
COUNTRY REPORT

South Korea
North Korea

2nd quarter 1997

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The Economist Intelligence Unit

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May 30, 1997 Summary

2nd quarter 1997

Inter-Korean relations: Relations between the two Koreas have improved slightly. North Korea has signalled a conditional willingness to attend the four-way talks to bring a permanent peace to the Korean peninsula. South Korea is supporting North Korea's bid to join the Asian Development Bank.

South Korea Outlook for 1997-98: Economic growth will slow to 5.9% in 1997, mainly due to a slowdown in domestic demand, but will rebound to 6.8% in 1998. The current-account deficit will narrow over the forecast period as terms of trade improve. Inflation will moderate to 4.4% in 1997 and 4% in 1998.

The political scene: The position of Kim Young-sam has been irreversibly weakened by the Hanbo and related scandals. His son has been arrested on charges of bribery and tax evasion. Mr Kim has himself been accused of irregularities in funding his 1992 election campaign. Lee Hoi-chang has become chairman of the ruling NKP. He is likely to be the party's candidate for the presidential election in December.

Economic policy: The government has backed down on labour reform. Freer hiring and firing has been postponed for two years. The proposals of the presidential panel on financial reform will be debated in parliament in June. The Fair Trade Commission under Yeon Yun-churl, a committed liberal, has been put in charge of deregulation.

Production and demand: Growth slowed in 1996, although it was rapid by average OECD standards. Public-sector investment took up some of the slack in the second half of the year. Exports and imports grew strongly in national accounts terms. Growth in manufacturing output slowed and will slow further. High-technology output is leading the way. Construction is still strong.

Wages and prices: Double-digit wage rises in 1996 will be followed by some slowdown in 1997-98. Domestic price pressures are easing as the economy slows, but won:dollar weakness and higher oil prices have contributed to higher won import prices.

Money and finance: M2 growth has been rapid in early 1997, while interest rates have fallen—and will fall further—despite a weakening won. Some banks have had difficulties raising funds abroad because of their exposure to the bankrupt Hanbo and Sammi companies. True to style, the state has stepped into the breach. The stock market has been weak and sustained recovery will be delayed.

Foreign trade and payments: Semiconductor exports continued to fall in value in the first quarter of 1997. In 1996 exports of producer goods were strong while imports of capital goods slowed. A widening current-account deficit in 1996 has highlighted the need to attract capital inflows as well as borrow abroad.

Business news: Hyundai, Samsung, LG and Daewoo are still the four largest *chaebol*. Standard & Poor's has downgraded Samsung Electronics' long-term rating outlook. South Korea's corporate insolvency rate has risen to its highest level in 14 years.

North Korea Outlook for 1997-98: North Korea's economy shrank by 3% in 1996. Negative growth will continue in 1997. The power struggle between Pyongyang's hawks and doves will intensify as the country's economic situation worsens.

The political scene: Hwang Jang-yop, one of North Korea's most senior leaders, has defected to South Korea. The defence minister, Choe Gwang, and his senior deputy minister have died. The composition of Mr Choe's funeral committee suggests a setback for civilian power-holders.

The economy, trade and investment: North Korea will face its worst famine ever this summer as the agricultural crisis deepens. According to South Korea, North Korea's trade fell by over 7% in 1996. South Korea has loosened regulations governing trade with the north.

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Inter-Korean relations

Signs of a thaw In early May there were some signs that relations between the two Koreas may be improving. More than a year after the USA and South Korea first proposed four-way talks with North Korea and China, without preconditions except to discuss how to move towards a permanent peace on the peninsula, Pyongyang may at last be ready at least to sit down at the table.

The grounds for cautious optimism are twofold. First, in March the north finally consented (after two postponements) to attend a briefing meeting about the four-way talks in New York with the USA and South Korea. Some newspapers hailed this as the first time the two Koreas had met to talk peace in 25 years. They have short memories. As recently as 1990-92 the northern and southern prime ministers met regularly to discuss peace and much else besides. They even signed an Agreement on Reconciliation, Non-aggression, and Exchanges and Cooperation in December 1991, although it was never implemented as concerns grew over North Korea's nuclear programme.

Thus there is no reason for the two Koreas not to talk if the will is there. That will has been lacking in Pyongyang in recent years, and sometimes in Seoul too. A significant shift is that the north has now not only sat down with the south at the briefing meeting, but in reporting it has for the first time acknowledged South Korea as a co-sponsor of the four-way proposal. Hitherto Pyongyang had clung to the stand that all it was doing, and was prepared to do, was to have bilateral dialogue with Washington.

Driven by desperation— The other reason to think that four-way talks may take place is that North Korea really has no alternative. The north's food situation is now so desperate that, brutally, if they do not talk then they will starve (see North Korea: Outlook for 1997-98). Even this stark prospect has not seen Kim Jong-il exactly rushing to the conference table, perhaps because it is not he and his ilk who are going hungry. Instead, Pyongyang has held out for food aid as a precondition of its attending the four-way talks. But on this, unlike some other tactical matters, the USA and South Korea see eye to eye. The allies insist that talks come first, but have hinted heavily that food aid will rapidly be forthcoming if only North Korea turns up for the talks.

Since turning up need not commit an endlessly prevaricating Pyongyang actually to sign anything, the chances are that the four-way talks will at least begin. How they will end is quite another matter. The hope, as ever, is that they may see North Korea finally making peace and opening up. However, despite the north's desperation, there is as yet no clear sign of such a will for real change. Quite possibly the four-way talks will be used as a ploy to elicit just enough food aid to keep the north going for a little longer, even though its plight grows more desperate and the underlying problems remain unaddressed.

—yet still the north hesitates Nonetheless, Pyongyang has yet to take the plunge. Having said it would give its reply on April 16 in New York, and despite optimism in Washington and

Seoul that this would be positive, in the event no deal was struck. It seems that the north was still holding out for prior food aid; when this was not forthcoming, the deputy foreign minister, Kim Kye-gwan, was left waiting for fresh instructions from Pyongyang.

Only after Mr Kim had headed home did Pyongyang clarify its position. North Korea has now said for the first time that it accepts the four-way talks, but only conditionally. It has demanded more confidence-building measures first, and more three-way discussions with the USA and South Korea, while complaining that "our equal footing at the talks has not been guaranteed". This refers to the asymmetry whereby China recognises both Koreas, while North Korea still lacks relations with the USA. Presumably, Pyongyang is therefore holding out for more food aid together with some upgrading of ties with Washington (for example, an exchange of liaison offices).

Sense or nonsense? Although a senior South Korean official promptly dismissed the north's new stance as "nonsense", this seems hasty. After all, China has never been enthusiastic about the four-way idea, which was originally a stratagem to counterpose to Pyongyang's insistence on talking peace with Washington alone, excluding Seoul. So the fact that the north now seems happy to contemplate a series of talks with the USA and South Korea could be regarded as mission accomplished. In any case, given the urgency of the food situation in the north, further movement on some combination of talks in the coming months seems likely.

Back to before the submarine Meanwhile, the past quarter has seen a number of small improvements, which have at least restored inter-Korean relations to where they were six months ago, before last September's submarine incident put everything on hold or in reverse (4th quarter 1996, page 5). Thus on April 1 the south's Red Cross announced its 14th and largest yet aid package, comprising \$1.1m worth of potatoes, powdered milk and radish and cabbage seed, to be shipped the short distance from Inchon to Nampo on April 3. This amount is derisory in the context of North Korea's needs; by comparison, the 150,000 tons of rice which Seoul sent in 1995 when floods devastated the north's food crop cost over \$200m.

KOTRA may set up in Rajin-Sonbong— Another positive sign was the visit to Pyongyang in late March of Hong Ji-soon, head of the North Korean division of the Korea Trade Investment Promotion Agency (KOTRA). This institution is nominally private, although it is in fact a government body—an ambiguity which lends itself to inter-Korean negotiation, since Pyongyang can pretend it is not talking to the southern government while Seoul knows different. Thus it was via KOTRA that rice aid to the north was initially discussed in 1995.

This time, the agenda was twofold: encouraging processing-on-commission trade, whereby southern firms send raw materials (and sometimes equipment) for the north to turn into finished goods; and the possibility of KOTRA itself opening an office in the Rajin-Sonbong free zone, thus paving the way for southern companies to set up there. All this was already on the agenda last summer before the submarine incident. However, at least relations are now back to the status quo ante, if not yet much farther on.

- as may a South Korean factory estate—
- Another similarly semi-governmental body, Korea Land Corporation (Korland), has also resumed contacts with Pyongyang. Already last August Korland representatives had visited Rajin-Sonbong to discuss setting up an industrial estate mainly for small and medium-sized South Korean firms (although foreign companies are also welcome), and conducted a feasibility study and survey. September's submarine incident then queered the pitch, but on April 20 Korland signed an eight-point letter of intent in Beijing with the north's Committee for Promotion of External Economic Cooperation.
- Korland's plans are ambitious. It is planning to develop an estate covering 1.3m sq metres in the first instance, but eventually rising to 6.6m sq metres, in the Yuhyon district of Rajin-Sonbong. This is close to port and rail facilities, as well as to a reservoir and a 20-kw thermal power station, thus minimising infrastructure costs and guaranteeing water and electric power (brown-outs are now common in North Korea). The total investment is put at some \$500m-600m, with at least \$100m for the initial stage.
- if Seoul permits
- All this would constitute the biggest South Korean investment in the north so far. It would also change the character of Rajin-Sonbong back towards its original purpose: hitherto the largest confirmed investments have been for a hotel, casino and bank, with investors showing little interest in manufacturing. This may explain why North Korea seems wholly positive about the venture. Presumably, Korland will be financing most of the construction of factories and facilities, something which a cash-strapped Pyongyang has been unable to do, thus diminishing the free zone's appeal as it stands.
- This is still subject to approval by the south's unification ministry. One can only hope that Seoul will give a clear green light, as such a project has both political and economic benefits. Politics aside, connecting South Korea's beleaguered small firms with cheap northern labour could revitalise such sectors as garments and footwear.
- KEDO sails on
- There has also been progress on the nuclear issue, which has been remarkably transformed from the peninsula's worst risk into its best hope. The past quarter saw a resumption of activities after some months of virtual hiatus due to the submarine incident. The most striking symbol was the unprecedented sight of a South Korean ship sailing into the northern port of Yanghwa—the port for the Sinpo light water reactor (LWR) site—on April 9, with a 54-strong team from the Korean Peninsula Energy Development Organisation (KEDO) on board. Inter-Korean sea lanes for the LWR project had been agreed in principle last year, but this was the first time they were put into use: previous KEDO delegations had gone the long way round, flying via Beijing to Pyongyang and then crossing the peninsula by slow train (North Korea has no other kind) to Sinpo.
- Hundreds to go north?
- The week-long visit went smoothly, with the ship returning to Tonghae in South Korea on April 16. More surveys were done and further protocols discussed. Matters resolved included immigration procedures, emergency drills and use of North Korean workers and materials. Issues still to be settled include mail and other communications, as well as the longrunning dispute over wage levels for northern workers. (Pyongyang wants these set at international levels,

but KEDO argues that local rates, which are much lower, are more appropriate.) These and other matters will be discussed when the next KEDO team goes north in May. Overall, there is optimism that actual construction could begin this summer. This will mean hundreds if not thousands of South Korean engineers working in the north, a circumstance which can hardly fail to affect and advance inter-Korean ties more generally.

Not flying yet

Sailing to Sinpo is of course not as quick as flying, which is what Seoul hopes its people will be permitted to do. This may depend on progress on opening North Korea's airspace more generally. Earlier hopes that Pyongyang may soon permit overflying of its airspace by civilian airliners (including those of South Korea) have yet to be fulfilled. A second round of International Air Transport Association (IATA)-brokered inter-Korean aviation talks in Bangkok in March (the first were held there last September) failed to produce an agreement. Although northern and southern air traffic controllers have agreed in principle to talk to each other (as of course they would have to), they apparently differ on the technical means of doing so. This does not sound like an insuperable obstacle, and there may be progress later in the year.

South Korea

Political structure

Official name	Republic of Korea	
Form of state	Presidential system; president and National Assembly directly elected, both on a first-past-the-post system	
The executive	The president (elected for a single term of five years) appoints the State Council (cabinet) composed of the president, prime minister and between 15 and 30 ministers. The State Council is not entirely composed of members of the National Assembly; last reshuffle March 1997	
Head of state	Elected president	
Legislature	Unicameral Kuk Hoe (National Assembly) of no fewer than 200 members (currently 299) elected for four-year terms; currently 253 seats are filled by direct election; the remaining 46 are distributed between parties in proportion to their share of the vote	
National elections	December 1992 (presidential) and April 1996 (National Assembly); next elections due by December 1997 (presidential) and April 2000 (National Assembly)	
National government	The ruling Democratic Liberal Party, itself formed by merger in 1990 of the then ruling Democratic Justice Party with two opposition parties, changed its name to New Korea Party (NKP) in December 1995. The NKP only gained 139 seats in the April 1996 election, but has since won over independents and others, giving it 157 seats and an overall majority of seven	
Main political organisations	Government: New Korea Party (NKP); opposition: National Congress for New Politics (NCNP); United Liberal Democrats (ULD); Democratic Party (DP)	
Main members of State Council	President	Kim Young-sam
	Prime minister	Koh Kun
	Deputy prime minister & minister of finance & economy	Kang Kyung-shik
	Deputy prime minister & minister of national unification	Kwon O-kie
Key ministers	Agency for national security planning	Kwon Yong-hae
	Construction & transportation	Lee Hwan-kyun
	Defence	Kim Dong-jin
	Education	Ahn Byoung-young
	Environment	Kang Hyon-wook
	Foreign affairs	Yoo Chong-ha
	Government administration	Kim Han-Kyu
	Health & welfare	Sohn Hak-Kyu
	Home affairs	Kang Wun-tae
	Information & communications	Kang Bong-kyun
	Justice	Choi Sang-yup
	Labour affairs	Jin Nyum
	Political affairs	Shin Kyung-shik
	Science & technology	Kwun Sook-il
	Trade, industry & energy	Lim Chang-yuel
Central bank governor	Lee Kyung-shik	

Economic structure

Latest available figures

Economic indicators	1992	1993	1994	1995	1996
GDP at market prices W '000 bn	240.4	267.1	306.0	351.3	393.6 ^a
Real GDP growth %	5.1	5.8	8.6	9.0	6.9 ^a
Consumer price inflation %	6.2	4.8	6.3	4.5	5.0
Population m	43.7	44.1	44.5	44.9	45.3
Exports fob \$ bn	75.2	81.0	93.7	123.2	127.9
Imports fob \$ bn	77.3	79.1	96.8	127.9	142.3
Current account \$ bn	-3.9	1.0	-3.9	-8.3	-21.3
Reserves excl gold \$ bn (Dec)	17.1	20.2	25.6	32.7	34.0
Total external debt \$ bn (Dec)	44.2	47.2	54.5	74.6 ^a	93.7 ^a
Exchange rate (av) W:\$	780.7	802.7	803.5	771.3	804.5

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Origins of gross domestic product 1995	% of total	Components of gross domestic product 1995	% of total
Agriculture, forestry & fishing	6.5	Private consumption	52.9
Mining & quarrying	0.3	Government consumption	10.4
Manufacturing	29.9	Fixed capital formation	36.6
Electricity, gas & water	2.4	Change in stocks	0.5
Construction	11.4	Exports of goods & services	33.2
Trade, restaurants & hotels	12.5	Imports of goods & services	-34.2
Transport, storage & communications	7.9	Statistical discrepancy	0.6
Financial & business services	17.2	GDP at market prices	100.0
Government services	5.8		
GDP at market prices incl others	100.0		

Principal exports 1995	\$ m	Principal imports 1995	\$ m
Transistors, semiconductors etc	19,373	Machinery & transport equipment	49,437
Textiles & fabrics	10,065	Mineral fuels & lubricants	19,013
Passenger cars	7,242	Chemicals	13,156
Ships & floating structures	5,533	Raw materials	11,713
Clothing & accessories	4,958	Food & live animals	5,926
Total incl others	125,058	Total incl others	135,119

Main destinations of exports 1996	% of total	Main origins of imports 1996	% of total
USA	16.7	Japan	20.9
Japan	12.2	USA	22.2
Hong Kong	8.6	China	5.7 ^b
China	7.6 ^b	Germany	4.8
Germany	3.6	Saudi Arabia	4.4

^a EIU estimate. ^b 1995 figure.

Outlook for 1997-98

A lame-duck president The political outlook for the rest of this year will be dominated by the presidential elections due on December 18. (The constitution bars the current president, Kim Young-sam, from standing for a second term.) This contest is now more open than it would have been, as Mr Kim's fears of becoming a lame duck in his final year in office have come true. The "double whammy" of bungled labour law reform and consequent union unrest earlier this year, followed by the ongoing Hanbo scandal, has so weakened the president as to destroy his expressed hope of picking the candidate from the ruling New Korea Party (NKP) to succeed him.

Sins of the son Kim Young-sam's sudden and surely irreversible weakening has three main causes. The labour law fiasco was a backlash against his high-handed methods and also cast doubt on his judgment, while the Hanbo scandal destroyed his administration's vaunted clean image by revealing that corruption continues much as before. Worst of all, the cloud of suspicion has fallen not just on close associates of Mr Kim but on his own son, Kim Hyun-chul. Although prosecutors have been unable to prove a link between Hanbo and Kim Hyun-chul, subsequent investigations into his dealings with other business groups led to his arrest on May 17 on charges of tax evasion and accepting bribes.

It is also possible, but unlikely, that the president's personal coating of Teflon may be damaged by renewed allegations that corrupt money helped to finance his 1992 election campaign. More probably, the opposition will judge him already sufficiently weakened and will not press for anything (such as impeachment) that might rock the constitutional boat, even if evidence emerges that could be so employed. Rather, they will seek to use the sleaze already revealed to damn the NKP as a whole.

New brooms in the ruling camp, as in 1992 Odd as it may seem, such smears are unlikely to succeed, because contenders for the NKP's own presidential mantle are no less keen to put clear blue water between themselves and a discredited president. Two of the "three Lees", Lee Hoi-chang and Lee Hong-koo, are therefore already distancing themselves from Kim Young-sam by criticising aspects of his government and party policy, such as top-down decision-making.

