demand for which was low in 1990 although it seems to have recovered somewhat as of 2014. But North Korea promises to be a treasure chest in this regard, if we can believe reports like those by Edward Yoon.[14] If South Korean capital and know-how could be used to extract, process and export gold, anthracite, magnetite, zinc, rare earths and other resources, then this could create an economic boom of sorts. The fact that resource-hungry China is an immediate neighbor would only magnify the effects. And by the way: What more could an export-oriented economy like that of South Korea wish for but, unlike for example Japan, to have 1,400 kilometers of land border with the biggest and most dynamic market of the world?

The above is an optimistic scenario, but it is not completely unrealistic. However, there is also a fly in the ointment. In addition to the fact that China, and very soon perhaps also Japan, has already begun to uncover that North Korean treasure while South Korea is watching helplessly and increasingly frustrated, there is also the specter of structural change looming over the heads of South Koreans.

Much to the disappointment of East Germans, not many sizeable West German enterprises relocated to the East after 1990. Frankly, why should they have done so? Wages had very quickly risen to a level that made relocation less attractive from the perspective of lowering labor costs. Taxes were more or less the same. Importantly, there were no locational advantages that would induce a massive migration of employers from West to East Germany. The South Korean National Assembly Budget Office (2015) seems to expect a similar development in Korea. It argues that Korean unification will "re-energize" the currently sluggish economy of South Korea, especially because development projects in North Korea are hoped to increase demand, thus leading to large-scale corporate investments and substantial job creation in the South. However, a major precondition for this would be to keep the North under separate economic management, which at least in the German case turned out to be politically unrealistic.

There are more reasons to be skeptical about such scenarios. A look at the industrial structure of Korea before 1945 is an indicator for how a "natural" distribution of industries along the peninsula would look like: agriculture and light industry in the South, heavy industry and electricity in the North. And that was when China had not yet been the economic jackpot that it is today. After Korean unification, industry will move. It will go to where the natural resources are, where electricity from hydropower is produced, and it will move as close as it can to its biggest market. In 2004, China has become South Koreas biggest export market and currently receives about 25 percent of South Korean exports, and still growing.[15]

If South Korea has a reason to be afraid of unification, then not because of its huge costs, but because of a massive structural change that will result in a dramatic loss of jobs and tax income in the South. This points to the fact that the costs and the benefits of Korean unification will not be distributed equally among all Koreans. As shown above, in Germany taxpayer's money was used to fund projects that created immediate revenue for a number of companies in the construction and retail sector. Another asymmetry will emerge in the distribution of transfers over time. In the German example, the logic of politics, and the logic of economics all suggest that spending will be particularly significant during the first years after unification. Unless this can be cushioned by a unification fund or external transfers, it will put a major short-term strain on fiscal resources and thus on society, despite that fact that in the long run of 45 years, the benefits of Korean unification are estimated to exceed its costs by a whopping three times.[16]

The Neighbors Might be Willing to Pay – at a Political Price

Last but not least, we should consider that a Korean unification will hardly take place in a foreign policy vacuum. It makes little sense to speculate about the actual attitudes of China, Japan, Russia and the United States regarding unification as long as we do not know when, and under what conditions, Korea's unification will take place. However, given the experience of South Korea after the normalization treaty with Japan in 1965 and considering the infrastructure projects currently being pursued by China and Russia in the northwest and northeast of the peninsula, it is fair to expect that those countries will be willing to invest into the building and rehabilitation of roads, railroads, harbors, pipelines, telecommunications facilities and even large-scale industries.

South Korea, mindful of the colonial past, has traditionally been skeptical regarding Foreign Direct Investment and rather opted for loans to finance its economic development.[17] But that was then, with the U.S. as a potent ally who was willing to go very far, and to bend the rules really strongly, in the context of the Cold War. While the latter might be coming back in its 2.0 version, it is unlikely that a unified Korea will again have so much leverage over an economic giant. And even though North Korea is supposedly even more xenophobic, nationalistic and self-reliant, reality is very different. Just think about the alarming trade dependency on China of 89 percent in 2013.[18]

Whether Koreans like it or not, if a unified Korea finds itself in a financially tense situation, offers of investment by the neighbors will have to be accepted. Because one lesson that can be learned not just from Germany, but also from other transformation economies in Europe, is that speed matters. As long as the necessary infrastructure is missing, economic development will not take place, and economic problems will accumulate, turn into social problems, and have political consequences.

That said, economic power usually comes along with political influence. The price for a most welcome external support of a quick upgrading of North Korea's economy after unification might be a lingering loss of independence – a nightmare scenario for most Koreans.

