KOREA'S ECONOMIC RELATIONS WITH JAPAN

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Abstract

Korea's economic relations with Japan, which were re-established as a result of the diplomatic normalization between the two countries in 1965, have transformed from dependent to interdependent. The extraordinary economic growth that Korea accomplished during the post-war period was largely due to intermediate goods imported from Japan, and technical cooperation and joint ventures with Japanese enterprises. However, in the 21st century, the dependence of Korean firms on Japanese technology has somewhat declined as global enterprises have appeared in Korea. In contrast to the post-war economic boom, Japanese companies now prefer to cooperate with their Korean counterparts, resulting in joint business ventures between Korean and Japanese firms being continuously developed. This reversal in the economic ties between Korea and Japan can be attributed to several reasons including: the rise of China; Japan's two lost decades; and Korea's push for domestic structural reform as well as economic globalization after the Asian Currency Crisis of 1997. Nonetheless, the issue of Korea's trade imbalance with Japan, which was established during the post-war period, still remains thereby serving as a serious impediment to FTA negotiations between Korea and Japan as well as Korea's TPP negotiations.

Introduction

Korea's economic relations with Japan in the post-war period were re-established with the diplomatic normalization of the two countries in 1965. At that time, Korea lagged far behind Japan in terms of economic development, and its GDP per capita was $100, which was only one-tenth of Japan's. Even though Korea's decision to normalize diplomatic relations with Japan still remains controversial, it may be regarded as an inevitable move in order to rebuild the country that had undergone an era of massive political turbulence and was completely destroyed by war. This is mainly because normalization with Japan involved financial aid in the name of compensation for Japanese colonial rule over Korea. However, the re-establishment of economic relations between Korea and Japan in 1965 reinforced Korea's economic subordination to Japan to a certain degree. The dominance-subordination nature of the economic relationship between the two countries was more noticeable in Korea's dependency on imports and technology from Japan. Even in the late 1980s after Official Development Assistance (ODA) from Japan to Korea had ended, as much as 30 percent of total imports still came from Japan. In addition, current leading Korean firms in the automobile, electronics, and chemicals industries adopted high-level technology by seeking technical cooperation or establishing a joint venture with Japanese counterparts.

The Asian Currency Crisis of 1997 hit Korea hard and prompted the Korean government to accelerate domestic structural reforms, which also led Korea to fully globalize its economy. With these efforts, global enterprises have gradually appeared in Korea. In addition, since the 2000s the Chinese economy has expanded rapidly, resulting in the economic relations between Korea and Japan taking on an interdependent form. The presence of Japanese companies in Korea has weakened, and the trend of Japanese firms preferring to cooperate with Korean counterparts has been observed. Korea's dependency on imports from Japan was recorded as 30 percent in the late 1980s, but this figure fell to 20 percent in the 2000s and to 10 percent in 2014. In contrast, total investment by Japanese firms in Korean companies was about $400 million in the 1990s, but this increased four-fold and amounted to as much as $1.5 billion in the 2000s.

The main purpose of this paper is to conduct a historical review of Korea's economic relations with Japan in the post-war period by reflecting on the trade between the two countries and the direct investment from Japanese firms. In this paper, it is observed that the economy of Korea relied heavily upon Japan since the normalization of diplomatic relations between the two countries in 1965 until the 1997 Asian Currency Crisis. This paper points out that this dependent characteristic of two countries solidified to a certain degree, and the trade imbalance issues have served as a serious impediment not only to the Korea-Japan bilateral Free Trade Agreement (FTA) negotiations but also to Korea's Trans-Pacific Partnership (TPP) negotiations. In this paper, it is considered that the economic ties between Korea and Japan have transformed into interdependent relations following the 1997 Asian Currency Crisis and Chinese accession to the World Trade Organization (WTO) in 2001. This paper will also introduce the case of the Japanese trading companies (in Japanese, *Shoji*) in Korea that lead Korean and Japanese joint business in third countries. It is also observed that this is one of the trends of economic cooperation between Korea and Japan. For the last section of this paper, the future prospects of the economic ties between Korea and Japan will be analyzed based on the historical review in the preceding chapters.