Thus the stage is set for a repeat of the 1992 presidential election. The then ruling Democratic Liberal Party, despite being tainted in the public mind by association with the military regimes of the 1980s, picked the former dissident Kim Young-sam as its candidate because he was a new broom and could win for them, which he duly did. Similarly, the NKP is all but certain to choose a candidate who will have fresh electoral appeal.

Three Lees and perhaps a Park For this reason, the EIU still thinks that the NKP is likely to win and that Lee Hoi-chang is likely to be its candidate. The NKP remains the only major party with a truly national following, and Mr Lee's prospects have been strengthened by his appointment as its chairman, replacing Lee Hong-koo (who also remains a contender). Both these Lees and indeed a third, Lee Soo-sung, are former prime ministers who nonetheless can and will present themselves as fresh faces

rather than career politicians. That will also be the pitch of a fourth contender, the maverick former independent Park Chan-jong.

Curtains for Kims? Popular disaffection with the present administration will do little to boost the electoral prospects of the opposition. There are several reasons for this. One is that the Hanbo scandal is ensnaring politicians from all parties, so none come out of it well. Another is the demographic disadvantage under which both main opposition parties labour in South Korea's first-past-the-post system. The National Congress for New Politics (NCNP), led by Kim Dae-jung, will sweep the board in Cholla in the south-west of the country and do quite well in Seoul, but the rest of the country remains resistant to this Mr Kim's charms. The United Liberal Democrats (ULD), led by Kim Jong-pil, has little support outside Chungchong and Taegu. An end to the era of the three Kims, which some in Seoul have been urging for years, thus now seems in sight.

Jailed ex-presidents may be pardoned Electoral considerations may also dictate that the former presidents Chun Doo-hwan and Roh Tae-woo will not serve out their lengthy prison terms for coup-making and corruption, even though in April the Supreme Court confirmed their sentences. The option of a presidential pardon still remains and may be exercised in the hope of winning back support for the ruling party in Taegu and North Kyongsang, from where the two former generals both hail. Any gains here, however, will have to be carefully weighed against the prospect of the NKP losing votes elsewhere in protest at the cynicism of clemency in such a context. Putting Mr Chun and Mr Roh behind bars was a popular move, which is why Kim Young-sam did it. Letting them out might prove a loser.

A "Big Bang" or a series of whimpers? Election years are nowhere conducive to sound economic policy-making, especially if it promises to be painful, and South Korea is no exception. Hence, it is unfortunate that so many economic chickens are coming home to roost just now, since there is little prospect of anything being done before 1998 that might risk losing votes. Much as the recently appointed deputy prime minister and minister of finance and economy, Kang Kyung-shik, talks of a "Big Bang", a series of whimpers looks more likely.

Restructuring the banks The next touchstone for economic policy will come in June when parliament debates the proposals for overhauling the banking system put forward by the Presidential Commission for Financial Reform. Few deny the need for radical restructuring in this area, even before the fall of Hanbo and Sammi and the wobbles at Jinro and Ssangyong laid bare the problems for all to see. Here too there is talk of a "Big Bang", and it is sorely needed. Only drastic consolidation and refinancing can render South Korea's banks in any shape to meet the challenge of market opening and competition in the next few years.

Piecemeal gradualism has been the style of Seoul's deregulation so far, and the presidential panel's first tranche of recommendations are anodyne stuff. In reforming the banks, there are two particular problems. One is ownership. Only the *chaebol* (conglomerates) have the capital and management skills needed to turn the banks around. Yet to let them buy up the banks runs counter to what little is left of Kim Young-sam's antitrust thrust and to public sentiment. (Under current rules, industrial groups may not own more than 4%

of the shares in each of the large commercial banks.) The other snag is that any rationalisation is bound to include substantial lay-offs, risking a renewed flare-up of labour unrest.

All quiet on the labour front

Otherwise, the labour front actually looks to be quieter than expected and indeed than usual at this time of year, with little sign so far of the customary "spring offensive". Reasons for this include the unions' victory in their struggles earlier in the year, with a revised law which legalises the Korean Confederation of Trade Unions (KCTU) at last while postponing for two years management's flexibility to hire and fire. Moreover, the fall of Hanbo and Sammi has brought home to workers the harsh truth that the companies on which they depend are not immortal, while the KCTU is aware that the public opinion which supported it in January would oppose any new disruption, given the state of the economy.

Indeed, some major companies have managed the hitherto unthinkable and agreed wage freezes or restraint with their workforces, at least for this year. It is a pity that such cooperation could not have come sooner. Overall, chances are that most of the structural obstacles to South Korean competitiveness (of which high wages are but one aspect) will largely be carried over into 1998, such that the task of seriously addressing them will be Kim Young-sam's unwelcome legacy to his successor.

After a slowdown in 1996—

Although GDP in 1996 expanded by what to many OECD countries would be seen as a rapid 6.9%, South Koreans, used to more sizzling rates of growth, saw the year as a recession. Export revenue was hit by adverse terms of trade effects, which were partly the result of the strength of the dollar. The profits, especially from exports, of South Korean companies, were down, while their costs were under upwards pressure from high interest rates and rising wages. These woes were exacerbated by the political problems faced by the government at the turn of the year.

South Korea: forecast summary
(% change year on year unless otherwise indicated)

	1995 ^a	1996 ^a	1997 ^b	1998 ^b
Real GDP	9.0	6.9 ^c	5.9	6.8
Industrial production	11.9	8.5	7.3	8.4
Consumer prices	4.5	5.0	4.4	4.0
Merchandise exports fob (\$ bn)	123.2	127.9	146.3	169.5
Merchandise imports fob (\$ bn)	127.9	142.3	154.2	178.9
Trade balance (\$ bn)	-4.7	-14.4	-7.8	-9.4
Current-account balance (\$ bn)	-8.3	-21.3	-13.8	-15.3
Average exchange rate (W:\$)	771.3	804.5	850.0	820.0

^a Actual. ^b EIU forecasts. ^c EIU estimate.

—the economy will bottom out in 1997—

Things will not get much worse in 1997, however, and a recovery is likely in 1998. The present government will not allow the country to fall into recession in the run-up to December's presidential election. Interest rates will be kept down, despite a volatile foreign exchange market, the monetary stance will be

accommodating but fiscal policy will be kept tight enough to prevent an upsurge in inflation.

—helped by an improving external environment

World trade growth in 1996 was low by recent standards, at an estimated 5.9%. Demand in Japan and in some west European economies was weak, and the dollar was exceptionally strong. Despite this, the performance of South Korea's exports in volume terms was quite strong. We expect stronger world trade growth in 1997-98 on the back of improved growth prospects in the EU, the USA (in 1997) and Japan (in 1998), as well as in many of the Asian economies with which South Korea trades. This, combined with the end of rapid dollar appreciation by the close of 1997, will provide a more congenial international environment for South Korea's exporters. Provided there is a clear result, the presidential election will put an end to the current political sclerosis and provide South Korea with stronger, more authoritative leadership. A more forceful approach to continued liberalisation, under the watchful gaze of the OECD, will be in evidence from early 1998.

Domestic demand growth will slow further in 1997—

We expect final domestic demand growth to continue to slow in 1997. This will manifest itself in slightly slower growth in private consumption, as a result of a slightly looser labour market and weaker consumer confidence. Investment will slow more markedly. Evidence suggests that private-sector investment in 1996 was hit by poor profits, high interest rates and the equity market slump. During the second half of the year it appears that growth in investment was being driven by the public sector. This will not continue in 1997 as the government tries to cut spending. Nor will there be much recovery in corporate investment until better economic conditions, including lower interest rates, a more stable won:dollar exchange rate and a stock-market recovery, feed through into investment plans for 1998. Overall GDP growth will therefore slow to just below 6%, the lowest rate since 1993.

—but recover in 1998

In 1998 we expect domestic demand growth to recover again. Fixed investment will gather momentum and consumer confidence will improve. Growth will rebound to 6.8%. External demand will continue to be quite robust in 1997-98. Export growth in national accounts terms will remain in double digits, while growth in imports, a function of export demand and investment, will be slightly higher. The engine of growth will therefore be domestic demand.

The current-account deficit will narrow

After its record high in 1996, the current-account deficit is set to narrow, from 4.3% of GDP in 1996 to around 2.7% in 1997-98. It will also fall in absolute terms, from \$21.3bn last year to an average of \$14.6bn in 1997-98. This will be chiefly the result of an improvement in the terms of trade for South Korean exporters. The invisibles deficit will remain large. Services earnings will be boosted by inwards tourism and transport, although outflows of financial services will rise in the wake of liberalisation. Outflows on the income account will rise rapidly, reflecting growing external liabilities.

Inflation will moderate—

The slowdown in the economy did not dampen inflation in 1996 because of the combined effects of strong wage rises, rapid M2 expansion and accelerating import prices in won terms. The result was a consumer price inflation rate of

5% for 1996 as a whole. We expect an improvement in 1997-98 as a result of slower economic growth, but inflation will still be higher than the OECD average. This is partly because growth will be higher than the OECD average, but also because of lingering inefficiencies and distortions in South Korean markets, which make for stickiness in price movements.

—as the won recovers

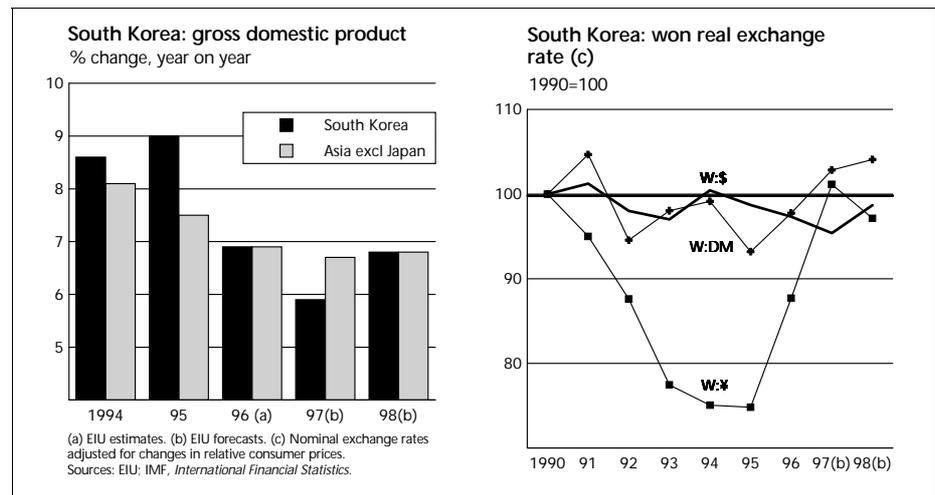
The won has had a rough ride so far this year. The large current-account deficit, scares over the financial health of South Korea's banks and *chaebol*, and scandal- and strike-induced political jitters combined with continued yen:dollar depreciation to force the won down to around W900:\$1 in early 1997. The Bank of Korea (the central bank) has not intervened to support the currency and has refrained from raising interest rates because of concerns about growth. We expect the yen to continue to appreciate over the rest of 1997 and into 1998. This will take pressure off the won. A more stable domestic political situation and an improvement in the external position and inflation will also combine with stronger inflows of portfolio investment to help strengthen the currency. We forecast an annual average exchange rate of W850:\$1 in 1997, rising to W820:\$1 in 1998.

South Korea: economic results and forecasts

(W bn at constant 1990 prices; % change year on year in brackets)

	1995 ^a	1996 ^b	1997 ^c	1998 ^c
Private consumption	138,015 (7.9)	147,538 (6.9)	157,128 (6.5)	167,812 (6.8)
Public consumption	23,433 (2.8)	24,792 (5.8)	26,031 (5.0)	27,333 (5.0)
Gross fixed capital formation	98,374 (12.4)	104,867 (6.6)	110,634 (5.5)	118,932 (7.5)
Final domestic demand	259,821 (9.1)	277,196 (6.7)	293,793 (6.0)	314,077 (6.9)
Change in stocks	164 (-0.4) ^d	900 (0.3) ^d	1,300 (0.1) ^d	1,800 (0.2) ^d
Total domestic demand	259,985 (8.6)	278,096 (7.0)	295,093 (6.1)	315,877 (7.0)
Exports of goods & non-factor services	106,768 (24.1)	121,823 (14.1)	136,198 (11.8)	153,222 (12.5)
Imports of goods & non-factor services	108,164 (22.1)	124,173 (14.8)	139,322 (12.2)	157,433 (13.0)
Net exports	-1,396 (0.5) ^d	-2,350 (-0.4) ^d	-3,124 (-0.3) ^d	-4,211 (-0.4) ^d
Statistical discrepancy	-1,053	-500	-600	-500
GDP	257,536 (9.0)	275,246 (6.9)	291,369 (5.9)	311,166 (6.8)
Net factor payments abroad	-2,802	-3,100	-3,250	-3,500
GNP	254,734 (8.7)	272,146 (6.8)	288,119 (5.9)	307,666 (6.8)

^a Actual. ^b EIU estimates. ^c EIU forecasts. ^d Change as a percentage of GDP in previous year.



Review

The political scene

A turbulent quarter

The year did not start well for South Korea. It began with continuing labour unrest over new laws passed on December 26 in extraordinary circumstances (at a dawn session of the National Assembly, of which opposition MPs were not notified), which unions and others felt were biased towards employers. While strikes and protests continued, in January the Hanbo group, the 14th largest *chaebol* (conglomerate), collapsed with debts of some \$6bn and charges that key figures close to the president, Kim Young-sam, including his own son, had been bribed to secure huge loans for the group. This “double whammy” has fatally weakened the president, who was forced to mark the start of his final year in office with an abject televised apology to the nation and to conduct yet another reshuffle of the cabinet, the ruling party and his personal staff.

Labour law volte-face

After weeks of demonstrations and deadlock, the labour issue was settled—at least for the time being—by the passage of revised legislation through the National Assembly on March 10, annulling the old new laws passed in December (which had theoretically gone into effect on March 1). The new laws contain two key concessions to the unions: immediate recognition of the hitherto illegal Korean Confederation of Trade Unions (KCTU), alongside the established and less militant Federation of Korean Trade Unions; and a two-year postponement of increased flexibility for management to lay off workers. There are also some crumbs for employers: more than one union at a given workplace will not be allowed until 2002; companies no longer have to pay striking workers; and employers’ salaries to full-time union officials will be phased out by 2001.

Both employers and unions predictably expressed dissatisfaction. The fact remains that in this, as in other domains, the country would do even better if more South Koreans could bring themselves to accept compromise more readily. If both sides of industry had genuinely sought a solution last year within the

framework of the presidential commission on labour law reform, the government would not have felt compelled to rush through its own law. The fair solution would have been more freedom for both sides—unions to organise, managements to hire and fire—and a bill to that end might have won grudging acceptance, particularly if it had been debated and passed fairly. As it is, production worth more than \$3bn was lost before a government cave-in which now bends the stick too far the other way. While it is right to decriminalise the KCTU, putting off greater flexibility in the labour market will do nothing to assist South Korea's competitiveness.

Death of a chaebol The climbdown over labour law reform had much to do with a further blow to the government which followed in late January, when the Hanbo group collapsed under the weight of its huge debts. (The economic aspects of this and subsequent corporate collapses—or wobbles—are discussed in Economic policy.) The Hanbo scandal, or “Hanbogate” as it was quickly dubbed, has primarily proved a devastating blow to Kim Young-sam, as charges grew that members of his own circle may have been implicated in securing unsound loans for Hanbo Iron and Steel, the attempts of which to build a huge (and still unfinished) new mill caused its downfall.

Hanbogate has destroyed Kim Young-sam's credibility Investigations into Hanbogate are still ongoing, and so the full fall-out is not yet known. The affair has, however, already fatally undermined Kim Young-sam's credibility, revealing as it does that, despite the president's vaunted crusade against sleaze and graft, corruption in high places continues much as before in South Korea. Particularly damaging is the apparent involvement of some of Mr Kim's closest political allies and, above all, of his son, Kim Hyun-chul, who had long been rumoured to be wielding substantial power (eg over appointments) despite not holding any official position himself. Matters were made worse by a perfunctory initial inquiry which was seen as a whitewash. Public outrage forced the replacement of a senior prosecutor and led to more substantial investigations. In connection with the allegations levelled against his son, Mr Kim has himself been accused of irregularities in financing his 1992 election campaign, which Kim Hyun-chul helped to manage. Kim Young-sam himself felt obliged to mark the fourth anniversary of his accession not triumphally, as he would have hoped, but with a humiliating televised apology to the nation for his “lack of virtue”—including, in this still Confucian-influenced society, for failing to bring up his son properly.

The affair has heightened public distrust of politicians of every stripe. Hanbo's founder, Chung Tai-soo, seems to have distributed his apple boxes (with cash under the fruit) to key members of all parties, as well as to his bankers. The outcome in general must be to strengthen the appeal of any candidate who can still credibly claim to have clean hands, such as Lee Hoi-chang.

Yet another reshuffle An inevitable consequence of Hanbogate was yet another political reshuffle, this time involving senior presidential aides and the ruling party as well as the cabinet (which had undergone a substantial reshuffle barely two months before). On March 4 Kim Young-sam appointed Koh Kun as his sixth prime minister in four years. This was an astute choice, as Mr Koh appeals to a range of usually opposed constituencies. He had wide ministerial experience gained

under Chun Doo-hwan in the 1980s, yet he comes from Cholla in the south-west, the main bastion of opposition to military rule. As mayor of Seoul in 1990, he was sacked by the then president, Roh Tae-woo, for opposing a plan to build housing on greenbelt land by none other than Hanbo (whose Mr Chung was later convicted of bribery in his bid to build); so his hands are clean. Seven further ministers were replaced on March 5, mainly in economic portfolios (see Economic policy).

Regional balance in the
Blue House

Four top presidential secretaries were replaced on February 28. Given the president's wide powers in South Korea, his top aides are similarly influential: they have been likened to a collective vice-presidency. Lee Won-jong and Lee Suk-chaе, who were responsible for political and economic affairs respectively, had both been widely criticised as the minds behind December's authoritarian passing of the labour law and another bill restoring more powers to the Agency for National Security Planning (NSP). They were replaced by a former journalist, Kang In-sup (political affairs), and the chairman of the Fair Trade Commission, Kim In-ho (economic affairs). The new presidential chief of staff is another ex-journalist, Kim Yong-tae, while the head of the Office of Supply, Ryu Jae-ho, has become secretary for general affairs.