Outlook: An Alternative Unification Scenario

To end on a note that is, depending on who is reading this, either positive or disturbing: Things might in fact proceed very differently. So far, although I have rejected it, I have implicitly applied the German scenario to Korea's unification, that is, an economically and politically weak North unifies with a South that is in most respects overwhelmingly superior. As of 2014, this is the most realistic expectation to have. But as much as the world has been waiting for a North Korean collapse since 1990, and even more so since 1994, we might end up waiting for the above kind of unification for another decade or two. Meanwhile, how could the situation have changed, and how would this influence the cost calculation of Korean unification? South Korean estimates of future developments point into the direction of a widening gap between the economies of the two Koreas, and thus growing costs of unification (National Assembly Budget Office 2015). But we should also consider another option.

Ever since the July measures of 2002 I have been writing about the possibility of an indigenous North Korean reform.[19] Back then I was criticized by colleagues who today propagate as commonsensical knowledge much of what I had foreseen, such as the social transformation triggered by North Korea's re-monetization and the emergence of a middle class. So perhaps we should not completely and instantly push aside this admittedly somewhat outlandish scenario.

Imagine: North Korea's leader, who is obviously intent on improving the living standard of his people, realizes that this will not be possible without more external economic cooperation, an at least partial privatization, competition, and price liberalization. Feeling safe enough to do so under the protection of his own nuclear umbrella, he embarks on a reform path that is North Korean in principle but also utilizes adjusted lessons from cases like China and Vietnam, namely the dual-track system[20] and special economic zones. China is a potent partner who provides necessary inputs of technology and finance, and serves as an export market to nurture infant industries. North Korea improves its capacity to utilize its rich natural resources and rehabilitates crucial parts of its infrastructure. Constant interaction with capitalist partners leads to a gradual but steady and broad buildup of capacities among North Koreans. As the knowledge gap between North and South Koreans diminishes, so does the economic gap. Eventually, both sides have reached more or less equal status. At the same time, U.S. influence in East Asia decreases. North Korea's pressure to expel American troops from the peninsula becomes more and more effective in South Korea. Finally, the Americans retreat to Japan, although they are not terribly welcome there as well. China acts as a broker between both sides that have long ago started to grow together through numerous instances of economic and cultural exchanges. Eventually, unification becomes just a formality. Costs of adjustment, infrastructure rehabilitation or social transfers are simply not an issue. A federal state is formed that initially consists of two parts but will later develop into a single central state or a federation that consists of all Korean provinces.

I should repeat that at this point, and perhaps at any point in the near future, this scenario is not overly realistic. But thinking ahead means also to leave the constraints of what too easily establishes itself as conventional wisdom. Using the German example as a magic orb that allows us to foresee Korea's future is tempting, but risky. Not only have the circumstances and details of German unification been incompletely understood; too many so-called lessons might actually be dangerously misleading.

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[1] This, and the question of a comparability of the German and the Korean case, is extensively discussed in Frank (2013). Frank, Rudiger (2013): "The Political Economy of Unification: North Korea and Implications of the German Experience", Choe Sang-Hun, Gi-Wook Shin and David Straub (eds.): *Troubled Transition. North Korea's Politics, Economy, and External Relations*, Stanford: Shorenstein Asia-Pacific Research Center, pp. 229-254.

[2] Chŏng, Ŭn-mi (2013): Min'gwani hamkkehanŭn t'ongil kibanjosŏngŭi p'ilyo [The need for a publicly and privately supported unification fund], *Minjokhwahae* Vol. 11-12 (December 2013), Seoul, pp. 24–27.

[3] Lee, Bu-hyoung (2014): "Estimation of the Economic Potential of Unified Korea", *Weekly Economic Review* 14-16, No. 587 (April 18, 2014), Seoul: Hyundai Research Institute.

[4] Hietschold, Marco (2010): *Die Integration des ‚Aufbau Ost' in die bundesdeutsche Finanzordnung: Potentiale und Perspektiven wachstumswirksamer Transfermittelverwendung* [The integration of "Eastern Reconstruction" in the federal German financial order: potential and perspectives of the use of transfers with effects on growth], Göttingen: Cuvillier, see in particular pp. 34–50.

[5] In German: "Aufbau Ost", the official name of the massive rehabilitation program of East Germany's economy.

[6] Thiessen, Friedrich (ed., 2009): Die Wessis. Westdeutsche *Führungskräfte beim Aufbau Ost* [The Westerners. West German executives in the reconstruction of the East], Cologne, Weimar and Vienna: Boehlau.

[7] An extensive discussion of these and other aspects can be found in Paqué (2009) and Ritter (2007). Paqué, Karl-Heinz (2009): *Die Bilanz. Eine wirtschaftliche Analyse der Deutschen Einheit* [The balance sheet: An economic analysis of German unification], Munich: Hanser Verlag. Ritter, Gerhard A. (2007): *Der Preis der Deutschen Einheit: Die Wiedervereinigung und die Krise des Sozialstaates* [The price of German unity: Unification and the crisis of the welfare state], Munich: C.H. Beck.