Korea's Economic Development and Reliance on Japan: The End of Japan's ODA and Start of Private Economic Cooperation

When looking at the process of economic development in Korea, which is often referred to as 'the miracle of the Han River,' the most crucial factor that led to economic success was the establishment of the second Five-Year Economic Development Plan (1967-1971). When it comes to Korea's economic relationship with Japan after diplomatic normalization in 1965, as many experts have pointed out, it is clear that Japan played an important role in triggering Korea's compressed economic development through Japan's ODA to Korea, trade expansion, and Foreign Direct Investment (FDI) by Japanese firms.

When Seoul and Tokyo signed the Treaty on Basic Relations between the Republic of Korea (ROK) and Japan, it was agreed that the Japanese government would provide financial aid to Korea including grant aid of $300 million, loan aid of $200 million, and commercial loans of $300 million. The Korean government decided to invest $120 million out of $500 million (combined grant loan and loan aid) into the construction of Pohang Steelworks which was Korea's leading steel maker. In this process Japanese steel makers such as Yawata Steel (now Nippon Steel & Sumitomo Metal) also engaged in technical cooperation with Pohang Steelworks. At that time, the Japanese Export Promoting Agency such as the Export-Import Bank of Japan (now the Japan Bank for International Cooperation) provided over $500 million as a commercial loan through the Korean government and this loan was utilized to import machinery and industrial plants from Japan.[1] In other words, Japan's ODA to Korea laid the basis for the economic development of Korea, focusing on the manufacturing sector. On the other hand, it also played a significant role in increasing Korea's level of economic dependency on Japan.

By analyzing the trade data between Korea and Japan during the process of Korea's economic development, it is possible to observe the extent to which the Korean economy relied on Japan.[2] When Korea normalized its diplomatic relationship

with Japan in 1965, Korea's total imports were $450 million, of which 40 percent ($182.25 million) came from the United States, and of which 35 percent ($166 million) came from Japan. The total trade value of Korea was $625 million, of which the U.S. retained 39 percent, followed by Japan which had 34 percent.[3] It is feasible to consider that Korea's trade pattern was characterized by its dependency on Japan until the late 1980s. Even though the United States was the largest trading partner for Korea in 1988, Japan had the highest proportion of total value of imports.[4] At the time, the items from Japan comprised IC semiconductors, hot-rolled steel sheets, automobile parts, machinery, and computer components. This illustrates that Korean companies' development in the electronics, automotive, and machinery industries was dependent on the Japanese firms' technology in the mid-1980s.

In another sense, Japanese companies' outward FDI to Korea also contributed to Korea's economic growth. It may be coincidental that the Korean government enacted 'the Law on foreign capital importation' in 1966 when the diplomatic normalization between Korea and Japan had just passed. Japan and the U.S. competed for the biggest share of inward FDI to Korea during the 1970s, but the Japanese share experienced a dramatic rise and was more than twice the amount of the U.S. counterpart share. The total share of Japanese inward FDI to Korea was recorded as 56.3 percent and 84.3 percent in 1984 and 1985, respectively, and the Japanese companies' presence was substantially high.[5] At this time Japanese firms focused not only on the service sectors, such as food and hotels, but also on manufacturing. In the case of the manufacturing sector, Japanese firms reinforced economic cooperation with their Korean counterparts by adopting a strategy wherein they first signed a technical cooperation contract and then established equity participation or a joint venture. In such cases, Japan's Mitsubishi Motors had begun to cooperate in the development of an automobile engine with Korea's Hyundai Motors, and later Mitsubishi also conducted equity participation in Hyundai Motors. Similarly, Sumitomo Corporation established a joint venture with Samsung Electronic Tube (now Samsung SDI) in manufacturing color TV picture tubes. This kind of cooperation was extremely important for Korea's economic development. In the 1980s, more Japanese companies including Otsuka Pharmaceutical, Alps Electric, and Yokohama Rubber invested in Korea.

Trade Imbalance between Korea and Japan

As the Korean economy relied heavily on Japan, concerns about an adverse balance of trade had grown. In fact, Korea never achieved a trade surplus with Japan after the Korea-Japan Basic Treaty was signed. The size of Korea's trade deficit already exceeded $1 million in 1974 and this number increased to $10 billion in 1994, and was recorded as between $20 to $30 billion after 2004. This phenomenon can be regarded as a very stark contrast while considering the fact that Korea's total trade surplus has been recorded as at least $9.9 billion and at most $47.7 billion every year except in the year 2008 when many advanced countries were hit by the global financial crisis.