Whatever the personal merits of these "worthies", regional balance looks to have been one consideration in their appointment. Three of the four hail from areas where the ruling party is not popular. Mr Kang is from Cholla, bastion of the main opposition National Congress for New Politics (NCNP); Mr Ryu is from Chungchong, heartland of the United Liberal Democrats (ULD), the second opposition party; and Kim Yong-tae is from Taegu, home to ex-presidents Chun Doo-hwan and Roh Tae-woo.

Lee Hoi-chang becomes
the ruling party
chairman—

The appointment on March 13 of Lee Hoi-chang as chairman of the ruling New Korea Party (NKP) was unexpected and can be read in different ways. Of all the ruling party contenders to succeed Kim Young-sam, Mr Lee has long been the most independent-minded. In 1994 he resigned (or was sacked) as prime minister in a quarrel over his lack of authority vis-à-vis the president. Kim Young-sam nevertheless invited him last year to join the NKP as an adviser, such was Mr Lee's popularity as a crusader against corruption in his earlier job as head of the Board of Audit and Inspection.

On the face of it, Mr Lee's promotion to party chairman reinforces his position as the NKP's most likely candidate for the coming presidential election. In happier times, Kim Young-sam would doubtless have preferred to offer such a plum post to someone more pliable. But there are complex undercurrents. The chairmanship was in fact first offered to Lee Han-dong, a stalwart of the Minjong faction associated with the disgraced Chun Doo-hwan and Roh Tae-woo, and himself one of the "nine dragons" contending for the NKP's crown. However, the offer was on condition that he abandon his presidential bid. Lee Han-dong refused and is now furious that no such condition has been imposed on Lee Hoi-chang.

—but may face a backlash

There are signs of a bandwagon starting to roll within the NKP to block Lee Hoi-chang. If key figures in the Minjong or Kim Young-sam's own Minju

faction gang up against Lee Hoi-chang, they could make life difficult for him. On the other hand, this could serve to burnish Lee Hoi-chang's image in the public mind as a fresh figure, in contrast with the murky machinations of the machine politicians—who may all want to stop him, but would find it hard to agree on a rival candidate. It may prove a hot summer.

Balancing the factions One consequence of Kim Young-sam's new weakness is that he must be attentive to divisions in the ruling party again, rather than riding roughshod over them. This can be seen in the NKP reshuffle of March 15, following Lee Hoi-chang's appointment as chairman, with key posts going to stalwarts of each of the two main factions. The new secretary-general is Park Kwan-yong, a loyalist from the president's own Minju faction, while the new chief policy-maker, Kim Zoong-wie, a former environment minister, is a stalwart of the rival conservative Minjong group.

A challenge for China— The major challenge of the past quarter in foreign affairs was that posed by the defection in February of the senior North Korean leader Hwang Jang-yop (see North Korea: The political scene). The fact that Mr Hwang fled to South Korea's consulate in Beijing put China in a very difficult position. Despite initial Chinese anger at Seoul for publicising Mr Hwang's flight, in the end Sino-South Korean relations withstood this severe test, with China eventually cooperating in letting him go first to the Philippines. Although Beijing will not move overtly on to the south's side while North Korea continues to exist, the handling of the Hwang affair indicates that relations between China and South Korea are on a more solid and practical footing.

—but a tiff with Taiwan By contrast, relations with Taiwan have hit a new low over a Taiwan deal to export low-grade nuclear waste to North Korea for dumping there. This has generated a rare unanimity in South Korea, with the government and environmentalists alike taking every opportunity to protest vigorously. Taiwan is unrepentant, insisting that it is a commercial contract and the waste in question is harmless.

While there may be some grounds for concern, it is hard not to see Seoul's antics as exaggerated and hypocritical. South Korea itself faces a much bigger problem of finding a long-term dump for the large amounts of higher-grade (ie more dangerous) waste produced by its still expanding nuclear power programme. It will also have to cooperate with Pyongyang in disposing of waste to be generated by the new reactors which it will build for the north under the auspices of the Korean Peninsula Energy Development Organisation (KEDO). The distinctly lukewarm responses of other countries to Seoul's pestering them to condemn Taiwan tell their own story.

High-level US politicians visit The past quarter saw an unusual flurry of top-level visitors from the USA. The newly appointed secretary of state, Madeleine Albright, the even newer defence secretary, William Cohen, the vice-president, Al Gore, and the speaker of the House of Representatives, Newt Gingrich, all came to Seoul in March or April as part of wider tours to key Asian capitals. The main agenda in all cases was how best to coordinate policy on North Korea and persuade Pyongyang to be positive about the four-way talks proposal. By comparison, bilateral issues between the

USA and South Korea have mostly been put on the back-burner for now. That may change with the arrest in Seoul on April 30 of a senior executive from the US defence contractor Litton on espionage charges. The case is not yet clear, but some have suggested that this may be retaliation for last year's arrest in the USA of a Korean-born navy analyst, accused of spying for Seoul.

Whose missiles? One potential conflict between Seoul and Washington concerns missiles. South Korea wants to buy a defensive anti-missile system and has let it be known that it is considering a Russian alternative to the US Patriot system. In response, Mr Cohen publicly opposed any such purchase before arriving in Seoul to discuss such matters, in a way which many South Koreans deemed high-handed. US unease is also in evidence over whether the USA will be allowed independent access to the North Korean defector Hwang Jang-yop, who is being monopolised (some say, guided) by Seoul's NSP. There are also niggles on trade, particularly Seoul's "frugality" campaign, although the large trade balance in favour of the USA has tempered Washington's militancy on this score.

Correct with Japan Relations with Japan have been good of late, with no Japanese politician slipping up over such issues as "comfort women" and the colonial past, and no flare-ups over the disputed Tokto/Takeshima islets (whose fate, however, remains unsettled). South Korea's foreign minister visited Japan in late April, mainly to coordinate policy towards North Korea. From Seoul's point of view, Tokyo is gratifyingly onside, more so indeed than is Washington. Japan supports four-way talks despite its own exclusion from them, it pays its dues to KEDO and, unlike the USA, it is in no hurry to shower extra food aid on Pyongyang, because it has several bilateral bones to pick with the north.

Economic policy

Rough ride all round Historians may well look back on 1997, and the first quarter in particular, as the time when the chickens finally came home to roost in South Korea. Issues which critics of Seoul's peculiar form of capitalism had long warned of as posing risks—ranging from unsustainable coddling of labour to blind corporate expansion, fuelled by debt and greased by corruption—burst dramatically upon the scene, in a way which ensures at last that they can no longer be swept under the carpet.

So far this year two major conglomerates, Hanbo and Sammi, have gone bankrupt, while at least two more, Jinro and Ssangyong, have been forced into urgent action (or rescued) to avoid a similar fate. Yet even now it remains unclear how far the will to grasp nettles is present in Seoul, particularly in an election year, when populist gestures such as "frugality" campaigns are more tempting than painful restructuring.

Labour law: the government backs down The year opened with a trade union backlash against both the content of new labour legislation, giving employers increased powers to hire and fire, and the manner of its passing at a dawn session of the National Assembly of which the

opposition was not informed. More than \$3bn of production was lost, particularly in the vehicle sector where the militant KCTU is strong. Although only 10% of South Korean workers are unionised, a mixture of fear of lay-offs and indignation at the way the bill was passed meant that the strikers attracted wider public sympathy than the government probably expected.

The fall of the Hanbo group in late January (see below) deflected attention from the labour issue and so weakened the government that it was forced to compromise with both the opposition and the unions on labour law reform. The revised law passed in March legalises the KCTU, while postponing freer hiring and firing for two years. In principle, this is bad news for South Korean competitiveness. In practice, there may be a silver lining. With the rocky state of the economy revealed by current figures and the Hanbo scandal alike, the previously unthinkable has happened: some firms have managed to negotiate a wage freeze with their workforces. If both sides of industry in South Korea can thus learn to cooperate, this may bode better for tackling problems of inflexibility and high costs than any forced restructuring.

The Hanbo scandal reveals
key weaknesses—

For the past four months concerns over labour issues in South Korea have become eclipsed by the Hanbo scandal. On January 23 Hanbo Iron and Steel, the country's second largest steelmaker, failed to honour due promissory notes, thus precipitating the bankruptcy of the entire Hanbo group, which with 24 subsidiaries was the country's 14th largest conglomerate.

It soon transpired that Hanbo owed an astonishing W5trn (over \$5.5bn) to 59 local financial institutions, with several major banks heavily exposed. Most of this was financing for a new steel mill, planned to be the fifth largest in the world, the costs of which more than doubled from W2.7trn to W5.7trn, and which remains unfinished. Hanbo Steel's debts were around 20 times its assets and roughly equal to the annual turnover of the entire Hanbo group. The end came when Hanbo's founder, Chung Tai-soo, refused the banks' demand that the mill itself and his family stake therein be offered as collateral for a further loan of W300bn to complete the project (although estimates for completion costs now exceed W1trn).

—above all, in the
banking sector

While the full details are still being unravelled, the many morals of the scandal fall under two headings. One is the way it has undermined Kim Young-sam by revealing widespread corruption not only continuing under his regime but also within his own coterie and possibly his own family (see The political scene). The implications for the economy are no less ghastly. Even without the corruption factor, how could major banks have lent such vast sums and gone on lending, apparently with no proper appraisal of either the steel mill's viability or the true creditworthiness of the borrower? For example, Korea First Bank, with total share capital of W1.8bn, lent W1.1bn to Hanbo. Korea First and several other banks involved have since been downgraded by the major ratings agencies.

Banks must learn to be
banks

Corruption aside, it is clear that South Korean banks have yet to learn to be banks. They are the creatures and the victims of a very particular history. Nationalised under the then president, Park Chung-hee, in the 1960s, they served for two decades as little more than conduits for Mr Park's industrial

policy. The government decided what sectors and firms to push, and the banks doled out the money. Despite mostly returning to private ownership in the 1980s, the legacies of that era still persist: objectively, in the burden of non-performing loans which they carry (because the state sometimes picked losers rather than winners); and subjectively, in the habit of lending at government behest rather than conducting their own evaluations and making autonomous decisions.

Sammi: the same story To make matters worse for the banks, a second steelmaker went bankrupt a few weeks later in March, again taking an entire top-30 conglomerate with it. Sammi Steel's debts total W1.7trn, or almost \$2bn. Sammi had been known to be in difficulty for some time, partly due to losses on a Canadian speciality steel acquisition, but also as a result of unwise expansion based on debt.

The buck stops with Jinro— Fears of a domino effect in corporate collapses were heightened in April when Jinro, the 19th largest *chaebol* by assets, was revealed to be in trouble. Although best known for making *soju*, South Korea's national spirit, in recent years Jinro had branched out into unrelated fields such as construction and retailing. The group has racked up debts of some W3trn, more than 20 times its equity. Unlike Hanbo and Sammi, however, Jinro's main creditors are non-bank institutions such as insurance companies, savings trusts and merchant banks, most of whom lent without any collateral.

On April 21 Jinro defaulted on some W30bn of promissory notes and other paper. Luckily for Jinro, the government had decided that two major corporate failures were enough. Three days earlier, 35 commercial and state banks announced that they would extend emergency credit to any top-50 *chaebol* at risk of bankruptcy and defer due debt repayments, provided the *chaebol* in question was basically sound. Since many banks are themselves in poor financial health, the government on April 23 announced a new bail-out fund worth W1.5trn, to be run by Korea Asset Management Corporation (KAMC), which will take over some of the W12trn in non-performing loans held by banks. On April 28 the bank consortium duly lent W80.4bn to Jinro.

—but is policy consistent? Opinion in Seoul is divided on the wisdom and viability of these measures. Critics believe that Jinro should have been allowed to go the way of Hanbo and Sammi and that rescuing Jinro sends a signal to other big *chaebol* that they need not shape up, since the government will, in the last resort, gallop to the rescue, or compel the banks to play the "white knight". There is also resentment that once again big is beautiful: the whales get bailed out, while small fry go to the wall. Technically, the government's bail-out plan is circular in that KAMC plans to raise its W1.5bn from the very banks it is supposed to help.

Nonetheless, there are counter-arguments. One is that a domino effect would have been a disaster which no responsible government should allow to happen, especially in an election year. Another is that, unlike in the past, rescue is not unconditional. Jinro has put land worth W1.2trn on the market and vowed to sell off half of its 23 affiliates to refocus on its core business. Its chairman, Chang Jin-ho, must use his own stockholdings as collateral for the new loans,

and if performance has not improved by the end of July Mr Chang must give up management rights.

Frugality, South Korean style—

Even as the Hanbo scandal and its aftermath exposed grave faults in the economy, one characteristic reaction dismayed South Korea's partners. There has been ample evidence in recent months that a "frugality" campaign was targeting imports deemed to be luxurious and that, despite repeated denials of any official involvement, the government was at the very least turning a blind eye to the zeal of bureaucrats on the ground, particularly in the customs service. Concrete examples include shops in Pusan being threatened with losing their supplies of South Korean cigarettes if they continue to stock Japanese brands, and a ban on Guinness on health grounds, because it apparently failed fizziness tests designed for lager not stout.

—has importers up in arms

While this might seem trivial, in the Korean context it set alarm bells ringing. South Korea, like Japan, is widely seen as a difficult market to penetrate. In the past, there was a panoply of explicit protectionist measures, both tariff and non-tariff. For instance, cars could not be imported at all until the late 1980s, and for several years thereafter anyone bold enough to buy a foreign car could expect a tax audit. This is all supposed to have changed. Seoul's accession to both the World Trade Organization (WTO) and now the OECD binds it to specific schedules of market opening and deregulation. Kim Young-sam's adoption of *segye-hwa* (globalisation) as his watchword is also supposed to indicate government enthusiasm for such steps.

Moreover, a 46 million-strong market with incomes per head approaching \$11,000 is seen as attractive and keen to purchase upmarket foreign brands, from Scotch whisky to BMWs. Hence, there was widespread dismay and anger in the first few months of this year, as more and more cases of an apparent reversion to economic nationalism began to be noted. As well as a host of bilateral protests, this prompted a sternly worded letter from the EU on April 3, threatening to take South Korea to the WTO if the frugality campaign continued. This threat was subsequently dropped following actions by the government to ensure the campaign does not discriminate against imported goods. The EU said, however, that it would continue to monitor South Korean policy in this area.

A red herring

One would have thought that the least the state could do would be to remind its well-educated citizens of some basic economic truths, such as the fact that consumer goods make up less than 12% of South Korean imports. It would be more pertinent to Seoul's balance-of-payments problems to seek to make more capital goods, and especially components, domestically. Another is that consumer demand is an engine of economic growth, whether or not some may deem it immoral. Yet another is both the theory and practice of free trade. A country so dependent on exports can ill-afford the risk of a backlash.

Frugal luxury limousines

What to outsiders looks like rank hypocrisy was illustrated at the Seoul Motor Show in late April. Hyundai unveiled what it described as a "super luxury" limousine, complete with television, VCR and minibar. Kia and Ssangyong, not to be outdone, will also launch limousines later this year. Given that the already visible trend in South Korea towards ever larger cars must be pushing up oil

imports, one might expect condemnation from the stern guardians of frugality. None has been heard so far.

Mergers and acquisitions:
foreigners need not apply

As well as the frugality campaign, several other events in the past quarter are redolent of economic nationalism. One such is the abortive takeover bid for Midopa, a major department store, which at best revealed contradictory attitudes. While the government says it is committed to making mergers and acquisitions easier so as to enhance competitiveness, hostile takeover bids are still seen as alien to the culture, particularly if foreigners are involved. With Midopa, the predator was South Korean, but some foreign money was involved. While the matter is sub judice—the bidder is accused of denying it was mounting a bid—it was striking how Midopa protected itself: by issuing bonds which were promptly snapped up by some of the biggest conglomerates, while the Federation of Korean Industries, (FKI), the *chaebol* club, muttered about disturbing existing managements and foreigners muscling in. Can this be the same FKI which has just opened a centre to promote free enterprise?

Amway targeted

There has also been unease over Amway, the US multilevel marketing company which has made rapid inroads in the local market for detergents and other household products. South Korean manufacturers and civic groups ran a campaign of advertisements denouncing Amway Korea on many counts, including making unfounded claims for its products. Amway counter-attacked, claiming this was sour grapes by those who were losing market share and accusing its critics of playing the nationalist card: for example, by accusing the company of worsening South Korea's trade deficit by importing its products.

Not constructing, but
inspecting

Likewise, the effects of market opening so far are mixed. Since the start of this year five foreign construction firms have been licensed to operate in South Korea. Not one has yet won a contract, even though they must by law be invited to bid for any project worth over W5.8bn (\$6.5m). Little wonder that one of the five, Bovis, has returned its contract. The rest have, however, found a niche in ancillary activities, such as design, supervision and, above all, inspection (as with the high-speed railway; see Business news).

New economics team is
appointed

As part of the fall-out from the Hanbo scandal, a fresh team of economics ministers was appointed on March 5. The new deputy prime minister and minister of finance and economy is Kang Kyung-shik. The fact that Mr Kang once held such posts as director of planning and price policy in the former Economic Planning Board might suggest an interventionist bent. In fact, the opposite appears to be the case. As finance minister during 1982-83 in the early years of the Chun Doo-hwan regime, it was he who spearheaded the first moves away from the patterns of state control which had characterised the Park Chung-hee era in the 1960s and 1970s. Since his new appointment, Mr Kang has been making encouraging noises about "Big Bangs", but so far it is mostly words rather than deeds.

The new trade minister is Lim Chang-yuel, who moves over from being vice-minister at the Ministry of Finance and Economy (MOFE). Mr Lim had a swift ascent as a civil servant in the old finance ministry, including international experience as a director of both the IMF and the World Bank.