[8] Trusteeship agency, established after unification to liquidate the former East German state property.

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[10] Schipper, Lena (2013): "Die Rente frisst den Bundeshaushalt auf" [Pension is eating up federal budget], *Frankfurter Allgemeine Zeitung*, 04.09.2013, http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/staatsausgaben-die-rente-frisst-den-bundeshaushalt-auf-12556533.html (accessed 12.05.2014).

[11] Shon, Jungmin and Howard A. Palley (2014): "South Korea's Poverty-Stricken Elderly", *East Asia Forum*, 10.05.2014, http://www.eastasiaforum.org/2014/05/10/south-koreas-poverty-stricken-elderly (accessed 12.05.2014).

[12] National Assembly Budget Office (2015): "Economic Effect of the Reunification of the Korean Peninsula", *Korea Focus* 2/2015, www.koreafocus.or.kr (accessed 02.03.2015).

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[14] Yoon, Edward (2011): *Status and Future of the North Korean Minerals Sector*, San Francisco: Nautilus Institute, http://nautilus.org/wp-content/uploads/2011/12/DPRK-Minerals-Sector-YOON.pdf.

[15] Song, Jung-a and Shawn Donnan (2014): China and South Korea poised for bilateral trade deal, *The Financial Times*, 03.07.2014, http://www.ft.com/cms/s/0/4ec9ab36-02aa-11e4-8c28-00144feab7de.html#axzz3BbSRlrZk (accessed 27.08.2014).

[16] My thanks go to an anonymous reviewer for pointing out these important aspects.

[17] Woo, Jung-en (1991): *Race to the Swift. State and Finance in Korean Industrialization*, New York: Columbia University Press.

[18] KOTRA (2014): 2013 *Pukhanŭi taewoemuyŏk tonghyang* (Trends in North Korea's foreign trade 2013), Seoul: Korea Trade and Investment Promotion Agency.

[19] Frank, Rudiger (2005): "Economic Reforms in North Korea (1998-2004): Systemic Restrictions, Quantitative Analysis, Ideological Background", *Journal of the Asia Pacific Economy*, Vol. 10, No. 3, pp. 278-311.

[20] Roughly: State owned enterprises work for the state under state-set conditions until they reach a given production target and are then free to produce whatever they want and to sell it on the free market.

PRESIDENT PARK GEUN-HYE'S UNIFICATION VISION AND POLICY

By Jo Dongho

Abstract

Achieving unification has been one of the most important national goals of all South Korean presidents. President Park is no exception, and clarifies that building a foundation for national unification is one of the four major objectives of her government. Her basic perceptions are "from small unification to big unification" and "unification bonanza." In order to seek unification, she takes three tasks: 1) normalizing inter-Korean relations through a trust-building process, 2) embarking on small-scale unification projects that will ultimately lead to a complete integration of the two Koreas, and 3) taking practical measures to prepare for unification by strengthening unification capabilities. President Park's unification vision is desirable in that her administration is taking a balanced approach between unification and exchanges and cooperation while past administrations took a lopsided approach either toward exchanges and cooperation or toward unification. Another positive aspect of Park's unification vision is that she approaches unification in terms of benefit rather than cost. However, criticism can be raised given that it may not be appropriate to seek out unification while even rudimentary official dialogue has been blocked. Resuming dialogue should be a priority in order to achieve peaceful unification.

Introduction

"Our wish is unification." This is a song the Korean people have been singing since childhood. For most Koreans, unification is a lifelong mission that must be accomplished. Korea had been one nation since the Shilla dynasty established a unified kingdom on the Korean Peninsula in 676. Therefore, the nation's current divided status is unusual from a historical perspective. Having experienced tragedy and bitterness during the Korean War, and suffering numerous provocations from North Korea after the war, Koreans consider unification the only fundamental solution to the consistent threat of another war on the peninsula. Moreover, unification is expected to provide an opportunity for further growth of the Korean economy.

In addition, separated family issues make unification one of the most urgent tasks for the South Korean government. As of June 2014, the number of South Korean applicants for reunion is 129,553. The applicants are those who have parents or siblings in North Korea. If we define separated family in a broader sense, such as including the applicants' children and/or grandchildren, the number is estimated to be several million. Indeed, there is a saying in Korea "ten million separated families' *hahn* (inner rancor and sorrow)."

In this regard, overcoming division or achieving unification has been one of the most important national goals of South Korean presidents. In fact, according to Korean Constitution Article 69, the oath of office commands the Republic of Korea president to pursue peaceful unification of the homeland. Like her predecessors, President Park has shown a strong interest in unification issues. In 2002, President Park Geun-hye, then chairperson of the political party Coalition for the Future, visited Pyongyang and had a private meeting with the late North Korean leader Kim Jong-il. This demonstrates that unification is one of her top priorities. In fact, President Park clarifies that building a foundation for national unification is one of the four major objectives of her government.