Tapping into Korea's nationalistic emotion was quite feasible as a result of the extreme harshness of Japanese colonial rule, still a vivid memory for the Korean people. In this respect, the Korean government announced the '1st Five-Year Plan for Correction of Trade Imbalance with Japan' in 1986 when Korea achieved its trade surplus for the first time after the post-war period.[6] According to this plan, Korea's trade imbalance with Japan stemmed from the condition that Korea's manufacturing sector, especially the manufacturing of machinery, materials, and components was not sufficiently competitive against the Japanese counterpart. For this reason, the plan suggested that Korea should substitute imports for the localization of these products and promote exports at the same time in order to correct the trade imbalance between Korea and Japan. The Korean government announced the '2nd Five-Year Plan for Localization of Machinery, Materials, and Components' in 1992. The second plan supported Korean companies through diverse government funding for the sake of the localization and included about 4,000 components and materials. Furthermore, this plan endeavored to provide financial assistance to Korean firms so that they could introduce hi-tech facilities.

Table 1 shows Korea's trade balance on the materials and components sectors from 1994 to 2014.[7] Since then Korea's balance of trade in the sectors of materials and components has turned into a surplus. The size of the surplus was recorded as $3 billion in 1997 and this figure has increased from $35 billion in 2006 to $100 billion in 2014. Nevertheless, it is important to note that Korea never achieved a trade surplus with Japan in any single year. For example, Korea had a $11.7 billion trade deficit with Japan in 2000, $20 billion in 2009, and $16.4 billion in 2014. Although the Korean government has attempted to rectify the trade imbalance with Japan, its negative balance of trade with Japan has not been solved and what is worse, the size of the trade deficit is growing rather than shrinking. In particular, 80 percent of Korea's trade deficit with Japan mainly resulted from materials and components. In this sense, the Korean government's localization policy in the field of materials and components, which has been in place since the mid-1980s, may encounter criticism of being ineffective. As mentioned earlier, this criticism is not entirely warranted given the fact that Korea's total trade surplus in materials and components amounted to $100 billion in 2014. These statistics should be seen as a slice of Korea's history of industrial development or structure. In other words, it shows that since the 1970s Korean companies imported intermediate goods from Japan, processed these imports, then exported these final products to third countries. This type of work formed an industrial structure based on export processing.

Table 1 Trade Balance on Materials and Components Sectors of Korea ($ million)

	1994	1997	2000	2003	2006	2009	2012	2014
Japan	-8,278 (-11,974)	-9,864 (-13,414)	-11,730 (-11,361)	-13,898 (-19,022)	-15,564 (-25,322)	-20,094 (-27,743)	-22,233 (-25,442)	-16,394 (-21,473)
World	-4,895	3,380	9,346	6,167	34,736	51,247	90,921	107,775

Note: figures in brackets refer to Korea's total trade balance with Japan.
Source: Ministry of Trade, Industry and Energy, *Materials & Components Technology Network*, http://www.mctnet.org/index.jsp (accessed 02.08.2016)

In the economic relations between Korean and Japan, there have not been any cases where the trade imbalance caused a trade friction or dispute. However, there is little doubt that the trade imbalance between Korea and Japan has served as an impediment to the Japan-Korea FTA (JKFTA) negotiations as well as multilateral FTA that include Japan as potential member. Korea and Japan entered into bilateral FTA negotiations in a politically and diplomatically cordial atmosphere in December 2003. However, assuming that Korea fully accepts the Japanese request in the JKFTA negotiations, there have been concerns that Korea needs to eliminate or reduce the tariff on manufacturing items, thereby possibly leading to the collapse of the Korean manufacturing sector. This scenario may be feasible as Japanese products with high competitiveness can dominate the Korean market under the FTA. In addition, Japan already eliminated the tariffs for almost all manufacturing items except agricultural products because it had joined OECD much earlier than Korea, therefore Korea only needs to reduce the tariff under JKFTA. In this respect, Korea requested that Japan proceed with the elimination of non-tariff barriers, but Japan rejected this request during the negotiation process. JKFTA negotiations have not proceeded and this confrontation between the two countries persisted in several working-level talks.