- FTC founder returns as its head—
The most intriguing economic appointment is that of Yeon Yun-churl, who returns as head of the Fair Trade Commission (FTC), the cabinet-level body which is the main, indeed sole, repository of antitrust sentiment in the government. In 1981 it was Mr Yeon, as a director of the then Economic Planning Board, who was instrumental in founding the FTC as a separate agency and in drafting the law on monopoly regulation and fair trade. Thereafter, he mostly made his career with his creation. As its vice-chairman, he insisted on attending meetings of economic vice-ministers and saw the FTC attain cabinet status. After an unhappy two years as head of the fisheries agency, Mr Yeon is now back in his dream job, as captain of the ship he largely built.
- and takes charge of deregulation
Hitherto, despite Kim Young-sam's initial reputation as a foe of the *chaebol*, the FTC has had little joy (despite its formal promotion) under this administration. Rather, MOFE and the Ministry of Trade, Industry and Energy (MOTIE) have made the case that what is good for Samsung is good for South Korea, arguing especially that during an economic downturn nothing should be done to harm the conglomerates as engines of growth. Thus the initial effort to force each *chaebol* to specialise in three core areas was soon abandoned, while the FTC's efforts to control and make more transparent intra-conglomerate transactions (eg cross-subsidies) have been resisted. But now the FTC has stolen a march. It has been put in charge of deregulation, and both MOFE and MOTIE must transfer their activities in this field (in finance and industry respectively) to Mr Yeon.
- A serious liberal
It will be fascinating to see how this works out, as Mr Yeon is a committed liberal who seriously wants the government to move definitively out of industrial policy and focus on competition. He also speaks his mind. In a recent interview, he gave his recipe for policy towards conglomerates: "Throwing them into head-on competition both at home and abroad, what else?" He added that they "should compete not as a fleet of vessels but as individual ships, becoming lean and efficient". His critique was succinct: "The problem is that they seek only to expand with borrowed money, while maintaining strong family ownership, an extremely shaky financial structure, and less than transparent management." And yet, he said, most "are still lobbying with all means available to maintain the status quo, while expecting the government to protect them from open competition with foreigners here". Should this continue, the risk is of "chain-reaction bankruptcies, much bigger even than those of Hanbo and Sammi".
- Deregulation or subsidiarity?
South Korean and foreign business alike continue to wonder about the balance between the real and the merely cosmetic in Kim Young-sam's professed commitment to cutting red tape. Earlier this year the government claimed that over the past four years it had scrapped or eased more than 5,000 administrative regulations, almost half of them in the area of economics. Business retorts that to build a factory in South Korea still requires submitting over 10,000 pages of documents and obtaining as many as 600 official seals of approval, a process that typically takes two years or more. Critics also claim that most changes involve the simplification of rules, but not their abolition.

Blaming the bureaucrats More generally, South Korea's still small but growing band of critics of extensive government involvement in the economy charge that leaving deregulation to the regulators (ie government) is a recipe for inaction. They note that the number of public officials has actually risen during the four years of Mr Kim's presidency, from 890,000 to 917,000. Lower-level bureaucrats are seen as the main obstacle to reform, fearing (perhaps rightly) that not only their powers but also their jobs may be on the line if deregulation takes hold. They will not be comforted by a study from the Korea Economic Research Institute, which recommended cutting the number of government officials to a mere 10% of its present level over the next five years.

Privatisation: in distress The *Korea Herald* reported on April 26 that MOFE was experiencing "severe distress" over its privatisation plans, to the point where on April 25 it was forced to cancel a planned draft bill, due to opposition from other ministries. MOFE wants to move towards privatising four major state enterprises: Korea Telecom; Korea Heavy Industries and Construction (Hanjung); Korea Gas; and Korea Tobacco and Ginseng. It had planned two measures: to raise the equity limit for individual private shareholders to 10%, and to increase managerial autonomy by bringing in outside directors and exempting these four enterprises from supervision by the Board of Audit and Inspection (BAI).

This pleased nobody. On one side are the *chaebol*, who want to pick these plums and hence demand an ownership ceiling of 20-30%. On the other side, both the BAI and the trade ministry have criticised MOFE's plan. MOTIE's professed view is that state companies where safety issues arise—meaning Korea Gas and Hanjung, which also builds nuclear power stations—should not be privatised. Many would see this as a smokescreen, however, for the ministry's reluctance to give up the power which comes from running such major enterprises. If the deadlock continues, the chances of any substantial privatisation before the presidential election in December are slim.

BOK and KDI argue over interest rates High interest rates are widely agreed to be a major factor inhibiting South Korean competitiveness, as they make capital expensive. In April Chang Dong-se, the president of the Korea Development Institute (KDI), the leading government think-tank, suggested that a 3% expansion of the money supply would pull down interest rates by the same figure, from 12% to around 9%. This brought a swift riposte from the Bank of Korea (BOK, the central bank), which accused Dr Cha of ignoring the risk of inflation. A BOK spokesman claimed that each percentage increase in money supply would cause an equivalent rise in inflation.

Production and demand

A boom by any other name— Provisional estimates for the behaviour of the components of demand during calendar 1996 have been released in press reports. Growth in all the components of GDP slowed in the full year, but to a pace that can hardly be considered recessionary. There are even signs that the economy gained momentum in the fourth quarter and the prospects for exports in 1997 have improved. Nevertheless, there is deep gloom about the economy's performance both last year and this.

—as the public sector drives growth

One reason for concern about the economy was the importance of the public sector in providing a stimulus in the second half of 1996. In terms of domestic demand, private consumption growth moderated in the second half of the year, in response to a general drop in confidence, despite continuing gains in incomes. Growth in government consumption, by contrast, accelerated, as the authorities responded to the slowdown by counter-cyclical spending, especially on construction.

Investment growth slowed in calendar 1996, to 6.6%, from a rapid 12.4% in 1995, but it accelerated in the second half of the year. Anecdotal evidence suggests that domestic private-sector investment lagged, while public-sector investment, especially in infrastructure, was brought forward. While the *chaebol* were complaining about difficult market conditions at home and abroad and while domestic investment plans were being scaled down, consolidated general government expenditure on capital formation rose by 23% in nominal terms, to W3,758trn, in the first ten months of 1996.

Problems with external demand

Although in national accounts terms the growth of exports remained quite robust for the year as a whole, there was a slowdown in the rate of export growth in the second half of the year. The full-year figure of 14.1% compares favourably in volume terms with the performance of other regional economies. The robust volume of South Korean exports in what was for many economies a year of depressed demand owes much to the past record of investment in upgrading export range and quality. When viewed in conjunction with the adverse movement in the terms of trade in 1996, it also suggests that the profitability of exports was severely dented last year.

South Korea: expenditure on gross domestic product
(% change, year on year; constant 1990 prices)

	1995	1996				Year ^a
	Year	1 Qtr	2 Qtr	3 Qtr	4 Qtr ^a	
Private consumption	7.9	7.4	7.1	6	7.1	6.9
Government consumption	2.8	5.8	5	5.2	7.2	5.8
Gross fixed capital formation	12.4	5	4.6	6.5	7.1	6.6
Change in stocks	-0.4	-0.7	-1.2	-1.3	n/a	0.3
Exports of goods & non-factor services	24.1	21.1	13.5	9.4	12.4	14.1
Imports of goods & non-factor services	22.1	15.7	12.3	11.7	19.5	14.8
GDP	9.0	7.9	6.8	6.4	6.5	6.9
GNP	8.7	7.5	6.7	6.4	6.6	6.8

^a EIU estimates, based on press data for whole year.

Sources: Bank of Korea, *Monthly Statistical Bulletin*; EIU.

Import volumes in South Korea are driven by a combination of investment demand and, in a country where raw materials are scarce and where exports have a high import content, export growth. They are not, as some of the more excitable elements in the South Korean media have been suggesting, a function of burgeoning consumer demand for luxury imports. Imports outpaced exports in 1996, growing by 14.8% in national accounts terms. In the second half of the year the acceleration in investment growth spurred an increase in the rate of import growth.

Growth in manufacturing output slows Overall manufacturing output continued to expand during 1996: at the end of November the index of manufacturing production stood 10% above its level at the end of 1995. A slowdown will have occurred during December and January 1997 as a result of strikes during those months. According to press reports, industrial production in February was only 6.2% above the year-earlier level, suggesting that disruption and weak demand will hit output growth throughout the first quarter.

High-technology output leads the way The output of textiles and clothing—South Korea's sunset industries—was down by 10% and 17% respectively in November 1996 compared with the fourth quarter of 1995, continuing a well-established trend. Notable gains were made in the output of communications equipment (including radios and televisions), which rose by 19%; office, accounting and computing machinery (up 41%); and vehicles (up 16.5%). This reflects the shift in industry away from low-technology assembly on an original equipment manufacturing (OEM) basis to high-value, high-technology output which sells on quality as well as price. The most notable recent success in this area has been the achievement of considerable export volumes of cars. The top seven carmakers sold 26% more vehicles in 1996 than they did in 1995. This year, in another demonstration of the industrial muscle of the *chaebol* (and their ability to absorb losses), South Korean producers decided to raise production of 64-megabit dynamic random access memory (DRAM) chips to power a new generation of computers. South Korea and Japan are the sole producers of the 64-megabit DRAMs. Taiwan also produces 16-megabit DRAMs, the prices of which have plunged in 1996, reducing export revenue and profits. The unit price for 64-megabit DRAMs was around \$50 in early 1997, compared with \$10 for 16-megabit chips, which is about 80% below the price at the end of 1995.

South Korea: seasonally adjusted manufacturing production
(1990=100)

	1995	1996		1996		
	4 Qtr	1 Qtr	2 Qtr	3 Qtr	Oct	Nov
Food & beverages	122.4	125.2	123.8	121.6	126.7	122.4
Textiles	80.2	77	78.2	74.9	75.1	72.2
Clothing	82.8	83.4	82.4	71.7	71.1	69.0
Chemicals & products	179.6	188.6	185.1	195.2	205.1	199.3
Rubber & plastic products	133.7	137.4	140.5	142	141.3	138.9
Basic metals	156.9	161.9	162.7	165.4	169	171.6
Fabricated metal products	131.8	133	140.6	143	140.6	139.2
Non-electrical machinery	159.4	162	156.7	161.5	178.6	172.1
Radio, TV & communications equipment	239.1	247.5	253.4	259	269	283.9
Office, accounting & computing machinery	296.1	335.7	318.7	344.8	400.6	416.8
Electrical machinery	158.5	158.8	162.3	177	177.5	167.2
Motor vehicles & trailers	219.9	237.7	239.0	255.2	256.9	256.2
Other transport equipment	169.2	196.3	203.4	205.5	243.7	214.2
Manufacturing	153.8	159.1	160.0	164.5	170.4	169.1

Source: Bank of Korea, *Monthly Statistical Bulletin*.

Construction is still strong

As noted in our previous report (1st quarter 1997, page 26), there are signs that the value of construction work is rising strongly. This is true of both residential and industrial and commercial construction, and public-sector investment is also playing a part. The floor area of construction approved fell by about 2.5% during 1996, although the value of domestic construction contracts rose by 15%.

Despite this continued growth across all sectors of construction, high interest rates and slower sales of new apartments in 1996 and early 1997 are hitting the profits from construction at home. Prospects are improving abroad, however; the value of overseas construction orders rose by as much as 18% to \$10bn in 1996, a banner year for the South Korean construction industry.

South Korea: construction indicators

	1995	1996				1997
	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	Jan
Permits for building construction (m sq metres)	31.89	23.66	30.86	29.16	30.14	7.40
Domestic construction orders received (W trn)	185.59	99.15	131.2	128.24	229.48	26.24

Source: Bank of Korea, *Monthly Statistical Bulletin*.

Wages and prices

Double-digit wage rises in 1996—

Nominal wages continued to rise rapidly in 1996; the average rise in manufacturing wages for the whole year was 12.4% in nominal terms, implying a real gain of around 7%. Although it can be argued that higher wages have been earned by productivity rises (1st quarter 1997, page 27), the rapid rise in South Korean wages in recent years clearly cannot be sustained indefinitely. The government and the *chaebol* are making much of the fact that the nominal level of wages in South Korea is 30% above the level in the UK (although non-wage benefits narrow the gap between the two countries considerably), at a time when corporate profits and exports have come under pressure.

—herald a slowdown

The Ministry of Labour Affairs has said it will not give guidelines for this year's wage increases, as it did in 1993-96. Instead, it will let management and employees set increases on their own.

South Korea: wages in manufacturing industry
(Won per month; averages)

		% change, year on year
1993	885,398	10.9
1994	1,022,496	15.5
1995	1,123,895	9.9
1996	1,261,168	
1996		
1 Qtr	1,170,845	15.6
2 Qtr	1,184,706	10.5
3 Qtr	1,333,248	12
4 Qtr	1,359,414	11.4

Source: Bank of Korea, *Monthly Statistical Bulletin*.

There is a general belief that wages will rise more slowly this year and in the future, despite calls by the KCTU for a 10.6% rise in 1997. Leading employers are pushing for a wage freeze in salary negotiations that usually start in April or May. The FKI, which represents the 30 leading business groups, has said it would aim to freeze total wage costs this year at last year's level. In spite of this, we expect wages in manufacturing to rise by around 10% in 1997; although the labour market has begun to loosen, it is still tight, especially at the highly skilled end, and manufacturing output growth will accelerate later in the year.

Domestic price pressures
are easing

Consumer prices rose by 5% in 1996, a rate of increase which the government regards as too high. It was boosted in 1996 by the effects of the falling won:dollar exchange rate and by the rise in oil prices in that year of 20%, to an annual average of \$21/barrel. Rising wages also put pressure on prices, as did bad weather in the first half of the year. Monetary policy was also accommodating as the authorities sought to bring domestic interest rates towards international norms.

Import prices rise

Data in the table below show the inflationary effect of the weakness of the won in 1996, when it depreciated by just over 4% against the dollar. Imports from the USA in the first 11 months were worth \$30bn, or 22% of total imports in that period. The won's appreciation against the yen in 1996 was 10.1%, and the value of imports from Japan in the first 11 months was \$28.8bn, virtually the same share as those from the USA. However, some of these imports are priced in dollars, so the strong dollar led to accelerating rises in the won prices of imports from the third quarter of 1996. Export prices also rose, but by less than import prices from the fourth quarter of 1996.

South Korea: consumer and producer prices
(% change, year on year)

	1995		1996				1997	
	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	Jan	Feb
Consumer prices	4.0	4.5	4.9	5.1	5.2	4.8	4.7	4.9
Producer prices	5.2	3.6	3.1	1.8	2.3	3.5	3.6	3.6
Export prices (won terms)	0.2	-0.9	-1.3	-1.9	1.8	3.5	3.7	5.4
Import prices (won terms)	2.9	-0.1	-2.4	-3.9	1.5	5.1	6.1	7.2

Source: Bank of Korea, *Principal Economic Indicators*.

Money and finance

M2 growth is rapid

Throughout 1996 and into early 1997 M2 growth remained rapid and above the official target ceiling of 15.5%. Liquidity injections into the banking system by the Bank of Korea, designed to help meet a growing need for working capital as inventories accumulated, have been partly responsible. The central bank has also explained the rise in M2 in terms of the flow of funds from trust to savings accounts, a process that has been continuing since May 1996, when the maturity of trust accounts was extended from one year by up to six months.

The same reasons have been adduced for a continuing rapid rise in M2 during the first months of 1997; in February it was 20.4% higher than a year earlier. The central bank said it saw no signs of excessive liquidity in February despite

an injection of funds to meet rising money demand for the Lunar New Year and to counter possible shortages after the Hanbo Steel failure. Further injections of liquidity have been taking place as the ramifications of the Hanbo and Sammi insolvencies take their toll on the country's banking system.

- Interest rates have fallen— Interest rates have been on a downwards trend since their last rise in mid-1996, although the benchmark yield on three-year corporate certificates of deposit (CDs) was higher at the end of 1996, at 12.57%, than at the end of the previous year (11.65%). Rates started to move down from September, as the financial authorities sought to buoy growth and to move towards narrowing the interest rate gap between South Korea and the other OECD countries. Commercial bank reserve requirements were cut in November 1996, to 5.5% from 7.4%.
- and will fall further— Despite the financial failure of Hanbo Steel, which was declared insolvent on January 23 because of huge debts, and the subsequent collapse of Sammi Steel, which may be followed by more revelations about excessive lending, based on poor decisions, to South Korea's highly geared corporate sector, the government intends to keep moving interest rates downwards. This is desirable not only because of the high real rates being paid on debt by South Korean companies which do not have access to subsidised lending, but also because at a time of rising external deficits it is desirable to discourage the now common practice of borrowing abroad at more competitive interest rates than are available at home. The authorities have made it clear therefore that they would like to see interest rates move down further in 1997; reserve requirements are expected to be cut during the first half of the year in furtherance of this aim.
- On May 28 the yield on the benchmark three-year corporate bond stood at just under 12%, compared with 12.6% at the end of December 1996. This downward trend suggests an expectation that interest rates and inflation will moderate. On the same day the overnight call rate stood at 11.7%, down from 12.2% at the end of January.
- despite a falling won— One hurdle in the way of lower interest rates is prolonged weakness or instability of the currency. After depreciating against the dollar by some 4% in 1996—this was mainly the result of the strength of the dollar—political and economic jitters took their toll in early 1997. The currency ended 1996 at W844.2:\$1. During the first three months of 1997 the combination of continued dollar:yen appreciation and anxieties arising from labour unrest and the fall-out from the Hanbo scandal put the won under hard pressure. In March the currency came close to W900:\$1. It has begun to recover since then, and we expect it to average W850:\$1 this year, implying a recovery in the second half as the economy stabilises. Interestingly, the central bank has not moved to defend the currency. This is partly because the level of reserves, at \$30bn at the end of February, has fallen since the second half of 1996. It can, however, also be seen as a recognition of the need to boost the country's competitiveness, even if there is a price to pay in terms of imported inflation.
- Banks have difficulties— The scandal surrounding the Hanbo and Sammi insolvencies has damaged the creditworthiness of several South Korean banks. Those banks which were the most heavily exposed to Hanbo, which collapsed owing nearly \$6bn in largely

unsecured loans that had been granted without due attention to the viability of the company's expansion plans, found themselves having to pay a substantial premium on international markets to get hold of foreign currency. Two leading US credit-rating agencies have downgraded ratings assigned to South Korean banks, reflecting fears about the state of the financial sector. Moody's Investors Service downgraded ratings assigned to Korea Exchange Bank, Korea First Bank and Cho Hung Bank in February, while Standard & Poor's downgraded Korea First Bank in April.

The Hanbo scandal, with its high-level political ramifications, the subsequent collapse of Sammi Steel and fears that the insolvencies could trigger a series of back-to-back bankruptcies have thrown the weaknesses of South Korea's creaking banking system into sharp relief. Too much lending is decided on the basis of political connections; there is still a cumbersome regulatory process distorting the activities of the financial sector; and too many lending institutions exist, many of them with an unsustainable volume of dubious loans on their balance sheets.

—and the state steps into
the breach

The South Korean authorities have reacted to avert a potential crisis in the corporate sector in traditional fashion. Earlier in the year the government had talked of a "Big Bang"-style solution to the financial sector's structural problems. It suggested a solution in the form of a forced liberalisation which would combine the removal of restrictions (which will anyway have to go now that South Korea is a member of the OECD) with the merger of several financial institutions, so that the strong would absorb the weak.