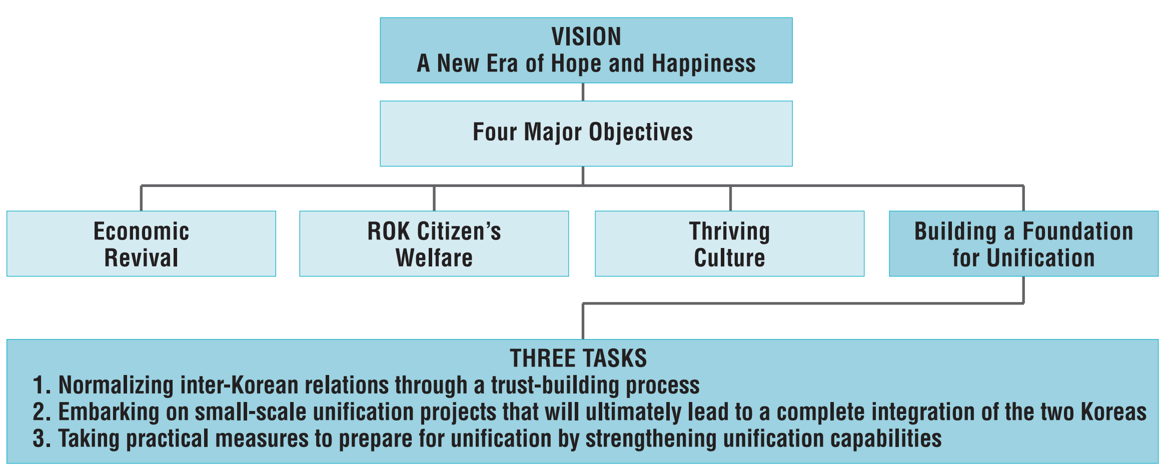
The purpose of this paper is to analyze the Park Geun-hye administration's unification vision and policy through President Park's public speeches and official documents published by the South Korean government. The Park administration's unification vision is then assessed in comparison with the unification policies of past governments. Lastly, the paper concludes with suggestions for the Park administration's unification vision and policy.

The System and Contents of President Park's Unification Vision and Policy

Under the grand vision of "A New Era of Hope and Happiness," President Park proposes four major national objectives: economic revival, ROK citizen's welfare, thriving culture, and building a foundation for unification. In her inauguration speech, President Park said that "I intend to lay the groundwork for an era of harmonious unification where all Koreans can lead more prosperous and freer lives and where their dreams can come true."

As noted with the three tasks in Figure 1, President Park's unification policy is based on a gradual and peaceful approach. Therefore, it is clear that President Park furthers President Noh Tae-woo and the following administrations'

Figure 1 President Park Geun-hye's Unification Vision and Policy



Source: Ministry of Unification.

unification formula, so-called "Unification Plan for One National Community." The three-stage unification plan is designed to reach unification after going through reconciliation and cooperation as a first stage and Confederation as a second stage.

Basic Perceptions

From Small Unification to Big Unification

The Park administration pursues unification step-by-step. With steady development in small-scale unification wherein the people of North and South Korea are united as one economically and culturally, she believes that Koreans will be able to take gradual steps toward large-scale unification, specifically political and institutional integration.

In this regard, President Park announced the DMZ World Peace Park initiative in her speech to the joint session of the U.S. Congress on 8 May 2013. She proposed that an international park be created inside the DMZ where peace and trust can grow and both Koreans and citizens of the world can meet in peace. Creating a space for "small unification" where all Koreans can be brought together within the DMZ, the greatest symbol of inter-Korean division and conflict, will provide South and North Koreans with opportunities to bridge cultural differences and open their minds to each other, thereby serving as a starting point towards "big unification."

President Park again proposed to the North the creation of the DMZ World Peace Park in her speech commemorating the 68th anniversary of Korea's liberation from Japanese rule on 15 August 2013. President Park presented the need for a new start for making the DMZ a zone of peace where the memories of war and threats of provocations that linger in the Korean psyche can be done away with once and for all, and the peninsula can become an area of trust, harmony, and cooperation. Her vision for the DMZ is to see it transformed, so that the weapons disappear, one small area at a time, until the entire place becomes one where peace and trust can grow. If the two sides that once pointed guns at each other were to come together in agreement to create a peace park in accordance with international norms and procedures, this would be the very starting point for peace and unification on the Korean Peninsula.

Such a gradual approach toward unification was confirmed once again in her Dresden declaration on 28 March 2014. President Park emphasized the need to broaden exchanges and cooperation between North and South Korea prior to unification by mentioning three urgent agendas for humanity, co-prosperity and integration.

Unification Bonanza

Unification is a national goal that, if achieved, will end long years of division and bring happiness to the Korean Peninsula. It is the hope of all Koreans, too. However, negative opinions exist as well claiming that unification will be too costly or not necessary.