Toward a Deeper Inter-dependency since the 1997 Asian Currency Crisis

Korea's economic relationship with Japan has not always been imbalanced. After the Asian Currency Crisis of 1997, the Korean government fully committed to pursuing drastic domestic structural reforms and has made considerable progress toward economic globalization by concluding numerous FTAs simultaneously. On the other hand, in 1999 the Korean government completely abolished the restriction on importing from Japan, the so-called 'diversity of origin' system which was introduced in 1978 to restrict the import of 258 manufacturing goods which were causing a huge trade imbalance. In this sense, the Korean government's bold measure on economic globalization was certainly meaningful in creating an environment where Korean companies endeavored to compete with Japanese counterparts on an equal footing.

Since 2000 several events in the region have brought about a remarkable change in the economic ties of Korea and Japan. Above all, China has been rising as a global economic power and the Korean government's efforts on economic globalization have been constant. In the early 1990s, while Japan's economic bubble burst and Japan experienced the so-called 'two lost decades,' the size of the Chinese economy grew to account for half of the U.S. economy, and surpassed Germany in 2007 and Japan in 2010. Moreover, Korea's trade flow started to divert from Japan to China, whereby the economic relations of Korea and Japan, which had been steady for 30 years and based on trade imbalance, started to crumble. Table 2 indicates that the share of Korea's import from Japan has been gradually shrinking and fell to 10.2 percent in 2014. Japan was the biggest import partner of Korea in 1988 accounting for 30 percent, but since 2010 Japan lost this position to China. Nonetheless, it should be carefully considered that the total trade value between Korea and Japan has not been reduced so far and the importance of hi-tech intermediate goods produced by Japanese firms for Korean firms is still relevant.

The decrease in Korea's dependence on Japan in trade can be observed in the trade flow of intermediate goods. Table 3 indicates that the trade of intermediate goods among East Asian countries rose in 2014 compared to 1990. In the case of Korea, its export of intermediate goods to East Asia had been 37.8 percent but increased to 59 percent in 2014. Considering solely the relation between Korea and Japan, Korea's export of intermediate goods moved from Japan to China. For example, 20.9 percent of Korean intermediate goods had been exported to Japan but this figure drastically fell to 6 percent in 2014. On the other hand, Korea exported only 2.5 percent of its intermediate goods to China in 1990, whereas this share experienced a massive increase and reached 36.2 percent in 2014. This can be attributed to the fact that as Korean and Japanese companies entered the Chinese market, the export of intermediate goods

Table 2 Korea's Trade Dependency with Japan and China (%)

Trade Partner		1990	1995	2000	2005	2010	2014
Japan	Export	19.4	13.7	12.0	8.5	6.1	5.6
	Import	26.7	24.6	20.1	18.6	15.1	10.2
China	Export	2.1	7.5	10.8	21.8	25.2	25.4
	Import	2.1	5.6	8.1	14.8	16.9	17.2

Source: UN Comtrade DB. http://comtrade.un.org/data (accessed 09.08.2016)

Table 3 Trade of Intermediate Goods among East Asia Countries (%)

		1990				2014			
		Import				Import			
		Japan	Korea	China	ASEAN	Japan	Korea	China	ASEAN
EXPORT	Japan	-	9.5	4.0	17.0	-	9.1	23.7	17.6
	Korea	20.9	-	2.5	14.4	6.0	-	36.2	16.8
	China	12.4	4.7	-	10.3	7.0	5.8	-	12.6
	ASEAN	23.2	3.9	3.1	-	9.2	4.9	18.4	-

Source: RIETI-TID2014 (RIETI Trade Industry Database 2014). http://www.rieti-tid.com (accessed 09.08.2016)

to China increased instantly. In this sense, Korea was able to reduce its dependency on Japan in terms of intermediate goods export. In spite of this change, Korea still represents 9 percent of Japan's total intermediate goods export which means that Japan still maintains its status as a supply base of intermediate goods for Korea.