The aftermath of the Hanbo affair has led to doubt about which, if any, the strong might be. The state has stepped in, in the form of the central bank, with an emergency credit line of \$1bn and pledges of support to banks experiencing difficulty, especially in raising foreign exchange. The authorities have also announced that they will lift some restrictions on access to foreign borrowing. The banks have responded by announcing that they will continue to support debtor companies and will not seek to cut back their assets or raise the costs of borrowing.

South Korea: money supply trends
(W trn; end-period)

	1995				1996				1997
	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	Feb
M1	309.21	316.26	313.71	388.73	342.7	345.88	380.62	395.42	387.38
% change, year on year	17.2	11.6	8.9	19.6	10.8	9.4	21.3	1.7	6.4
M2	1,317.80	1,362.86	1,397.68	1,539.45	1,516.91	1,597.54	1,697.6	1,783.12	1,828.41
% change, year on year	17.4	15.6	13.9	15.6	15.1	17.2	21.5	15.8	20.4

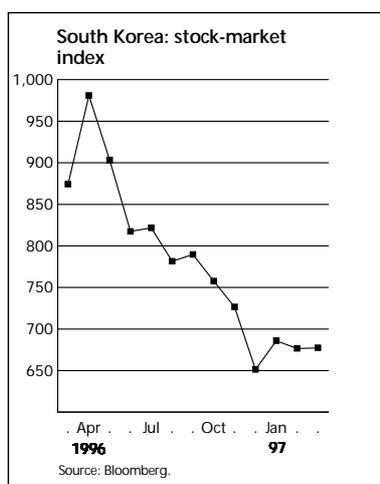
Source: Bank of Korea, *Principal Economic Indicators*.

The stock market feels the
chill

The stock market fell by 32% in dollar terms between the end of 1995 and the end of 1996, with the Korea Stock Price Index (KOSPI) ending the year at 652, down from 882 at the end of 1995. It recovered slightly in early 1997 as the government's commitment to lower interest rates and to a measure of liberalisation of the rules restricting foreign participation boosted confidence. The flow

of new issues was limited as it was recognised that the market had had to absorb too much—more than W9trn—in new shares in 1996. The foreign stockholding ceiling was raised from 20% to 23% at the beginning of May.

Recovery will be delayed



Although the fundamentally strong economy and the better prospects for exports in 1997 suggest that the market will recover, and especially if the remaining restrictions on foreign participation in the stock and capital markets are lifted, this will take time. Political uncertainty is now also a factor affecting the economy. The government has announced that the planned privatisation of part of Korea Telecom will have to await an improvement in the market, one which will probably be delayed until after the elections.

South Korea: stock prices (end-period)

	1996				1997		
	Mar	Jun	Sep	Dec	Jan	Feb	Mar
KOSPI index	866.8	817.4	789.7	651.2	685.1	681.2	667.2

Source: Bloomberg.

Semiconductor exports continue to fall in value

Foreign trade and payments

The decline in the value of semiconductor exports in 1996 (1st quarter 1997, page 31) continued into the first quarter of 1997. Press reports put the trade deficit in the first quarter of the year at \$7.43bn (fob-cif). This is much larger than the \$4.61bn deficit recorded in the first quarter of 1996.

Excluding semiconductors, exports rose 3.8% in the first quarter of 1997, to \$26.31bn. The value of semiconductor exports was reported as being down by a massive 40%, thanks to continued price weakness. Exports of home electronics fell by 4.2% and automobiles by 26%. As the decline in the price of 16-megabit DRAM chips appears to have ended—although prices have yet to start recovering from around \$10 a unit in the spot market—a recovery in the value of South Korea's exports, boosted by the switch to production of larger capacity chips is now due (see Production and demand). We expect the fob-cif trade deficit in 1997 to be \$16.9bn, after \$20.5bn in 1996, partly as a result of an improvement in the terms of trade.

Exports of producer goods continue to advance

A detailed breakdown of exports and imports by category is available for the first 11 months of 1996. The pattern it shows is a familiar one. Exports in the sunset sector—textiles and clothing—continued to decline, while exports of automobiles, electric-power machinery, power-generating equipment and ships performed strongly. Most other categories, including household electrical and office machinery, performed moderately as South Korean exporters suffered declines in profits to retain market share.

South Korea: exports of selected commodities

(\$ m)

	1994	1995	% change	Jan-Nov		% change
				1995	1996	
Apparel & accessories	5,653	4,958	-12.3	4,555	3,870	-15
Passenger cars	4,470	7,242	62	6,476	8,094	25
Footwear	1,780	1,506	-15.4	1,388	1,130	-18.6
Textiles & fabrics	7,838	8,735	11.4	8,025	8,001	-0.3
Transistors, chips etc	11,848	19,373	63.5	17,504	15,735	-10.1
Iron & steel	4,456	5,107	14.6	4,687	4,112	-12.3
Office machines	3,607	4,967	37.7	4,456	5,108	14.6
Telecommunications equipment	3,687	4,244	15.1	3,861	3,997	3.5
Refined petroleum products	1,608	2,291	42.5	2,086	3,274	57
Chemical elements & compounds	2,116	2,955	39.7	2,697	2,699	0.1
Television receivers	1,698	1,901	12	1,667	2,050	23
Sound equipment, VCRs etc	1,757	1,824	3.8	1,644	1,659	0.9
Radios	1,092	909	-16.8	848	493	-41.9
Ships & floating structures	4,945	5,533	11.9	4,874	6,364	30.6
Household electrical goods	1,485	1,685	13.5	1,548	1,758	13.6
Textiles yarn	1,055	1,331	26.2	1,205	1,329	10.3
Musical instruments & parts	1,199	1,385	15.5	1,258	1,336	6.2
Rubber tyres & tubes	1,233	1,330	7.9	1,214	1,400	15.3
Electric-power machinery	1,105	1,322	19.6	1,187	1,455	22.6
Power-generating equipment	1,002	1,212	21	1,109	631	43.1
Total incl others	96,013	125,058	30.3	113,301	117,622	3.8

Source: Bank of Korea, *Monthly Statistical Bulletin*.Imports of capital goods
slow

Reflecting a slowdown in the rate of growth of investment in 1996, one that will continue in 1997, growth in the value of imports of capital goods such as power-generating machinery slowed dramatically compared with 1995. Commodity price movements had an impact on imports; a 29% rise in the value of imported crude oil was the result of higher international oil prices and has prompted the government to look for ways of curbing demand for imported crude oil, chiefly by proposing large domestic price rises as seen in the aftermath of the 1979 oil shock.

South Korea: imports of selected commodities

(\$ m)

	1994	1995	% change	Jan-Nov		% change
				1995	1996	
Machinery & transport equipment						
of which:						
transistors, chips etc	6,983	9,838	40.9	8,957	10,379	15.9
power-generating machinery	2,768	3,891	40.6	3,490	3,311	-5.1
electric power machinery	1,737	2,181	25.6	2,015	2,079	3.2
telecommunications equipment	2,221	2,659	19.7	2,436	2,826	16
office machinery	2,615	3,570	36.5	3,205	3,624	13.1
metalworking machinery	1,788	2,341	30.9	2,159	2,957	37
textiles machinery	1,217	1,087	-10.7	1,007	671	-33.4
motor vehicle parts	1,118	1,304	16.6	1,208	1,153	-4.5
aircraft	2,208	2,479	12.3	2,428	2,173	-10.5

continued

	1994	1995	% change	Jan-Nov		% change
				1995	1996	
Measuring & controlling instruments	2,664	3,607	35.4	3,259	3,508	7.6
Chemicals, pharmaceuticals & plastics	6,839	9,437	38	8,694	8,490	-2.3
Mineral fuels etc						
of which:						
crude petroleum	8,878	10,809	21.8	9,850	12,709	29
Inedible raw materials						
of which:						
hides & skins	922	991	7.5	924	812	-12.1
iron ore & ferrous waste	1,944	2,312	18.9	2,168	1,968	-9.2
timber	1,012	1,047	3.5	959	888	-7.4
raw cotton	590	771	30.7	705	664	-5.8
Food & live animals	2,198	2,575	17.2	2,477	2,862	13.5
Non-ferrous metals	3,066	4,617	50.6	4,267	3,820	-10.5
Total incl others	102,348	135,119	32.0	123,313	136,632	10.8

Source: Bank of Korea, *Monthly Statistical Bulletin*.

A widening current-account deficit—

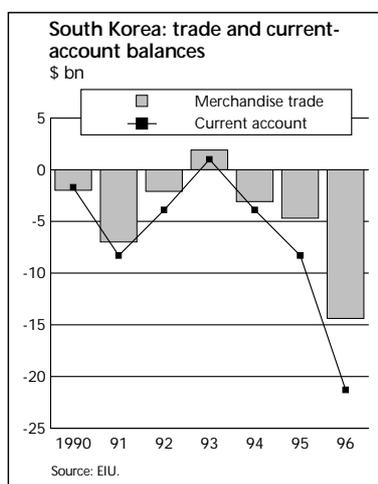
As a result chiefly of the large rise in the trade deficit in 1996 the current account (both on IMF and national definitions) plunged deeply into the red in 1996. For the full year we estimate an (IMF-based) deficit of \$21.3bn. Figures for the first 11 months of the year, on Bank of Korea definitions, show the trade deficit up by 186% and the invisibles deficit up by 66.5%. This rise is largely the result of widening services deficit (exports of services are correlated to exports of goods; outwards tourism has risen rapidly) and a widening gap on the income (interest, profit and dividends) account as a result of the progressive accumulation of overseas liabilities.

South Korea: current- and capital-account balances (\$ m)

	1994	1995	% change	Jan-Nov ^a		% change
				1995	1996	
Merchandise exports	93,676	123,203	31.5	111,623	116,652	4.5
Merchandise imports	-96,822	-127,949	32.1	-116,539	-130,714	12.2
Trade balance	-3,145	-4,747	50.9	-4,916	-14,062	186
Invisibles balance	-1,989	-3,640	83	-3,330	-5,546	66.5
Net transfers	604	-561	n/a	-464	-721	55.4
Current-account balance ^b	-4,531	-8,948	97.5	-8,710	-20,329	133.4
Long-term capital balance	5,862	7,827	33.5	6,592	10,475	58.9
Basic balance	1,331	-1,120	n/a	-2,118	-9,854	365.2
Short-term capital balance	3,163	5,592	76.8	5,006	4,484	-10.4

^a Provisional. ^b Bank of Korea and IMF figures differ, but not greatly, in the computation of the services and income items in the current account.

Source: Bank of Korea, *Monthly Statistical Bulletin*.



—highlights the need to attract capital

Developments on the capital account are dictated by the rising current-account deficit, taking the country's total external indebtedness to an estimated \$93.7bn by the end of 1996, adding \$19bn to the debt in one year. South Korea can raise large sums on the international debt markets. But the aftermath of the

Hanbo affair, which raised the cost of foreign exchange to South Korean banks, and the sheer size of the current-account deficit have underlined the need to attract foreign direct investment (FDI) as an alternative way of financing the savings-investment gap. In 1996 FDI approvals inflows were reported as having risen by 39%, to a still rather modest \$3.2bn. Portfolio investment flows are much larger, and will rise further as liberalisation proceeds, but the government is well aware that this can be a volatile source of financing for a structural current-account deficit.

Business news

Top 30 *chaebol*: latest list

The Fair Trade Commission (FTC) has published its annual list of the top 30 *chaebol* in terms of assets. The FTC does not just do this as a matter of information. The top 30, unlike smaller business groups, are banned from cross-investing among their affiliates, while their investments in other firms must not exceed 25% of net assets.

There are no changes in the top ten. Further down, four groups have fallen out of the rankings: Hanbo and Sammi (due to bankruptcy), together with Kukdong and Byucksan. They have been replaced by the chipmaker Anam, and Keopyung, Miwon and Shinwon. The highest riser is Hansol, up from 22 to 16, while Halla, Kohap and New Core have also gone up. Conversely, Doosan, Daelim and Tong Yang have all slipped slightly. As ever, the “big four”—Hyundai and Samsung in the lead, together with LG and Daewoo—are much bigger than most of the rest, although a further five groups now boast gross assets in excess of W10trn. Sales figures show a similarly disproportionate lead.

Kim Young-sam's bid early in his presidency to force the *chaebol* to specialise is a faded memory. The total number of subsidiaries owned by the top 30 rose from 669 last year to 819 now (as at April 1, in either case), due variously to mergers, acquisitions and forays into new business lines.

FDI up almost fourfold

South Korea's economic woes are not discouraging all outside interest. Figures from MOFE indicate that FDI in the first quarter of 1997 totalled \$2.12bn: a remarkable year-on-year rise of 372%, and equivalent to two-thirds of the total for the whole of 1996. By sector, the rise was almost equal in manufacturing (\$907m, up 370%) and services (\$1.22bn, up 373%). Since the actual number of investments rose far less (by 12%, from 226 to 253), it follows that the average size of projects is growing rapidly. In fact, these particular quarterly figures may well be distorted by three massive investments, which alone account for more than half of the total: Ireland's Pan-Pacific has bought a 31% stake in Samsung Motors for \$291m; \$210m is accounted for by a new French wholly owned bottler for Coca-Cola; and a US firm has paid \$750m for 80% of Bohyang, a hotel company. It remains to be seen whether FDI continues to grow at such a rate during the rest of the year and beyond.

Doosan denies rumours

The collapse of Hanbo and Sammi and the near-fall of Jinro have naturally led to fevered speculation in Seoul as to which other *chaebol* might sink in a sea of debt. In May the president of Doosan, a top-20 conglomerate by assets, wrote

to *Business Week* to deny that his group was in any special difficulty, as the magazine had claimed that analysts believe.

Hyundai says no to Hanbo

The fall of Hanbo adds a new twist to the on-off saga of Hyundai's wish to get into steel. With Hanbo's still unfinished new facility (as well as its existing plant) due to be auctioned in May, Hyundai would seem the obvious buyer. Not so, apparently. Hanbo has gone for electric and Corex-type furnaces, whereas Hyundai favours an integrated steel mill with a conventional blast furnace. Nevertheless, Hyundai is reclaiming a large site adjacent to Hanbo's plant at Tangjin, which it claims is for an oil refinery.

Whether or not Hyundai bids for Hanbo (or has its arm twisted to take it on), controversy persists as to whether likely demand for steel justifies expanding capacity. The government had used forecasts of oversupply as its reason to thwart Hyundai's desire to build a mill producing between 6m and 9m tons. However, the research institute of POSCO, the largest Korean steelmaker (soon to be the world's biggest as well), predicted that this year global demand for steel will exceed supply by some 54m tons. Indeed, the main shortfall (over 67m tons) will be in Asia, largely due to burgeoning demand in China.

On April 16 Hyundai began full operation of what it claims is the world's largest commercial vehicle factory at Chonju in North Cholla. This will turn out 18,000 buses and 82,000 trucks and specialist vehicles a year, with expected annual turnover of W1.7trn (\$1.9bn). The hope is that by 2000 about half of the total will be exported.

Daewoo will resume cooperation with GM

Meanwhile, Daewoo has said that it will resume closer cooperation with General Motors (GM), with which it had a 50:50 joint venture until 1992 (which is why the Daewoo cars now being sold around the world closely resemble the last generation of GM models). Although the split was less than amicable, and the two have since been competitors (for example, in Poland, where Daewoo beat off GM), they have continued to cooperate on components. It remains to be seen what form the new cosiness takes.

Standard & Poor's downgrades Samsung Electronics

On April 24 the US credit-rating agency, Standard & Poor's, downgraded Samsung Electronics' long-term rating outlook from stable to negative. The reason cited was the industry-wide slump in chip prices rather than any special weakness of Samsung, which was praised for its commitment to R&D—and also noted as receiving preferential treatment from government because of its key role in exports. The long-term rating itself remained at A, but with a proviso that any large rise in debt might lead to downgrading here as well.

Exposed in Vietnam

Insofar as South Korean companies have an overall strategy at all, beyond growing as fast as they can borrow and expanding in all directions simultaneously, emerging markets form an increasingly important part of the picture. In a sense, the *chaebol* are placing a massive bet on rolling back the developing countries over the next two to three decades. That is, they are counting on a huge expansion of consumer demand across Asia, Latin America and the former communist bloc, consequent on these areas growing rapidly (as South Korea itself did) out of poverty and towards rich country living standards. So

when an Uzbek or a Bolivian or Romanian buys his or her first colour television or car, they hope it will be South Korean.

It is a bold strategy, but not without pitfalls. The risk, as well as the reward, inherent in new markets was brought home by reports in late April that South Korean companies are especially heavily exposed to debts (especially deferred letters of credit) owed by some of Vietnam's shakier banks. Daewoo, Sunkyong, Ssangyong, Kolon and Hyosung were among the companies mentioned. Of a total debt of some \$800m, some 60% is thought to be to South Korean trading houses, which in consequence have held urgent talks with the central bank in Hanoi.

- Bankruptcy rate highest for 14 years South Korea's corporate insolvency rate reached its highest level for 14 years in February, and maintained it in March. The percentage of promissory notes outstanding that are in default stood at 0.24% in both months, the worst since May 1982. This figure has doubled since September 1996, when it was 0.12%.
- High-speed rail travail The Seoul-Pusan high-speed railway continues to be more travail than travel. When the project was launched in 1992 it was scheduled to cost W10.6trn (almost \$12bn at the current exchange rate) and to be ready by 2002 in time for the soccer World Cup and the Asian Games in Pusan. But squabbles over routing from newly empowered local governments, combined with the discovery of flaws in the first test sections built, have put the completion date back by three to four years. The costs could now go as high as \$20bn. A new blow came in April when a US firm brought in to inspect construction reported that five out of 37 bridges built so far between Seoul and Taejon must be rebuilt if they are not to pose a safety risk. The construction companies at fault are some of South Korea's best-known names, including Daewoo, Halla and Hyundai. With the 32 people killed when a bridge collapsed in Seoul in 1994 and the 450 deaths from the Sampoong department store collapse in 1995 still fresh in peoples' minds, the government is taking no chances.
- Will they fly? Despite the collapse last year of a proposed aircraft joint-venture consortium with China, and the unsuccessful outcome of Samsung's bid to buy Fokker, South Korean ambitions to build passenger aircraft are by no means grounded. The latest version is a consortium of consortia, linking South Korea's "big four" in this field—Samsung, Daewoo, Hyundai and Korean Air—with Aerospace International Regional in Europe, itself a consortium grouping UK, French and Italian interests.
- LG thinks big— While the consensus among outside observers is that South Korean conglomerates are unwise to regard sheer size as a virtue—usually as measured by turnover or assets, and especially if attained by piling up debt rather than issuing equity—the *chaebol* themselves seem loth to agree. Thus in April the chairman of LG (formerly Lucky Goldstar) celebrated the group's 50th birthday by declaring that it will invest no less than W60trn (\$67bn) by 2000 to attain global sales of W130trn (\$145bn) by that year. Of this new investment, W10trn is earmarked for R&D while W50trn is for new plant. (These proportions may in themselves cause unease: another criticism of South Korean-style blind

expansionism is that too much of it consists of making more of the same, while too little is spent on the research needed to upgrade technical quality.)