In her presidential press conference on 6 January 2014, President Park Geun-hye drew up a blueprint for the reunification of the two Koreas, describing it as a huge opportunity for the South Korean economy to leapfrog to a whole new level. She said that "Unification is *daebak* (bonanza). Some Koreans oppose unification for fear the costs would be too high. But I believe unification would be a chance for the economy to make a huge leap." She cited investment guru and commentator Jim Rogers, who has repeatedly expressed his willingness to invest in North Korea on the upbeat outlook that unification will be realized in the near future and a unified Korea will emerge as one of the strongest economies in the 21st century.

It is very likely that the Korean Peninsula will make great strides following unification. The South Korean economy will grow considerably. North Korea too will develop rapidly. In addition, as a new logistical hub connecting the Pacific and Eurasia, a unified Korea will contribute to world economic development. As part of her effort to make unification a reality, President Park launched the Presidential Committee for Unification Preparation on 15 July 2014, which will create and propose the agenda for unification.

Major Contents of Three Tasks

Normalizing Inter-Korean Relations Through a Trust-Building Process

Trustpolitik is President Park's signature foreign affairs principle. The Park administration stresses building trust between Pyongyang and Seoul to manage peace and improve inter-Korean relations. In the short run, her government plans to attempt to strengthen deterrence and security while trying to normalize inter-Korean relations and to achieve durable peace on the Korean Peninsula in the medium-long run. In order to carry out the task, the Park administration focuses on the following four projects.

- **Resolving humanitarian issues:** When providing 'pure' humanitarian assistance to the vulnerable groups in North Korea, including infants and pregnant women, the South Korean government will work closely with international organizations to decide the appropriate time and method of assistance regardless of the political circumstances and security situation on the

Korean Peninsula. The government is determined to solve the issues pertaining to the separated families, prisoners of war, and abductees.

- **Adhering to the existing agreements and creating dialogue channels:** The Park administration places top priority on national security. Based on this principle, the ROK government will decide whether or not to resume inter-Korean dialogue and attempt to settle North Korean nuclear issues. In order to solve such pending issues on the Korean Peninsula, the Park administration will carefully consider the shifting international circumstances and North Korea's behavior and act accordingly. The South Korean government takes the position that all agreements signed between Seoul and Pyongyang must be fulfilled by both parties and any additional agreements should only be considered when both Seoul and Pyongyang carry out the existing agreements.
- **Promoting reciprocal inter-Korean exchanges and cooperation:** The South Korean government will carefully examine North Korea's nuclear development and take it into consideration when deciding whether or not to internationalize the Gaeseong Industrial Complex and promote economic, social and cultural exchanges, and cooperation between North and South Korea. The ROK government will establish the Inter-Korean Exchanges and Cooperation Office in Seoul and Pyongyang only when the conditions are met. The ROK government will initiate the *Vision Korea Project* when trust is restored between North and South Korea and when there is progress in denuclearization of North Korea.
- **Confidence building and promoting mutual exchanges and cooperation between North and South Korea:** The Park administration will first attempt to terminate North Korea's military provocations and then move toward building trust in the areas of the military and politics and promoting reciprocal exchanges and cooperation between the two Koreas.

Embarking on Small-Scale Unification Projects That Will Ultimately Lead to a Complete Integration of the Two Koreas

The Park administration emphasizes building a foundation for a unification era that ensures everyone's happiness by re-establishing the vision for a unified Korea and creating economic and green communities. Four projects are outlined for this task.

- Creating a green community through a *Green Détente*: When there is progress in denuclearization of North Korea, the ROK government will embark on an inter-Korean environment project with an aim to build a joint green community. The joint environment project will seek to promote green economy, conduct joint research on the ecology of the DMZ, Mt. Baekdu and contiguous regions, and build a new renewable energy complex within the Gaeseong Industrial Complex.
- Paving a path towards an era of unification that ensures everyone's happiness: The Park administration will strive to create favorable conditions for the enactment of the North Korean Human Rights Law both at home and abroad. The ROK government will work closely with civil organizations and the international community when seeking ways to improve the lives of the North Korean people and pursuing humanitarian cooperation with North Korea.
- Launching the *Vision Korea Project*: When trust is restored between Seoul and Pyongyang and North Korea makes visible progress in denuclearization, the ROK government will build an inter-Korean economic community by launching the 'Vision Korea Project.' In the medium to long term, the Park administration will consider developing industrial infrastructure such as railways, roads, electricity, and information communication.
- Embracing and refining the *Unification Plan for One National Community*: The Park administration will promote public discourse on how to embrace and refine the *Unification Plan for One National Community*. The ROK government will respect the national consensus on this issue and consider various options by carefully examining citizens' voices expressed in public hearings and academic papers.