A surge in Japanese firms' FDI to Korea serves as momentum in that the economic relationship between Korea and Japan then becomes interdependent. In fact, as explained earlier, some Japanese manufactures had carried out joint ventures with Korean companies in the 1980s, but in the 2000s Japanese firms paid less attention to this type of business because it seemed less profitable. However, as a result of this, Korean companies such as Samsung Electronics, LG Electronics, and Hyundai Motors have accelerated their global business expansion through export and local production since the 2000s, and many Japanese companies have sought to supply their Korean counterparts with components and parts, advanced materials, and production facilities. Other factors that encouraged Japanese companies to shift to local production in Korea include: the improvement of transportation and telecommunications infrastructure; high levels of technology; availability of excellent human resources; and low corporate income tax rates.[8] When Korea came near to overcoming the Asian Currency Crisis in 1999, Japan's FDI to Korea increased from $400 million to $1.8 billion and this trend continued during the 2000s. In particular, in 2012 Japan's FDI to Korea increased nearly two times compared to the previous year, amounting to $4.5 billion. This can be seen as the result of the Great East Japan Earthquake of March 2011 and the appreciation of the Japanese *yen* that followed.[9]

The Case of Economic Cooperation between Korea and Japan in Third Countries

Since 2000, many Korean companies have achieved global competitiveness and enhanced their global presence. This means that Korean firms are on par with Japanese counterparts in terms of the level of global competitiveness, but at the same time strengthens the foundation for Korean and Japanese companies to cooperate and complement each other. In particular, economic cooperation between Korean and Japanese enterprises in third countries have often been observed after the global financial crisis of 2008 and the Great East Japan Earthquake in 2011. This is meaningful in that Korea's economic relations with Japan have transformed from a unilateral dependence to an interdependent form.

The first case of cooperation between Korean and Japanese companies in third countries occurred in the business of constructing the Tihama Co-generation plant in Saudi Arabia in December 2003. In this case, Korea's Hyundai Industries gained a part of the Japanese Mitsui Corporation contract. There have been 50 cases of cooperation in energy and resource development, and the field of cooperation includes the following sectors: combined cycle power plans; coal thermal power generation; wind power generation; geothermal power generation; LNG terminal construction; shale gas exploitation; fertilizer manufacturing plants; mining; and seawater desalination. In the manufacturing sector, there are four cases of cooperation in the sectors of steel, synthetic rubber, milling.[10]

In fact, the energy and resource development sector in third countries is the most typical area where cooperation between Korean and Japanese firms occurs. Since 2000 the global economy has been dominated by emerging markets and the demand for energy and the construction of plants and infrastructure has increased. International oil prices skyrocketed in 2009 creating conditions that offered an unprecedented opportunity for Korean and Japanese enterprises to work together in third countries. This cooperation was conceivable because of their respective complementary strengths. For example, Japanese trading companies' information gathering and financing capabilities and Japan's commercial banks and Export Credit Agency's project financing capabilities were united with Korea's construction and manufacturing skills. Since 2006 Korea's construction performance has surpassed Japan's in the overseas plant market and engineering sector. As the status of Korean enterprises in the global market has been upgraded, Japanese commercial banks, Export Credit Agency, and trading companies have started to recognize the Korean companies' capabilities.

In fact, as international oil prices have been plunging and emerging markets' economic growth has slowed since 2015, there is great concern about the fact that Korean and Japanese companies show signs of faltering in their joint businesses in third countries. Nonetheless, the two countries have been continuing their cooperation in the field of energy and resource development. Moreover, Korean automobile part suppliers attempt to expand cooperation with Japanese suppliers and export their products to automobile companies in third countries. This can be seen as an example that goes beyond the existing framework mainly lead by Japanese trading companies. Considering these positive examples, the economic cooperation between Korea and Japan is expected to expand in the future.

The Future: TPP Negotiations and East Asian Mega FTAs

In the 21st century, economic relations between Korea and Japan based upon interdependence are more likely to intensify. This paper has investigated the economic ties between the two countries in terms of bilateral perspective. However, if it is observed through the East Asian perspective as a whole, Korea will expand economic globalization with interdependent economic relations with Japan. The Korean government will continue to push economic policy based on open globalization to help Korean enterprises utilize the East Asian market and Japanese technology and capital.