Anxiety is not eased by the sectoral allocation. Semiconductors are to get the lion's share (W18trn, of which two-thirds is to develop next-generation chips), followed by chemicals (W13trn) and electronic goods (W12trn). While obviously such huge investments are based on forecasts of what will be profitable, it would be more encouraging if returns rather than sales were highlighted, particularly considering that massive expansion in the current generation of chips created the glut and plunging prices which so damaged all concerned in 1996. If all South Korean majors think like LG, the same will happen again.

—but is big beautiful?

They do indeed think this way, as witness an article in the *Far Eastern Economic Review* on May 1 by Park Ung-suh, the president of Samsung Economic Research Institute, entitled: "Big Is Beautiful". While this made some fair points about economies of scale and global presence, Mr Park was alarmingly silent on both the risks of debt-financing and overcapacity, not to mention the way the *chaebol* crowd out and stifle smaller South Korean firms. One does not have to share the knee-jerk reactions of those commentators for whom any failure to maximise immediate gratification to shareholders is *ipso facto* sinful, to fear that South Korean conglomerates may be failing to adapt to new times—or to learn from the fate of their Japanese equivalents (which remain South Korea's abiding reference group) which also prioritised market share over profitability.

FKI launches centre for free enterprise

The Federation of Korean Industries, which represents the *chaebol*, is possibly better known for special pleading than independent thought. Lately, however, it has launched two intellectual initiatives, even though it promptly retracted one of them. In April the FKI's Centre for Free Enterprise (CFE) was opened. Its director, Gong Byeong-ho, said his models include the Cato Institute and the Heritage Foundation in the USA, and the Adam Smith Institute in the UK. While sternly critical of big government, the CFE seems silent on monopoly and big business.

It is unclear how the new centre relates to the FKI's older think-tank, the Korea Economic Research Institute (KERI). In April KERI issued a report whose thrust was even more radical. This advocated sacking 90% of all bureaucrats and abolishing at least seven ministries, including all those concerned with the economy. It also called for defence spending to be cut, since in the next century "national security will be meaningless" (one hopes Kim Jong-il shares this view). The private sector should be involved in education. Democracy itself must be scrutinised, as politicisation of economic policy leads to slower growth. No sooner had this remarkable document been published on April 11, however, than it was hastily withdrawn. Rumour has it that Chey Jong-hyon, the chairman of FKI (and also of Sunkyong) who commissioned the study, feared a negative reaction from the government and officialdom.

North Korea

Political structure

Official name	Democratic People's Republic of Korea	
Form of government	One-party rule, based on the ideology of <i>juche</i> (self-reliance)	
The executive	Since 1992, the National Defence Commission now ranks above the Central People's Committee, which in turn is above the State Administration Council (cabinet). All are notionally responsible to the Supreme People's Assembly	
Head of state	Indirectly elected president. Vacant since the death of Kim Il-sung in July 1994	
National legislature	Unicameral 687-member SPA directly elected for five-year terms. A Standing Committee substitutes when the SPA is not in session	
Regional legislatures	Each province, city, county or district elects people's assemblies or committees. These committees elect local officials to carry out centrally decided policies	
National elections	None since April 1990. The election due in 1995 was not held. The SPA has not met since April 1994	
National government	The Korean Workers' Party (KWP) controls all arms of the state. Since the death of Kim Il-sung, military figures have had a growing influence	
Main political parties	Government: Nominally, the KWP is in coalition with the Social Democratic Party and the Chondoist Chongu Party	
Key holders of state & party positions	President	vacant
	Vice-presidents	Pak Song-chol; Li Jong-ok; Kim Yong-ju; Kim Byong-sik
	Prime minister	vacant
	Vice-premiers	Kim Yong-nam; Choe Yong-nim; Kim Bok-sin; Kang Hui-won; Kim Yun-hyok; Kim Hwan; Kim Chang-chu; Chang Chol; Hong Song-nam; Kong Chin-tae
	Key politburo members	Kye Ung-tae; Chon Byong-ho
	Key ministers	
	Chemicals industry	Kim Hwan
	Defence	vacant
	Electronics & automation industry	vacant
	Finance	Yun Ki-chong
	Foreign affairs	Kim Yong-nam
	Foreign trade	Li Song-dae
	Machine industry	Kwak Bom-gi
	Metal industry	Choe Yong-nim
	Public security	Paek Hak-nim
	Railways	Pak Yong-sok
Chairman of the State Planning Commission	Hong Sok-hyong	

Economic structure

Latest available figures

Economic indicators	1992	1993	1994 ^a	1995 ^a	1996 ^a
Real GNP growth %	-5.0 ^a	-3.5 ^a	-2.0	-4.2	n/a
Rice production ^b '000 tons	n/a	1,330	n/a	n/a	1,340
Population m	22.2	22.6	23.0	23.4	23.7
Exports ^c \$ bn	1,020	1,020	840	590	n/a
Imports ^c \$ bn	1,640	1,620	1,270	1,470	n/a
Trade balance \$ m	-620	-600	-430	-880	n/a
External debt ^d \$ bn	n/a	n/a	9.8	n/a	n/a
Exchange rate ^e (av) Won:\$	2.16	2.17	2.17	2.15	2.15

May 30, 1997 Won2.20:\$1^f

Origins of gross domestic product 1994 ^c	% of total
Agriculture, forestry & fishing	29.5
Mining	7.8
Manufacturing	23.6
Electricity, gas & water	4.8
Construction	6.3
Services	27.9
Total	100.0

Main destinations of exports 1995 ^g	% of total	Main origins of imports 1995 ^g	% of total
Japan	27.9	China	32.6
South Korea	20.8	Japan	17.2
China	5.2	Russia	4.7
Germany	4.0	South Korea	4.3
Russia	1.2	Germany	2.9

^a EIU estimates. ^b UN Food and Agriculture Organisation (FAO) figures. ^c Bank of Korea estimates. ^d Including rouble-zone debt, at pre-1990 values. ^e Official rate until 1991; market rate thereafter. ^f Market rate. ^g Cited in a book by Marcus Noland: *The North Korean Economy*, Institute for International Economics, Washington DC, 1995.

Outlook for 1997-98

- Looking grim** The outlook for North Korea can be considered on several levels. As it stands, it is grim in the extreme, especially as regards the economy. 1996 was another year of economic contraction, and there is no reason to suppose that 1997 will be any different. Factories are said to be operating at only 30% of capacity, if that. Above all, the already critical food situation threatens to develop into full-scale famine in the next few months unless massive aid is forthcoming.
- But North Korea does not have to, and arguably cannot, continue as it is. The EIU quoted in its last report the assessment of the outgoing head of the CIA, John Deutch, that within the next two to three years Pyongyang must make peace, make war, or implode (1st quarter 1997, page 40). We broadly share this view. There is also a null hypothesis: things cannot continue as they are.
- Starved into talking** While predicting the responses of so unpredictable a regime remains hazardous, the chances are that sooner or later this year North Korea will be starved to the conference table. The USA and South Korea have hinted heavily that serious food aid will be forthcoming if Pyongyang agrees to take part in four-way talks (together with China) towards peace on the peninsula. Conversely, both allies have remained firm that no talks mean no food.
- On past form, however, turning up for talks would not imply any quick substantive breakthrough. North Korea will expect (and probably get) enough grain to tide it over the summer simply as a reward for being there. The prospect looms of a prolonged and unedifying process, whereby Seoul and Washington dangle further tranches of grain and other aid on condition of specific concessions and reforms by Pyongyang.
- But will they change?** The question is whether this forthcoming bout of dialogue will ultimately prove any more effectual than the several false dawns of the past. The case can be argued either way. Pessimists can point to Kim Jong-il's speech of last December (see The political scene), which betrays a mind-set woefully and wilfully unready to tackle what he admits are serious problems in a forward-looking manner.
- Faced with such evidence of recalcitrance, the optimist's retort is simply that North Korea now has no choice. It can no longer survive on its own; hence, however reluctantly, it must now bite the bullet. Or bullets, because the task is twofold. Externally, it is high time for real peace with South Korea and the wider world generally. Internally, the need is for Chinese-style economic reforms. The two are linked, in that given the north's dire circumstances, reform will need aid to back it up and make it work.
- Peace at last?** On the external front, one way forward may be to reactivate the inter-Korean accords signed in 1991 but never implemented, while at the same time pursuing a peace treaty that would replace the 1953 armistice and so at last end the Korean War. The challenge here will be to find a formula which allows Pyongyang to pretend it is dealing bilaterally with the USA, as it wishes, while *de facto*

accommodating the concerns of South Korea (and indeed China, whose stance is not easy to predict).

That may sound a tall order. But the success of the Korean Peninsula Energy Development Organisation on the nuclear issue shows that such devices are possible. Still another dimension is whether other powers, notably Japan and Russia, may seek a role in any proceedings which start to look like a serious peace settlement in north-east Asia. Japan has been self-effacing until now, partly because it knows that neither Korean state would allow it a formal seat at the table because of bitter memories of colonialism. Russia, on the other hand, has been calling for some time for a multination conference on Korea, in which it would of course play a part, but has found no other takers.

Investment, more like Solving these knotty diplomatic issues may well prove less tractable, or at least more prolonged, than making economic progress. One fairly safe prediction for the next two years is that South Korean companies will at last gain more or less free access to the north, as their Taiwan equivalents have in China. The need for them is greater than ever, while the will to stop them is declining (for different reasons) in both Seoul and Pyongyang. Reunifying Korea will be fiendishly expensive, so the sooner the *chaebol* (conglomerates) set to work on investment and reconstruction, the better.

It is quite possible that North Korea will invite southern firms to invest without formally undertaking market reforms. In that case, economic transformation will proceed by default, as southern firms take over sector after sector and create their own new market relations. Over time, this growing series of dynamic enclaves will *de facto* come to constitute the new North Korean economy. If Pyongyang does embrace reform, so much the better, but the point is that one way or the other it will happen anyway. The old planned economy is already dead in the water, and it will not be revived.

But who is in charge? All this, however, begs the question of who is (or will be) actually in charge in North Korea. This remains unclear, and may well become more so. The defection in February of the senior North Korean leader Hwang Jang-yop seems certain to trigger off a struggle for position and power which in some ways is long overdue. Substantively, the odd uneasy truce between Pyongyang's hawks and doves, whereby both pursue their contradictory agendas simultaneously (as witness last September's investment forum and submarine incursion), cannot last indefinitely. Nor can the equally odd freezing of the formal aspects of political life, such as the failure of the Supreme People's Assembly to convene—and above all, Kim Jong-il's curious failure so far to be officially enthroned as his father's successor.

There may be trouble— In our view, there is no guarantee that any of this will happen smoothly. North Korea runs the tightest of ships, but the mask of unity has already begun to slip and could slip further. Anything is possible. Kim Jong-il may be crowned, and reinvent himself as North Korea's Deng Xiaoping by introducing economic reforms. Or he may be pushed aside (or held captive, literally or metaphorically), probably by soldiers whose programme is likely to be hardline but may just conceivably be pro-reform. Either way, with the ship of state drifting on to

the rocks, the temptation must be strong for either hawks or doves—who believe they, and they alone, can plot a course that avoids shipwreck—to seize control of the bridge.

—at the grass roots If this suggests there may well be open intra-elite conflict in Pyongyang, the same goes for the grass roots. Here too, the remarkable fact that hitherto social order has held up, despite what are now the extreme privations of near-famine, must not be taken to imply that it will continue to do so indefinitely. Even if they buy the line that their sufferings are the fault of blockading imperialists rather than their own rulers, a people who after decades of relative security are now forced to forage for dear life cannot be unscathed or unchanged by this shattering experience. Hence, it is quite possible that there may be localised unrest over food or other issues, which could escalate into wider disorder or rebellion, especially if sections of the army were to take different sides, as happened in Romania in 1989.

Thinking the unthinkable In this connection, the most sombre of Mr Deutch's three scenarios must not be ducked. It is always possible that a cornered and desperate regime in Pyongyang may decide to go out fighting. That would be suicidal, but it could inflict great human and material damage on South Korea before the war was won. It goes without saying that the main objective of allied policy must be to avoid pushing the north into such a corner (or to stop it painting itself into it, as it tends to). In this context, starving the north to the conference table might be deemed a strategy not without its risks.

Our view is still that ultimately North Korea has no future. Either the war or the implosion scenario mean that not just the regime but the state itself will cease to exist. The peace and reform scenario may buy time and is greatly to be preferred. But it too will unleash political changes, such as a groundswell of popular demands to join the capitalist gravy train in the south. One way or another, South Korea thus faces in the medium and long term the daunting prospect of absorbing the north in a process of German-style reunification. And as is now clear, like in Germany, reunification must proceed in tandem with the internal economic restructuring necessary to preserve national competitiveness. This dual task and burden will shape the united Korea of the next century.

Review

The political scene

Top ideologist defects— The unnatural stasis which had gripped formal political life in North Korea since the death of Kim Il-sung in July 1994 was rudely shattered on February 12, when one of Pyongyang's most senior leaders sought asylum in the South Korean consulate in Beijing. Hwang Jang-yop, a philosopher by training, is credited with formulating the creed of *juče* or self-reliance which has replaced Marxism-Leninism as North Korea's official state ideology.

But his role went much further than that. As a long-serving president of Kim Il-sung University, he was mentor to thousands of top cadres. Latterly, as a party secretary and chairman of the Supreme People's Assembly's foreign affairs committee, Mr Hwang was a more frequent traveller than most of his peers. In fact, he was en route home from a visit to Japan—where his efforts to meet government officials, and it is said to plead for food aid, had been rebuffed—when he defected, together with a long-time aide. Ranked 25th in the hierarchy—he had been higher in the past—he is the most senior North Korean leader ever to defect.

—putting China on the spot

The immediate result was an unprecedented diplomatic conundrum for China, which was forced to weigh its old alliance with North Korea (sealed in blood in 1950-53) against its booming new friendship with South Korea, which in a few years has become an important trading partner and source of investment.

In the event, Beijing handled the affair with both skill and propriety. The strong protective cordon thrown around the consulate bespoke real fears that the north might try to seize Mr Hwang, who Pyongyang at first claimed had been kidnapped (although within a week the north indirectly signalled that it recognised he had defected). More than a month elapsed before he was allowed to leave, on March 18; even then it was not directly to Seoul but to a third country, the Philippines. After a further month there, Mr Hwang finally arrived in Seoul on April 20 by special aircraft.

Repentant, or out-manoeuvred?

Exactly why Mr Hwang defected remains unclear. Meanwhile, letters allegedly written by him both during and before his sojourn in Beijing offer some clues, as well as some mysteries. It seems that both the south's Agency for National Security Planning (NSP) and the *Choson Ilbo* newspaper may have had advance knowledge of Mr Hwang's plans, and some of the materials published under his name are suspiciously consistent with the NSP's world view, such as a claim that Pyongyang has as many as 50,000 agents in the south, including many in high places. This has predictably set off yet another "reds under the bed" scare in Seoul.

More convincing are two other themes: that Mr Hwang had become disillusioned with North Korea, and that the feeling is mutual. The former is not without contradictions; for example, despite accusing the north of "feudalism" in one letter, Hwang Jang-yop still had only praise for Kim Il-sung. Still, even the beginnings of doubt sufficed to bring him under suspicion and indeed, since last May, surveillance. As he tells it, his biggest quarrel was with hawks who seriously contemplate making war again on their fellow Koreans, something which he has come to regard as anathema. While acknowledging that people will consider him crazy, he seems to have hopes of acting as some kind of go-between in inter-Korean relations.

Saviour or diversion?

How Hwang Jang-yop will be received in Seoul in the longer term remains to be seen. Some opposition MPs, fearful that the ruling party will make partisan capital from him in an election year, have even suggested he be kept at arm's length, although that is unlikely. Mr Hwang will have information on who

holds what views in the Pyongyang leadership and where real power lies. He will be well rewarded for such information.

However, he may not rest easy. Just days after his defection, unknown assailants shot and fatally injured an earlier elite North Korean defector in a suburb of Seoul. Lee Han-yong was a nephew of Song Hye-rim, Kim Jong-il's former mistress and mother of his son, who last year was herself reputedly trying to reach Seoul from exile in Moscow. Mr Hwang will doubtless hope for better protection from what most assume was the long arm of Pyongyang's vengeance. As he stepped off his aircraft, which had been escorted by jet fighters, Mr Hwang was wearing a bullet-proof vest.

Defence minister and deputy die, while premier is presumed dismissed

Whereas there had been almost no turnover of positions in Pyongyang in the two and a half years since the death of Kim Il-sung, Hwang Jang-yop's defection seemed to act as a catalyst for a flurry of wider changes in North Korea's top echelons. Nine days later, on February 21, the defence minister, Marshal Choe Gwang, died suddenly, apparently of a heart attack. This was followed less than a week later by the death of his senior deputy minister, Vice-marshal Kim Gwang-jin. On the same day as Mr Choe's death, Pyongyang sent a condolence message to China for the death of Deng Xiaoping in the name of Hong Song-nam as acting premier. The implication that Kang Song-san has been dismissed as prime minister seemed confirmed by Mr Choe's funeral committee, from which Mr Kang's name was missing despite his having (or having had) high rank in the Politburo.

A setback for civilians—

The composition of Mr Choe's funeral committee suggested a setback for civilian power-holders (whether party or state) in general, and for reformers in particular. For the first time, three top military leaders were listed ahead of some full Politburo members, occupying slots six to eight in the rankings. Further down, the lower three-quarters of the list (positions 23 to 85) consisted almost exclusively of military figures. Conversely, no mere cabinet ministers nor even deputy premiers made the list unless they also held party rank as full or associate Politburo members. By contrast, the last time a defence minister died (O Jin-u, just two years before), the funeral committee was both much longer (240 names) and better balanced between military and civilian leaders.