Taking Practical Measures to Prepare for Unification by Strengthening Unification Capabilities

The Park administration stresses the importance of raising public awareness of the need to prepare for unification both at home and abroad. In order to reinforce unification capabilities, the ROK government focuses on building a national consensus on unification and North Korea policy, and obtaining support from the international community. In terms of reinforcing unification preparation, the ROK government strives to expand the scope of human resources, finances, and institutions. The three projects highlighted to fulfill this task are:

- **Improving the customized program for North Korean refugees' resettlement:** The ROK government will reinforce the existing medical support system for North Korean refugees and provide personalized education tailored by age group. The Park administration will advance the re-education system and provide concentrated education to young people so they can obtain economic independence in South Korean society. The Park administration will open the *Cultural Center for North Korean Refugees* with an aim to help them become integral agents and leaders in realizing peaceful national unification. This center will serve as a communication hub for North Korean refugees.
- **Reinforcing capabilities for practical unification preparation:** The ROK government will improve the cooperation channels so relevant organizations can effectively communicate with each other. The Park administration will consider enacting a law that secures necessary finances for unification and build a cooperation system to boost cooperation among research institutes both at home and abroad. The ROK government will also strive to develop balanced education contents.
- **Forming a consensus on unification in the international community through unification diplomacy:** The ROK government will launch and operate a '1.5 track consultative group' in cooperation with civil organizations. The 1.5 track will target neighboring countries. The Park administration will also promote the *One National Unification Network Project* with an aim to raise awareness of the need to prepare for unification among Korean expatriates.

Review of Past Administrations' Unification Vision and Policy

Unification has been a long cherished wish of the South Korean government, but it looked like a dream that would not come true. However, Germany's unification in 1990 was a wake-up call to Koreans and helped them to realize that unification is indeed possible. Unification has become a wish that is realistic and a dream that can be achieved. It was the most precious and positive lesson that the German unification brought to the Korean people.

In 1990 when German unification occurred, South Korea was administered by President Noh Tae-woo. President Noh presented "Nordpolitik" as his foreign policy principle and reached out to socialist countries and traditional allies of North Korea. He also tried normalization of relations with North Korea through the so called "July 7 declaration" in 1988. North Korea was not a simple enemy anymore and even the North was defined as a partner for unification. For the first time since the end of the Korean War, economic cooperation with North Korea became legalized and contacts between the two Koreas were made in various fields. In September 1989, President Noh announced *Unification Plan for One National Community* during his address to the National Assembly. As an origin of the current government's unification approach, the plan sought to achieve unification gradually through increased exchanges and cooperation.

The Inter-Korean Basic Agreement was signed between South and North Korea in 1991. The agreement defined inter-Korean relations as "not being a relationship between states but a special interim relationship stemming from the process towards unification." Acknowledging that unification could not be achieved any time soon, the two Koreas agreed to respect one another with formal recognition. They also agreed to the principle of non-interference in internal affairs, no efforts of insurrection against one another and no military provocation. In addition, South and North Korea concurred to seek unification gradually by recovering national homogeneity through exchanges and cooperation. Even though unification was seen as down to earth after the German unification, the Noh administration's inter-Korean policy was more focused on exchanges and cooperation rather than unification itself.

During the Kim Young-sam administration, unification talks were mainly focused on absorption. In the 1990s, with the end of the Cold War, North Korea was hit hard by the collapse of the socialist bloc and lost its ground in international political and economic relations. The North Korean leader Kim Il-sung who had ruled the country for decades died suddenly in 1994. To make matters worse, because of an unprecedented severe 100 year flood, North Korea was in a dire economic situation. In addition, facing cold weather damage and drought in the following years, North Korea entered the "arduous march" where several hundred thousand North Koreans died of famine.

The Kim Young-sam administration assessed that North Korea would collapse in the not too distant future. In fact, President Kim described the North as a 'malfunctioning airplane' during his interview with a Japanese newspaper in June 1996. According to his diagnosis, there was nothing for the South Korean government to do to achieve unification. His administration would wait to absorb North Korea upon its collapse. With this background, Kim's unification vision naturally led to absorption of North Korea and all relevant details and specific plans had to be prepared focusing on this merge. The substance of Kim's unification vision had nothing to do with the *Unification Formula for the Korean National Community* that the Kim administration promoted outwardly. As the name of the formula indicates, it was tweaked from President Noh Tae-woo's *Unification Plan for One National Community* that pursued gradual and peaceful unification.

However, North Korea did not fall down. Actually, the Kim Dae-jung administration, inaugurated in 1998, did not want North Korea to collapse. One of the Kim Dae-jung administration's three major principles was to exclude discourse on unification by absorption. Actually, he prohibited unification discussion knowing that it would lead to absorption and therefore arouse North Korea's anger.