It is very crucial to review the major trade negotiations currently in progress in the region so as to predict economic relations between Korea and Japan. These encompass the China-Japan-Korea FTA (CJKFTA), Regional Comprehensive Economic Partnership (RCEP), and TPP. Following the Asian Currency Crisis of 1997, the Korean government recognizes the importance of economic and financial cooperation with East Asian states and it is widely regarded that Seoul has paved the way for FTA negotiations with Tokyo. Nonetheless, as noted, the two countries have failed to produce any fruitful outcome in the FTA negotiations process. Even though Korea has concluded several major FTAs including with the U.S., European Union, and China, it has not succeeded in either a bilateral or multilateral FTA with Japan. This can be seen as a contrast to the fact that Japan, as one of the major members, concluded TPP negotiations in October 2015.[11] In fact, U.S. policy pertaining to the FTA is rather uncertain. It is also uncertain whether the Korean government will take a passive or active attitude in pursuing the negotiation of multilateral and bilateral FTAs with Japan. In spite of these uncertainties, mega-FTAs in East Asia can stimulate economic relations between Korea and Japan.

[1] Abe Makoto, "Ilbonui Daehan kyungjehyupryop [Japan's Economic Cooperation with Korea]," HanilKwangesa: *1965-2015 [The History of Korea-Japan Relationship: 1965-2015]*, 2015: pp. 56-58.

[2] Park Cheol-Hee ("The Pattern of Cooperation and Conflict between Korea and Japan: Theoretical Expectations and Empirical Realities," *Japanese Journal of Political Science* 10(3), 2009: pp. 247-265), and Ja-Hyun Chun ("Have Korea and Japan Reconciled? A Focus on the Three Stages of Reconciliation," *Japanese Journal of Political Science* 16(3), 2015: pp. 315-331) analyze the Korea-Japan relation in a political perspective. They argue that in spite of a historical controversy and territorial dispute, Korea and Japan have constructed 'irreversible trends of improved cooperation,' and have worked towards an understanding achieved to date from an international reconciliation perspective.

[3] UN comtrade DB, http://comtrade.un.org/data (accessed August 9, 2016).

[4] KOTIS (KITA data base), http://www.kita.net (accessed August 2, 2016).

[5] Ministry of Trade, Industry and Energy, *Foreign Investment Statistics*, http://www.motie.go.kr/motie/py/sa/investstatse/investstats.jsp (accessed August 3, 2016).

[6] Kim Do-Hyung, "Hankuk kyoungjebaljungwa Hanil kyungjekwankeui Junge [Korea's Economic Development and the Development of Korea's Economic Relations with Japan]," *HanilKwangesa:1965-2015 [The History of Korea-Japan Relationship: 1965-2015]*, Seoul (2015): pp. 29-31.

[7] Materials sector in Materials & Components Technology Network's classification consists of metal materials, chemical materials, ceramic materials, and textile materials.

[8] Mukoyama Hidehiko, "Japan-South Korea Economic Relations Grow Stronger in a Globalized Environment," *Pacific Business and Industries*, Vol. VII, No. 43 (2012): pp. 15-17.

[9] Ministry of Trade, Industry and Energy, *Foreign Investment Statistics*, http://www.motie.go.kr/motie/py/sa/investstatse/investstats.jsp (accessed August 11, 2016).

[10] KIEP's paper (*Hanilkiupui Jekuk Kongdongjincyul Hwalsunghwa Bangan Yongu [Research on the Cooperation between Korean and Japanese Enterprises in Third Countries]*, Seoul: Korea Institute for International Economic Policy, 2013) refers to the cooperation pattern between Korea and Japanese companies in third countries and the role of Japanese trading company and Commercial bank.

[11] Kim Gyu-Pan ("Japan's Participation in TTP Negotiation: Prospect and Policy Implications for Korea," *World Economy Update*, Vol. 3 No. 21, Korea Institute for International Economic Policy [2013]: pp. 1-8) attempted to find the reasoning behind Japan's participation in the TPP negotiation in that their participation is not only in competition with China but also in competition with Korea in global market. Sohn, Yul ("The Abe Effect on South Korea's Trade Policy," *Asian Perspective* 39 [2015]: pp. 461-481) analyzed how Japan's participation in the TPP imposed challenges for the Korean government in making FTA making strategy.