—and for reformers

Still more ominous is the disappearance from the list of several of Pyongyang's small band of putative reformers, headed by Kang Song-san. Mr Kang has been known to be ill for some time and had not been seen in public since June 1996. Nonetheless, the fact that this relatively sprightly figure, at the age of 66, remained nominally in post, while still ranked fifth in the Politburo (he had once been second only to Kim Jong-il), held out some hope for potential change. It was Mr Kang who introduced North Korea's first joint-venture law during an earlier stint as prime minister in the 1980s, and thereafter helped create the Rajin-Sonbong free-trade zone while governor of North Hamgyong province. His acting successor, Hong Song-nam, is harder to read: an older man (72) and Czech-trained engineer who has held various economic posts, including three separate stints as chief planner.

Two other worrying absentees from Choe Gwang's funeral committee were Yon Hyong-muk and Choe Yong-nim, both of whom should have been there as associate Politburo members (which suggests they have been demoted). Yon Hyong-muk is also a former prime minister (1988-92), in which capacity he led the premier-level talks with South Korea between 1990 and 1992. Replaced by the returning Kang Song-san in that year, he had since served as governor of the northerly Chagang province. Choe Yong-nim is (or was) minister for the metals industry and is a former chief planner. However, encouragingly, if puzzlingly, both men reappeared for some of the Army Day festivities in late April.

- Military moves** Although the military as a whole has clearly risen in the rankings relative to civilians, it would be wrong to see them as a united force. Even the fate of Choe Gwang, who ranked sixth in the hierarchy, may not be straightforward. Perhaps it would be paranoid to see his death and that of his deputy in quick succession, so soon after Hwang Jang-yop's defection, as anything other than circumstantial, even as Kim Il-sung's demise, just when he was about to hold summit talks with Kim Young-sam, was presumably sheer coincidence. In the hothouse intrigues of North Korea's twilight years, as in late imperial Rome, all manner of conspiracies are possible.
- Gwang, Gwang, gone** Thus Choe Gwang's obituary—strangely short, and tucked away on an inside page of the *Pyongyang Times*—could not but fall silent on the 1970s and 1980s, when Mr Choe, who had been chief of staff in the 1960s already, fell so far from grace as to work as a miner, even though his wife had been a surrogate mother to the young Kim Jong-il. The dear leader himself failed to show up at either the bier or the funeral, unlike for O Jin-u when he did both. One may surmise, too, that some of his military colleagues were not sorry to see the last of the old guerrilla, who had kept the lid on both generational change and factional conflict in the armed forces.
- Then there is Ri Ha-il—or is there? Promoted vice-marshal as recently as 1995 Mr Ri was not listed on the funeral committees for either Choe Gwang or Kim Gwang-jin (the latter being an all-military affair comprising all the rest of the top brass). Yet just when his political obituary was being written, he too resurfaced in late April. By contrast, Chon Mun-sop is on the way up. A general who holds a civilian post as chairman of the State Inspection Committee, Mr Chon has risen from 37th to 15th in the pecking order. In short, while the precise ins and outs of different factions remain as yet unknown (hopefully soon to be illuminated by Hwang Jang-yop), it is clear that power struggles and jockeying for position are now under way.
- New minister of agriculture** Two further personnel changes are worth noting. As is often the case, it was a casual broadcast rather than a specific announcement which disclosed, on March 11, that North Korea now has a new minister of agriculture (or chairman of the agricultural commission, as the post is known in Pyongyang). He is Han Ik-hyon, who had served for more than a decade as vice-chairman of the rural economic committee in South Hwanghae, one of the main rice-growing provinces in the south-west. The fate of his predecessor Kim Won-jin is not known.

Earlier, a Russian source reported that Hyon Jun-guk, the director of the party's international department, has been replaced by one of his deputies, Kim Yang-gon. This may indicate an impending change of line in foreign policy, although none is yet discernible. In any case, this post is influential and can be a stepping stone to higher office, as it was for Kim Yong-sun, who is now a party secretary.

Our dear leader speaks

The Seoul newspaper *Choson Ilbo* seems to have good contacts in Pyongyang, or perhaps just in South Korean intelligence circles. Having apparently had advance knowledge of Hwang Jang-yop's defection, in late March it achieved another scoop with the publication by its sister monthly journal, *Wolgan Choson*, of a speech given by Kim Jong-il last December at Kim Il-sung University as part of its 50th anniversary celebrations.

This sounds authentic enough and it offers little comfort. The dear leader began by criticising a student art performance he had just seen, as lacking "spirit and vigour"—contrasting it unfavourably with the militant spirit of similar performances by army troupes. In fact, the entire tenor of the speech was to praise the military and denigrate all others, not just students but also party and state cadres, directly in some cases: "The responsible secretary of Kim Il-sung University's party committee has failed to properly conduct the ideological education of the students." That must be a dismissal at least, if not a ticket to the gulag. It cannot have been a happy occasion.

Party pooper

Kim Jong-il's berating of the Korean Workers' Party (KWP) and its cadres was extraordinary. He accused the party of "fail[ing] to carry out a major role in the Fatherland Liberation War" (ie the Korean war), due to "the manoeuvres of anti-party, counter-revolutionary factional elements who infiltrated". Victory, which is how Pyongyang portrays it, was thus "entirely because of the wise leadership of the leader, the outstanding military strategist and ever-victorious iron-willed brilliant commander" and was aided by the North Korean army who "fought and paid with their lives, all for the leader rather than for the party" [sic].

Even today the leader comes first, at least according to the leader. "The people now unconditionally accept the directives of the party's Central Committee because of my authority, not because party organisations and functionaries carry out their work well." Not that there are "factional elements" any more. The problem now is rather that "party organisations are incompetent" and "do not work in a revolutionary manner". Hence, "considerable confusion is created in socialist construction".

Mushroom for improvement

Take mushrooms. Inspired by a lecture by Kim Jong-il, "The army built many vegetable greenhouses and it is making efforts to grow many mushrooms in each unit. But little work in this regard is being done in society." Instead, party cadres tend to just write reports and "keep a low profile. This is extremely wrong". Or worse, they "merely sit in the office and groan or chatter".

Like father, like son. Berating the cadres was a regular hobby of Kim Il-sung's. But at least Kim senior also took some responsibility for the state of the economy, whereas his son takes none (see below). Hence, most of his speech was

little more than a rant against hapless party cadres for failing to solve problems, such as the food shortage, which are neither of their making nor within their power to cure.

Peddling egoism Kim Jong-il's speech also acknowledged the food crisis—"Heart-aching occurrences are happening everywhere"—and also of the risks it poses: "Telling people to solve the food problem on their own only increases the number of farmer's markets and peddlers.... This creates egoism among the people, and the party's class base can come to collapse." Nonetheless, his main concern is "to prepare decisive measures to guarantee military provisions.... If they knew we did not have military provisions, the US imperialists might immediately raid us." As this last comment suggests, the dear leader's overall tone and attitude is dismayingly unreconstructed. Nothing in this speech suggests the slightest penchant for reform, or even sincere constructive engagement. On the contrary: "Whether we can overcome difficulties encountered is a fierce class struggle. Difficulties may generate wavering elements, complaining elements, and all types of strange people..."

Toothpaste and traffic Some of it is frankly bizarre. "I do not permit expedientialism at all. When I visit the People's Army units, I never allow those units to replace things such as toothpaste." At one point, he suddenly veers off to assert: "We have to solve the traffic problems in Pyongyang"—not something any visitor to its almost car-free streets has ever been aware of—and blames it on failure to stagger working hours. Perhaps he means the overcrowded and underpowered trolley-buses. He remarks elsewhere that: "The state of the railway system in the country is beyond description." Overall, the impression is of a Neronian figure, self-absorbed and passing the buck, with real leadership qualities conspicuously absent.

Nuclear ties with Taiwan The past quarter has seen considerable ructions over what is indeed, on the face of it, a somewhat bizarre deal between two Asian states which for different reasons have become international pariahs. On January 11 the Taiwan electricity company, Taipower, signed a contract with North Korea to export 60,000 barrels of nuclear waste for dumping. This precipitated an ongoing row between Taipei and Seoul (see South Korea: The political scene). China too is thought not to be best pleased, but the deal seems to be going ahead regardless. It could be worth over \$100m to Pyongyang. It may also presage broader cooperation between North Korea and Taiwan, such as investment.

Jeremiads against Japan Attitudes towards Japan continue to be contradictory. On the one hand, Pyongyang has been calling on Tokyo to resume talks towards establishing diplomatic relations, which were held in the early 1990s but broke up without agreement. North Korea has a strong incentive here, in that Japan has already agreed in principle that full relations would be accompanied by a substantial aid package as reparations for colonial rule in the first half of this century, on the precedent set when Tokyo tied the knot with Seoul in 1965. While no figure has been set, this would amount to several billion dollars at least. The north could certainly use the money.

It is all the more curious therefore that even while demanding that Tokyo must talk, North Korea has shown no let-up in its anti-Japanese diatribes. The Pyongyang media accuse Japan unceasingly of plotting to stifle North Korea and to reinvade the peninsula and Asia generally. This does not seem tactful in the circumstances. Likewise, Japanese concerns over the issues which torpedoed the talks last time are angrily dismissed rather than politely addressed. A case in point concerns the bizarre allegations that North Korea has kidnapped assorted Japanese over the years, apparently to train their own agents to pass for Japanese. These charges resurfaced recently when a defector in Seoul claimed to have met one such victim. Stonewalling is no solution in the end: it merely means there will be no relations, and hence no reparations.

Two more downers: As well as the revived charges of kidnapping, Pyongyang's chances of better ties with Tokyo suffered two further setbacks this spring. One was the Japanese foreign minister's pointed allusion to unconfirmed reports that North Korea has deployed missiles on its east coast, facing Japan. Understandably, missiles are at the top of Tokyo's security concerns vis-à-vis its pugnacious neighbour. Unlike over the nuclear issue in the past, Pyongyang does not deny having missiles, or testing them a few years ago, although it does deny selling them in the Middle East (see below). Here too it is curious and perverse that North Korea seems so brusquely oblivious to its neighbour's (and potential benefactor's) legitimate concerns, unless it believes that threats are the best way to extract aid.

—and drugs On April 19 Japanese police arrested the captain of a North Korean freighter, the cargo of which was found to include 70 kg of amphetamines, with an estimated street value of almost \$100m. Given Japan's uncompromising attitude towards drugs, the chances of Tokyo releasing any of its ageing rice stocks to feed the north—as it did in 1995, to the tune of 500,000 tons, and as some have urged it to do again—must now be remote.

Cultivating Washington While North Korea's relations with the USA of late have mainly revolved around the four-way talks, there are also some specifically bilateral issues between them. One is missile sales, which were discussed (to little effect) in Berlin in April last year. At long last, a second round of talks has been arranged. Little movement is currently visible on two further matters: mutual opening of liaison offices in each other's capitals, and joint searches for the remains of those missing in action in the north.

Asking for aid from Africa Kim Yong-nam nowadays seems to function more as a very senior internal figure than in his nominal post of foreign minister. In late March, however, he set off for a tour of several African countries, many of which are old friends (although all now also recognise Seoul). While the main purpose of this trip may have been political—a failed bid to drum up support to deny Seoul observer status at the Non-Aligned Movement meeting in Delhi in April—South Korean sources claim that while in Zimbabwe Mr Kim asked for 100,000 tons of maize. To be asking for aid from Africa, where in the past North Korea has itself been an aid donor (including in agriculture), is a stark sign of Pyongyang's present plight.

The economy, trade and investment

- A year of rehabilitation? As the economy goes from bad to worse, so the formalities (as in politics) go by the board. North Korea's last seven-year plan ended in December 1993, with the first-ever admission of non-fulfilment—albeit unquantified, and blamed on external circumstances—ie the collapse of socialist markets—rather than any internal failings. This was succeeded by a “period of adjustment”, originally billed vaguely as for two or three years, in which priority was to go to three sectors: light industry, farming and exports. That would indeed have been a welcome shift away from the traditional obsession with heavy industry. In practice, however, there was little sign of any such reorientation, even before two years of floods devastated agriculture.
- Seventh year of shrinkage According to South Korea's Ministry of National Unification (MNU), the North Korean economy shrank in 1996 for the seventh successive year, by 3%. For the record, MNU's estimates for each year from 1990 to 1996 inclusive are (minus in all cases): 3.7%, 5.2%, 7.6%, 4.3%, 1.8%, 4.6% and 3%, giving a cumulative decline of more than one-quarter. Such MNU figures have been criticised for spurious precision, but there is little reason to doubt the general trend. Moreover, if population growth of around 14% (from 21 million to 24 million) is factored in as well, income per head will have shrunk by over one-third in the 1990s so far. Nor is there yet any sign of this fall bottoming out—unlike in Cuba, where a parallel plunge in the first half of the decade for similar reasons has now given way to a recovery of sorts, thanks to cautious but judicious economic reforms of the kind which North Korea continues to eschew.
- Not my problem, says Kim Jong-il Kim Jong-il's speech last December offered no encouragement to hopes of economic reform (see The political scene). Even more extraordinarily, and despite admitting that “the most urgent issue to be solved at present is the grain problem”, the man whose media deify him as the world's greatest leader explicitly disavowed any intention of leading at all, so far as the economy is concerned. “At this time, when the situation is complicated, I cannot solve all knotty problems while handling practical economic work. I should take charge of the party, the army, and other major sectors. If I handle even practical economic work, it will have irreparable consequences on the revolution and construction. When he was alive, the leader [Kim Il-sung] told me not to get involved in economic work. He repeatedly told me that if I got involved in economic work, I would not be able to handle party and army work properly. Strengthening the army is more important than anything else....”
- Such passing the buck is as astonishing as it is unconvincing. As mentioned, Kim even admits (he could scarcely deny) that grain is the most urgent issue. Yet the best he can come up with is to berate party and state cadres for failing to solve the problem, implying that it is merely political or a matter of effort and will rather than of organisation and system. It is hard to believe that his hearers found this any more convincing than the outside world.
- Famine looms It now seems certain that this summer North Korea will face its worst famine ever, as what little grain was harvested last autumn starts to run out. Increasingly urgent appeals and dire warnings have issued from international agencies

on the spot, such as the Red Cross and the UN World Food Programme (WFP). Horror stories of children and others dying have emerged from just across the border in China, where people still go to and fro on family visits or to trade. In April Pyongyang for the first time admitted that 134 children had died of malnutrition, without specifying a place or time period.

WFP doubles its appeal

Recent weeks have seen an escalation of the sums being sought by aid agencies, and (to a markedly lesser extent) of aid actually pledged. Thus WFP's ongoing appeal for some \$42m was more than doubled after its head, Catherine Bertini (a former US assistant secretary for agriculture), visited Pyongyang in March, and was raised further in April. The USA and South Korea gave \$10m and \$6m respectively to the earlier appeal, but in April Washington pledged a further \$33m. Sums of this order do not begin to meet North Korea's needs. However, it is unlikely that serious aid will be forthcoming until and unless Pyongyang agrees to attend four-way talks.

How hungry, exactly?

While all agree that North Korea faces a desperately serious food shortage, the numbers cited continue to vary. South Korea's Korea Rural Economic Institute (KREI) claimed in April that the north's harvest last year was only 40% of what it needed. KREI estimated total demand at between 6m and 6.2m tons, while grain output was no more than 2.8m tons and may have been as low as 2.4m tons, leaving a shortfall of 3.4m-3.6m tons. Given that part of the aggregate demand is for animal feed or industrial use (eg alcohol), the total needed directly for food last year was around 4.4m tons. Even so, the shortfall would thus be of at least 1.6m tons.

Other South Korean sources reckon that the north harvested somewhat more last year: perhaps 3m-4m tons. Sceptics in Seoul also suspect that Pyongyang may still have grain stockpiled for military consumption, which it is refusing to release. Inevitably, there is no way to confirm such claims, which North Korea naturally denies. What is not in doubt, however, is that as things stand, this summer will be desperate. It remains to be seen how good a harvest a weakened people can bring in this autumn, even if nature is kinder than in the past two years and flooding is avoided.

North Korean agriculture: what is the problem?

The crisis in North Korean agriculture has been a long time in the making. The floods of the past two summers are the climax to a whole series of structural problems. While it is hard to assign precise weights, contributory factors include the following.

- Unfavourable mountainous terrain. Only around 20% of North Korea is cultivable. The flatter south was always Korea's ricebowl.
- Collectivisation. Although collective farms seem to have been less of a disaster than in some other communist countries, there is little doubt that incentives would produce higher yields if contract farming or private ownership were introduced. There are reports of recent marginal concessions in this regard, but still no full-blooded reform as in China or Vietnam.
- Mono-cropping. Kim Il-sung's insistence on rice and (mainly) maize as priorities has been baneful in several ways. Overdense planting of maize has

backfired, causing losses due to disease and infestation. Unbalanced diet is another result of the neglect of other food crops and of animals, even though North Korea's uplands are well suited for grazing. A new campaign this year to create pasture and encourage animal breeding may have come too late, as many farm animals have reportedly been slaughtered for food (and in the absence of feedgrain for them).

- Fertiliser has become a problem, although accounts differ on exactly why. One version is that overuse of inorganic fertilisers has exhausted the soil and caused yields to decline. The alternative view is that shortage of fertiliser is the problem, due to the virtual shutdown of factories (see below). Either way, recent months have seen a big campaign to "produce manure"—apparently meaning organic fertiliser of all kinds, both animal (including human) and vegetable—to plug the gap.
- North Korea's industrial crisis—itsself caused by mutually reinforcing shortages of fuel, inputs and foreign exchange, combined with worn-out machinery (and workers)—has other knock-on effects in farming. Not only fertiliser, but tractors, fuel, electricity (for irrigation pumps) and machinery of all kinds are in short supply. Aid workers have observed that the farm sector is perforce largely reverting to human muscle power as its major resource, at a time when many people are weakened by hunger.
- Ecologically, terracing high up on the hills to grow more maize has proved a double disaster. Yields were marginal at the best of times, while the loss of tree cover loosened the soil. The floods of 1995 and 1996 not only destroyed these terraces, but swept the gravel and other debris downstream, dumping them on and thus damaging or destroying prime agricultural land in the coastal plains.