Alternatively, the Kim Dae-jung administration chose the so-called 'Sunshine Policy' which focused on exchanges and cooperation with a belief that interaction and economic assistance would change North Korea's attitude. After the historic inter-Korean summit in 2000, the first ever since the end of the Korean War, more active exchanges and cooperation were emphasized rather than unification itself. Mt. Geumgang tourism and the Gaeseong Industrial Complex project, symbols of inter-Korean economic cooperation, were launched under the auspices of the Kim Dae-jung's administration. His government provided an enormous amount of aid each year, ignoring criticism from the conservatives that South Korea gave too much for nothing. The Roh Moo-hyun administration carried forth Kim Dae-jung's unification policy with almost no changes. There were almost no talks about unification, but rather talks about exchanges and cooperation only.

After ten years of the two liberal and progressive leaders' control, President Lee Myung-bak took office in 2008. Even though Lee was from the conservative circle, he was active in inter-Korean exchanges and cooperation in the beginning. His administration suggested a slogan "Stick to the principle, but approach flexibly." It sounded like a balanced policy toward North Korea between principle and flexibility. However, looking more closely based on Lee's subsequent words and deeds, it turned out that flexibility was emphasized more. He reiterated that inter-Korean relations should be assessed not by ideology but by pragmatism. He showed his strong willingness to bring about a robust and high performance in inter-Korean relations.

However, a series of unfortunate accidents ensued. First, on 30 May 2008, North Korea fired three short distance missiles from the West Sea. On 11 July 2008, a South Korean tourist to Mt. Geumgang was shot dead by a North Korean soldier and Mt. Geumgang business was halted. In the following year on 30 March, a Hyundai Asan staff member was detained for more than 130 days, and on 5 April 2009, North Korea tested a long-range missile *Gwangmyeong II*. As a highlight of continuing provocations from the North, on 26 March 2010, the South Korean navy ship *Cheonan* sank by a North Korean torpedo and 46 seamen were killed. The Lee administration had to halt all inter-Korean economic exchanges and cooperation except the Gaeseong Industrial Complex. This counter-measure, "the May 24 sanctions," is still in effect.

If we divide the South Korean governments' North Korea policies into two categories—one, exchanges and cooperation policy reflecting today's divided situation, and the other, unification policy wishing for tomorrow's unified peninsula—the Lee administration could not help but choose the latter because all activities for exchanges and cooperation were halted due to the sanctions he imposed. In addition, the possibility of North Korea's collapse was raised again due to the deteriorating health condition of Kim Jong-il. In his address for the Korean Liberation Day ceremony on 15 August 2010, President Lee suggested creating a 'unification tax' saying "unification would come unexpectedly like a thief in the middle of the night." It was one of the most specific unification plans among all other proposals that his predecessors presented.

Assessment and Suggestions

President Park's unification vision is desirable in that her administration is taking a balanced approach between unification and exchanges and cooperation. Her remarks such as "building trust step-by-step" and "from small unification to big unification" can be interpreted as emphasizing their importance in a pre-stage of unification. However, it does not mean that President Park considers unification as a minor task or a task on the back burner.

President Park's interest and dedication toward unification can be easily identified in her active role in forming the Presidential Committee for Unification Preparation. She decided to serve as the head of the committee and has been playing an active role by administering all six committee meetings and proposing the unification agenda by herself. It clearly shows that the Park administration considers unification as a task that should be pursued concurrently with a policy of exchanges and cooperation. In fact, President Park has asked the members of the Presidential Committee for Unification Preparation to come up with inter-Korean business items contributing to the promotion of exchanges and cooperation. She added that finding and implementing those projects should be the number one task for the committee.

As previously mentioned, Park's approach toward unification is quite positive given that past administrations took a lopsided approach either toward exchanges and cooperation or toward unification. Unification and exchanges and cooperation are two sides of the same coin. A desirable unification comes as a result of expanded exchanges and cooperation, and unification without sufficient exchanges and cooperation could be a disaster rather than a blessing.

Another positive aspect of President Park's unification vision is her approach in terms of benefit rather than cost. Most previous governments formed their unification policies with reference to cost only and President Lee Myung-bak's unification tax was an exemplary case of such an approach. It resulted in a lowered level of national consensus on unification as it made Koreans feel that unification required an enormous cost and they should sacrifice themselves to bear the burden. Unification bonanza, the term President Park used during her press conference, demonstrates how her unification policy is different from ones of her predecessors. By approaching it in respect to benefits, she emphasizes the positive results that unification provides the nation. Such out-of-the-box thinking is expected to reduce Korean indifference, ignorance, and negative perception of unification. It helps Koreans associate benefit rather than cost when it comes to unification in economic terms.

There is also negative assessment of Park's unification vision. Paradoxically, President Park's unification bonanza may worsen inter-Korean relations as the bonanza could apply only to South Koreans, leading to total loss or disaster for North Koreans. As there is a saying "it takes two to tango," unification must be worked on together. Park's unification team should have been more cautious in choosing terminology, looking for words and terms that sound pleasant to North Korea as well.

It is also uncertain that unification is a bonanza to other countries that have stakes on the Korean Peninsula. Even though the U.S., China, and Japan assert that they support a unified Korea, it is still possible that the status quo could serve their national interests politically, economically, and militarily. Before the Park administration asserts unification bonanza, her foreign affairs team should have coordinated more closely with neighboring countries and have worked harder to persuade them that Korea's unification is positively linked to their interest. If unification is a bonanza only to South Korea, no country will support unification of the peninsula.

Another criticism is that it may not be appropriate to speak out on unification when even rudimentary official dialogue has been blocked. It is clear that the Park administration is pursuing gradual and peaceful unification—not an abrupt and forceful one. Then, resuming dialogue should be a top priority task.

Economic theory says that unification is a sum of three parts: development, transition, and integration. Once unification is achieved on the Korean Peninsula, the North Korean economy must be developed because of the huge economic gap between the North and the South. Transition of the North Korean from a planned, socialist economy to capitalist, market based system is another important task. Integration of the two economies is inevitable and essential.

German unification tackled these three tasks at the same time, leading to tremendous cost and trouble for Germany. In the Korean case, the situation could be much worse since the North Korean economy is much less developed than the former East Germany and the South Korean economy is much smaller than the former West Germany. Thus, it would be better for the North Korean economy to develop and transition to a considerable extent before unification. In other words, we have to focus on opening and reforming the North Korean economy through exchanges and cooperation before going directly to unification.

Table 1 The Most Concerning Issue During the Process of Unification

Category	%
Enormous unification cost	43.2
Social instability such as increasing unemployment, crimes, etc.	25.3
Political and military instability	15.2
Mass immigration of North Koreans into South Korea	12.5
Disorientation of foreign policy	3.6
None	0.2
Total	**100.0**

Source: Korea Broadcasting System, *2014 National Survey on View of Unification,* 2014, p. 35.

Indeed, South Koreans support an engagement policy which promotes exchanges and cooperation. According to a KBS survey on South Koreans' view of unification conducted in August 2014, the most concerning issue in regards to unification was the enormous cost. It implies that policies to reduce unification cost should be implemented first before unification itself. Again, the South Korean government needs to pursue development and transition of the North Korean economy prior to integration of the two economies. If the Park administration keeps this implication in mind, it could leave the greatest legacy for future generations on the Peninsula.

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Leading Economic Indicators for Korea

	2007	2008	2009	2010	2011	2012	2013	2014
Growth Rate of Real GDP (%) Annual change at Chained 2005 Constant Prices	5.5	2.8	0.7	6.5	3.7	2.3	2.9	3.3
GDP Current US$ billions	1,122.7	1,001.7	902.3	1,094.3	1,202.7	1,222.4	1,305.4	1,410.0
GNI Per Capita US$	23,033	20,463	18,303	22,170	24,302	24,696	26,179	28,180
Current Account Balance Current US$ billions, BOP basis	11.8	3.2	33.6	28.9	18.7	50.8	81.1	89.2
Consumer Prices (%) Annual Change at 2010=100 Constant Prices	2.5	4.7	2.8	3.0	4.0	2.2	1.3	1.3
Unemployment Rate (%)	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.5
Inward Foreign Direct Investment US$ billions	8.8	11.2	9.0	9.5	9.8	9.5	12.8	9.9
Stock Price Index Average	1712.46	1529.49	1429.04	1764.99	1983.42	1930.37	1960.5	1982.16
Exchange Rate Average *Won*/US$	936	1,260	1,165	1,135	1,152	1,071	1,055	1,099

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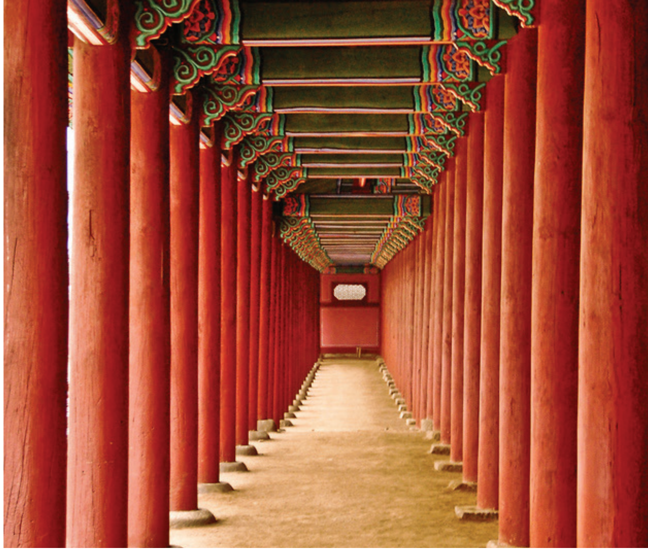

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