Fluctuating figures

On April 5 the North Korean news agency, KCNA, offered as near as Pyongyang ever gets to production figures. Things are looking up, it seems: "The gross industrial output value increased by 19% as compared to the fourth quarter last year." Coal, ore (unspecified: perhaps iron), lead, zinc, magnesia clinker and light industry all increased output "drastically". To be precise, "coal production increased by 2.8 times and ore ... by 1.83 times".

Almost doubling or tripling mining output in successive quarters is of course not normal growth: it can only mean recovery from a very bad patch. Just how bad, they may have inadvertently revealed. On March 31 North Korean radio, KCBS, declared that a further 1.82m tons of coal were produced in the first quarter of 1997 than in the preceding one. Putting the two figures together, coal production in the final quarter of 1996 was a paltry 1m tons or so. Yet in the late 1980s, North Korea was mining 50m tons of coal each year.

KCNA also gave other relative figures on a year-on-year basis, ie compared to the first quarter of 1996. Lead and zinc were up 61%, knitwear 20%, cloth 8% and underwear 6%. Export value was also up by 6%. If credence can be placed on these figures, perhaps 1997 will be the year when North Korea's free-fall at last bottoms out.

New electricity law passed

The government newspaper, *Minju Choson*, told its readers on January 31 that: "The State Administration Council has recently enacted the Electricity Act." No

date was given, nor is it clear by what authority the SAC, which is North Korea's cabinet, could enact anything, this being the prerogative of the Supreme People's Assembly (SPA), or rather—since the SPA has not met in almost three years, and elections due in 1995 did not take place—of its standing committee.

It is also unclear from this account why a new law was deemed the proper framework for what sound more like administrative and technical matters. For example: "The act ... specifies what is required to ... organise staggered production, to struggle to reduce the per-unit power consumption rate, and to prevent power waste." There is much more of this kind. While at one level any move in Pyongyang to enhance the law (as opposed to just doing as it pleases) is to be encouraged, the fear in this instance must be that the law may serve as a threat, and as a substitute for the technical remedies—above all, to increase output of electricity—which are what North Korea's serious power shortage really requires.

A northern *chaebol* with a difference

North Korea has apparently reorganised some of its state trading corporations to resemble South Korean conglomerates (*chaebol*), at least superficially. On April 8 KCNA briefly profiled one such, the Kwangmyong Trading Group. Kwangmyong is said to group "about ten companies under it", with over 500 "production bases" between them. Its main exports (no figures given) are "agricultural produce, aquatic products, garments and non-ferrous metals". The group's president, Choe Chong-hun, claimed that "over 100 production bases had been built across the country this year". He cited two in particular: Songchongang Trading in South Hamgyong province has 19 new units producing metals and farm products, while in Nampo Namsan Trading has "15 units for electronic articles, handicraft articles and garments".

This form of organisation is evidently meant to coordinate production and export across the country of anything that may earn foreign exchange. Less clear, however, is how much autonomy Kwangmyong has in its overall management, let alone at enterprise level; still less to what extent it can retain earnings and profits. There is no question of private ownership. This is a *chaebol* with a difference.

Trade was down by 7% last year

According to South Korea's unification ministry, North Korea's trade fell again in 1996, by 7.3%. The total dropped to \$1.9bn, compared with \$2.05bn in 1995. Exports were down 14%, from \$740m in 1995 to \$640m, while imports slipped by 4%, from \$1.31bn to \$1.26bn. China was Pyongyang's largest trading partner, with a total of \$570m, followed by Japan at \$520m. Together, China and Japan accounted for more than half of all trade. By contrast, Russia recorded a mere \$50m, in sharp contrast with Moscow's dominant position until 1990.

These figures as published are incomplete. For political reasons, Seoul refuses to include inter-Korean trade as "foreign". Nonetheless, the general trend is not in doubt, and remains depressing. Pyongyang's trade total peaked at \$4.64bn in 1990, and has been in free-fall ever since. (A slight rise in trade with China last year was mainly due to an extra 540,000 tons of grain, which—like much else with Beijing—was presumably not paid for.)

Trade with the EU: who pays?

The Bank of Korea (BOK), South Korea's central bank, has been looking at North Korea's trade with Europe. The trend is striking. Between 1991 and 1995 Pyongyang's exports to the EU fell by 34.5%, from \$100.8m to \$65.9m, while imports rose by 65%, from \$130.4m to \$215.1m. In fact, in 1995 North Korea ran a trade deficit with every single EU country, often strikingly so. Germany, which has long been Pyongyang's main partner for trade in western Europe, was the only EU member state where the ledger was anywhere near balance.

This raises a question. Since Pyongyang repeats this pattern with just about all its trading partners, and no one is lending it money or granting credit in view of its past appalling record of defaults, how exactly is it paying for these and other imports? In the absence of other resources, except perhaps subventions from pro-north Koreans in Japan, this can only fuel the suspicion that smuggling and other illicit activities are now the main way that North Korea stays afloat. (There will be arms sales to Iran and others, but these are probably bartered for oil.)

The BOK gave a partial breakdown by category. The three major import categories were: vehicles (\$30.6m), machinery and other heavy industrial goods (\$25.2m), and grain (\$13.7m). It did not say what North Korea sold in return (where it did so at all). But Pyongyang habitually sells its gold in Germany, from which it also takes industrial and other waste (which may count as a quasi-export in that North Korea is paid to dispose of it).

North Korea: trade with EU countries, 1995
(\$ m)

Country	Total trade	Exports	Imports	Balance
Germany	80.1	37.5	42.6	-5.1
Netherlands	38.0	3.0	35.0	-32.0
UK	38.0	3.1	34.9	-31.8
Italy	30.8	3.7	27.1	-23.4
Sweden	26.1	1.1	25.0	-23.9
Belgium	23.2	7.5	15.7	-8.2
Others	44.8	10.0	34.8	-24.8
Total	281.0	65.9	215.1	-149.2

Source: *Korea Economic Weekly*, April 21, 1997, citing Bank of Korea.

Inter-Korean trade:
balanced by aid

Trends in inter-Korean trade are also interesting. For most of its short history (such trade only began just under a decade ago, in late 1987), Pyongyang has run a rare and useful surplus: exporting mainly minerals to Seoul, while buying little in return. Latterly, the volume had declined, partly due to last September's submarine incident, but this year, for the first time, the ledger is almost balanced. There seem to be two reasons. On the one hand, the north's crippled industries have difficulty producing anything, while on the other, the south's grain and other aid (rather than true trade) is creeping up. The latter trend seems set to continue, particularly since on March 31 Seoul lifted its ban on southerners sending rice to the north.

North Korea: inter-Korean trade
(\$ m)

	Total trade	Exports	Imports	Balance
1994	194	176	18	158
1995	287	223	64	159
1996	252	182	70	112
1996 (Jan-Feb)	31	23	7	16
1997 (Jan-Feb)	35	19	16	3

Source: *Korea Economic Weekly*, April 21, 1997, citing industry sources.

Seoul eases restrictions For several reasons, inter-Korean business is likely to become brisker this year. Whether or not the four-way talks take place, tension between the two Koreas has eased since last year's submarine incident. On March 28 South Korea loosened its regulations governing trade with the north. Ten items, mainly foodstuffs (from fish to ginseng), can now be traded without prior approval by the government. It will also be easier to sell machinery and equipment to the north: a crucial condition for any substantial investment, which is what is needed. Yet caution is still the watchword. The day when South Korean firms have anywhere near the \$30bn of investment in the north that their Taiwan counterparts now hold in China is still a long way off. Meanwhile, northern industry is deteriorating to the point where investing in it, even if Seoul would freely permit this, becomes increasingly expensive and unattractive.

Chaebol go nuclear Remarkably and seemingly independently of the ups and downs of Pyongyang's broader relations with the wider world, the nuclear issue is increasingly shifting from political risk (long since defused) to business opportunity. Among the shipload from the Korean Peninsula Energy Development Organisation, which was transported north to the nuclear site in Sinpo in April, were representatives of the four big South Korean companies who have been contracted by the Korea Electric Power Corporation (KEPCO) to build the north's new light water reactors. Hyundai was chosen for its nuclear experience, Dong Ah as a major construction firm and Daewoo for its contacts in the north (it has the first and so far only southern joint-venture factory in the north). The fourth is the state-owned Korea Heavy Industries, which will supply equipment and materials. While the prime motive for this project remains political rather than economic, any contract worth an estimated \$5bn clearly has a business dimension as well. If all goes to schedule, the ground could be broken as early as June.

North Korea to join the ADB? North Korea has notified the Asian Development Bank (ADB) of its desire to become a member. Although the general issue has been broached before, what is new is that for the first time South Korea (which is already a member of the ADB) has said it would welcome Pyongyang's membership. Perhaps not altogether tactfully, Seoul's deputy premier, Kang Kyung-shik pointed out on April 6 that membership would enable the 30 or so South Koreans employed by ADB to travel freely to the north, and generally open the place up. From North Korea's viewpoint, membership would bring access to the Asian Development Fund, which could provide up to \$200m per year in aid. On the other hand, Pyongyang would also have to furnish the economic data and statistics which it has failed to publish for more than 30 years. Any ADB-financed projects

would also have to be open to international bidding. But certainly, for North Korea to join ADB would be a welcome sign of opening.

Getting technical with
Russia

On April 10 a North Korean deputy science minister and his Russian counterpart signed a protocol on scientific and technical cooperation. This is one of several agreements which have been inked over the past year or two and which suggest that relations with Moscow are gradually being revived. What is less clear is the scale or substance of any such ties, which remain bedevilled by two problems. Neither side has much money, and the new Russia will not countenance the endless freebies that the former Soviet Union tolerated. Second, Pyongyang has been sharply critical of Russia's keenness to sell its latest weaponry to South Korea.

Getting there

The sheer physical task of getting to North Korea remains difficult. The national airline, Air Koryo, flies twice a week to and from Beijing and just once to Moscow and on to Berlin. Its nominal services to Sofia and Khabarovsk are not currently running regularly. However, from April Air Koryo's newest route, which connects Pyongyang with Bangkok via Macau, was due to double in frequency to two flights per week (on Mondays and Thursdays in both directions).

China Northern has postponed resumption of its Wednesday service from Beijing, which usually starts in April after a winter break. But another door opened elsewhere. In April China extended use of its Quanhe port of entry in Hunchun city to foreigners: previously, it had been restricted to Chinese and North Koreans only. Xinhua on April 15 described this as "the only passage leading to the Rajin-Sonbong free-trade zone". Quanhe will eventually be upgraded to a category 1 port of entry.

Quarterly indicators and trade data

South Korea: quarterly indicators of economic activity

		1994	1995				1996				1997
		4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr
Industrial production	Monthly av										
General, seasonally adj	1990=100	147	144	149	152	153	159	159	160	168	n/a
Construction											
Permits issued ^a	'000 sq metres	12,111	8,511	12,351	7,616	10,630	7,885	10,287	9,721	10,047	n/a
Employment											
Employed	'000	20,019	19,593	20,582	20,722	20,618	19,971	20,932	21,093	21,060	n/a
Unemployed	"	417	487	405	399	386	455	413	391	439	n/a
Wages & prices											
Monthly earnings	1990=100	190.6	171.4	181.5	201.5	206.5	198.2	200.5	225.7	212.7 ^b	n/a
Consumer prices:	"	130.8	132.7	134.9	136.1	136.6	139.2	141.8	143.2	143.2	107.3 ^c
change year on year	%	5.8	3.6	4.8	4.0	4.4	4.9	5.1	5.2	4.8	n/a
Producer prices	1990=100	113.0	115.1	117.2	117.8	117.1	118.7	119.3	120.5	121.2	122.7 ^c
Share prices	"	141.8	122.4	119.3	126.3	125.1	115.5	121.8	108.0	99.9	n/a
Retail sales: value	"	139	137	137	133	151	151	150	145	162	n/a
Money	End-Qtr										
M1, seasonally adj:	W bn	30,047	31,746	32,338	31,784	35,993	35,220	35,366	38,564	34,980 ^d	n/a
change year on year	%	12.6	17.5	11.5	8.7	19.8	10.9	9.4	21.3	n/a	n/a
Foreign trade	Qtrly totals										
Exports fob	\$ m	28,787	26,192	32,050	32,072	34,744	31,496	33,175	29,576	35,468	9,108 ^c
Imports cif	"	29,270	30,523	34,742	34,441	35,414	35,665	37,080	37,092	40,503	12,592 ^c
Exchange holdings	End-Qtr										
Gold ^e	\$ m	93.8	92.6	94.8	94.3	94.5	98.2	95.7	99.2	92.3	86.1 ^f
Foreign exchange:											
Bank of Korea	"	25,032	25,879	27,614	32,072	31,928	32,634	35,748	32,038	33,327	29,756 ^f
other banks	"	20,938	21,918	24,649	25,831	27,806	29,537	30,080	31,029	32,385	n/a
Exchange rate											
Market rate	W:\$	788.7	771.5	758.1	768.4	774.7	782.7	810.6	821.2	844.2	863.9 ^f

Note. Annual figures of most of the series shown above will be found in the Country Profile.

^a 32 cities and 90 towns. ^b October only. ^c January only. ^d End-November. ^e End-quarter holdings at quarter's average of London daily price less 25%. ^f End-February.

Sources: Bank of Korea, *Monthly Statistical Bulletin*; IMF, *International Financial Statistics*.

South Korea: foreign trade
(\$ m)

	Jan-Dec 1992	Jan-Dec 1993	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1996
Imports cif					
Wheat, unmilled	544	674	783	467	724
Maize	847	702	696	1,265	1,572
Hides & skins, raw	903	881	922	991	891
Rubber, crude	466	447	552	729	703
Wood, unmanufactured	919	1,183	1,012	1,047	963
Pulp	740	628	828	1,453	1,192
Cotton, raw	634	535	590	772	714
Iron ore	880	888	797	851	918
Coal	1,616	1,733	1,777	2,081	2,337
Crude petroleum	9,548	9,151	8,878	10,809	14,432
Chemicals	7,668	8,235	9,763	13,157	13,231
Textile yarn & fabrics	2,212	2,249	2,927	3,455	3,307
Iron & steel	2,778	2,488	3,734	5,504	4,647
Non-ferrous metals	2,025	2,226	3,066	4,617	4,126
Machinery & transport equipment	28,966	28,417	37,408	49,437	54,675
of which:					
power-generating equipment	2,782	2,493	2,768	3,891	3,666
metalworking machinery	1,582	1,184	1,788	2,341	3,192
office machinery	1,735	2,001	2,615	3,570	3,992
telecommunications equipment	1,377	1,645	2,221	2,659	3,069
electronic components etc	6,012	5,650	6,983	9,838	11,448
aircraft	1,965	1,846	2,208	2,479	2,766
ships	840	719	1,468	1,556	1,934
Scientific instruments etc	1,977	2,284	2,918	3,881	4,164
Total incl others	81,775	83,800	102,348	135,119	150,339

continued

	Jan-Dec 1992	Jan-Dec 1993	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1996
Exports fob					
Food	2,119	2,060	2,295	2,656	2,724
of which:					
fish	1,039	964	1,025	1,144	1,067
Crude materials, inedible	1,073	1,160	1,430	1,790	1,608
Mineral fuels	1,742	1,852	1,746	2,472	3,866
Chemicals	4,455	4,922	6,339	8,944	9,148
Rubber tyres	1,053	1,132	1,233	1,330	1,549
Paper & manufactures	511	567	829	1,170	1,228
Textile yarn & thread	1,042	944	1,055	1,331	1,470
Cotton fabrics	373	382	459	510	543
Other textile fabrics	5,362	6,062	7,380	8,225	8,160
Iron & steel	4,399	4,744	4,456	5,107	4,549
Non-ferrous metals	484	476	751	1,100	1,010
Machinery & transport equipment	32,547	36,950	47,068	65,646	67,584
of which:					
power-generating equipment	784	845	1,002	1,212	693
office machinery	3,091	3,474	3,607	4,967	5,673
radio & television receivers	2,721	2,589	2,791	2,810	2,737
sound & video recorders	1,479	1,582	1,757	1,824	1,747
telecommunications equipment	2,337	2,922	3,687	4,244	4,404
electronic components etc	7,763	8,078	11,848	19,373	17,305
cars	2,534	3,884	4,470	7,242	9,089
ships	4,113	4,061	4,945	5,533	7,127
Clothing	6,770	6,166	5,653	4,958	4,221
Footwear	3,184	2,309	1,780	1,506	1,236
Total incl others	76,632	82,236	96,013	125,058	129,715

Source: Bank of Korea, *Monthly Statistical Bulletin*.

South Korea: direction of trade

(\$ m)

Exports fob	Jan-Dec 1993	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1996	Imports cif	Jan-Dec 1993	Jan-Dec 1994	Jan-Dec 1995	Jan-Dec 1996
USA	18,138	20,553	24,132	21,671	USA	17,928	21,579	30,404	33,305
Japan	11,564	13,523	17,049	15,767	Japan	20,016	25,390	32,606	31,449
Hong Kong	6,431	8,015	10,682	11,131	China	3,929	5,463	7,752	n/a
China	5,151	6,203	9,518	n/a	Germany	3,955	5,159	6,584	7,239
Singapore	3,110	4,152	6,689	6,439	Saudi Arabia	3,735	3,807	5,416	6,667
Germany	3,593	4,314	5,965	4,705	Australia	3,347	3,783	4,897	6,272
Malaysia	1,430	1,652	2,951	4,333	Indonesia	2,588	2,843	3,325	4,013
Taiwan	2,296	2,732	3,882	4,005	Italy	1,398	1,954	2,425	3,070
UK	1,661	1,783	2,874	3,222	Malaysia	1,947	1,876	2,515	3,007
Indonesia	2,095	2,540	2,958	3,198	UK	1,401	1,662	2,387	2,994
Thailand	1,761	1,835	2,428	2,664	Taiwan	1,407	1,800	2,564	2,725
Total incl others	82,236	96,013	125,058	129,715	Total incl others	83,800	102,348	135,119	150,339

Source: Bank of Korea, *Monthly Statistical Bulletin*.

North Korea: direction of trade

(%)

Exports	Jan-Dec 1995	Imports	Jan-Dec 1995
Japan	27.9	China	32.6
South Korea	20.8	Japan	17.2
China	5.2	Russia	4.7
Germany	4.0	South Korea	4.3
Russia	1.2	Germany	2.9

Source: Institute for International Economics, Washington DC, *The North Korean Economy*.