The Impact of a Shaky Japan-South Korea Relationship on Economic Relations
—What Should Japan and South Korea Do Now?—

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Summary

1. Political and diplomatic relations between Japan and South Korea are close to rock-bottom. This situation reflects not only a lack of capacity to repair the relationship, but also the fact that no-one has any idea where to begin. Issues relating to historical perceptions have played a direct role in this cooling of relations, but other factors also appear to be involved, including changes in the environment surrounding Japan and South Korea, such as the collapse of the Cold War structure and the emergence of China, as well as changes in the political and social situation in South Korea.

2. The economic changes that occurred in the 2000s also need to be taken into account when analyzing the current relationship between Japan and South Korea. While South Korea enjoyed continuous growth accompanied by accelerating globalization, Japan went through years of economic stagnation. Japan’s waning importance to South Korea is apparent from the decline in its reliance on trade with Japan. This decline in Japan’s importance has also weakened the motivation to repair the relationship.

3. We need to focus in particular on South Korea’s declining reliance on Japan for production goods and capital goods. There are three reasons for this. First, globalization has brought a shift in South Korea’s import sources. Second, South Korea has strengthened its parts and raw materials industries. Third, Japanese companies have increasingly shifted to local production in South Korea. Many industries are still reliant on imports from Japan, but the importance of this factor is not generally recognized since the goods concerned are traded between companies.

4. Japan’s waning importance has been reflected in changes in the South Korean government’s foreign policy stance toward Japan. At the same time, South Korean foreign policy has focused increasingly on China. This has resulted from China’s increasing importance in terms of security, especially the stabilization of the situation on Korean Peninsula, and also from an economic perspective.

5. In the past, deteriorating relations between the governments of Japan and South Korea have not had a significant impact on the economic relationship. This reflects the core importance of relationships between large corporations, which have built trust through their business activities. Historical perceptions have rarely affected Japanese companies directly in the past, but there is concern about a situation that has emerged recently. South Korean workers conscripted during World War II have brought lawsuits against Japanese companies, and the South Korean high court has handed down verdicts requiring the companies concerned to pay compensation.

6. Japan and South Korea need to arrange a summit meeting in order to achieve even a modicum of progress toward the resolution of these bilateral issues. However, so far there is no indication of when such a meeting might occur. It will be difficult to achieve any improvement in the short-term perspective if both governments stubbornly adhere to positions based on fundamental principles. Even if they are unable to reach a common perception of history, Japan and South Korea should still strive to reduce the gaps between their perceptions. Japan and South Korea need to renew their awareness of their common interests and build a strong relationship based on reciprocal benefit.
Introduction

It would be no exaggeration to say that political and diplomatic relations between Japan and South Korea are currently near rock bottom. This situation reflects not only a lack of capacity to repair the relationship, but also the fact that no-one has any idea where to begin to make improvements.

So far this deterioration of the political and diplomatic relationship has not impacted significantly on the economic relationship. At the heart of the economic relationship are relationships between major corporations, which have built trust through their business activities. Japanese companies have rarely been directly impacted by issues stemming from perceptions of history.

However, a recent development has raised concern about the effect on business with South Korea. That concern was triggered by a verdict in the South Korean high court ordering Japanese companies to pay compensation as a result of a lawsuit brought by South Korean workers conscripted during World War II. There are now fears that issues based on perceptions of history could impact on business. In November 2013, Japan’s three main business organizations and the Japan-Korea Economic Association were prompted by their fears that the compensation question might damage the good relationship between Japan and South Korea to issue an unprecedented statement calling for the settlement of this issue. This move is indicative of the importance of South Korea to Japanese companies.

Japan and South Korea need to arrange a summit meeting as soon as possible in order to achieve even a modicum of progress toward the resolution of these bilateral concerns. However, so far there is no indication of when such a meeting might be held. In this sense, the relationship between Japan and South Korea can be said to have reached a crossroads.

While perceptions of history have obviously played a role in this cooling of the relationship, to understand the current state of Japan-South Korea relations, we need to focus on changes in the environment surrounding the two countries. First, Japan’s importance from a security perspective has waned since the collapse of the Cold War structure. Second, Japan has become less important economically to South Korea because of the accelerating globalization of the South Korean economy in the 2000s. This decline in Japan’s importance has also eroded the motivation to improve the relationship.

The United States, with which South Korea signed a Mutual Defense Treaty in 1953, remains a vital presence for South Korea from a security perspective. China has also become increasingly important from a security viewpoint since the turn of the century, especially in relation to the stabilization of the situation on the Korean Peninsula, as well as from an economic performance. The South Korean government’s foreign policy stance toward Japan has changed in this context, and there appears to have been a shift away from Japan.

In this article, we will reexamine the economic relationship between Japan and South Korea from these perspectives and within the context of environmental changes affecting the two countries. We will then consider the outlook for Japan-South Korea relations, including the economic relationship.

In Part 1 we will look at the recent cooling of the relationship between Japan and South Korea. In Part 2 we will analyze changes in Japan’s presence from a South Korean perspective as a result of the accelerating globalization of the South Korean economy in the 2000s, while also showing that Japan continues to play an important role in the areas of production goods and capital goods. In Part 3 we will focus on the cracks that have recently started to appear in the economic relationship. In Part 4 we will consider the future outlook for the relationship between Japan and South Korea.

1. Continued Cooling of Japan-South Korea Relations

(1) A Deteriorating Relationship

Among the factors that caused a dramatic worsening of relations between Japan and South Korea
were a landing on Liancourt Rocks (Takeshima in Japanese, Dokdo in Korean) on August 10, 2012 by then President Lee Myung-bak, and President Lee’s subsequent comments on August 14 about a visit to South Korea by the Emperor of Japan\(^1\).

Evidence of this cooling of the relationship can also be found in the results of the Cabinet Office’s annual public opinion survey on foreign policy (Fig. 1). In the October 2012 survey, 39.2% of respondents indicated that they felt a sense of affinity toward South Korea (“I feel affinity”—9.7% + “I generally feel affinity”—29.4%). This is dramatically lower than the previous year’s total of 62.2% (“I feel affinity”—20.3% + “I generally feel affinity”—41.9%) and is the lowest result since the turn of the century. (The all-time low was 34.5% in 1981.) The year on year decline was the biggest recorded since the survey began in 1978.

There was little improvement over the next year. The results from the October 2013 survey showed that 40.7% of respondents felt a sense of affinity (“I feel affinity”—8.4% + “I generally feel affinity”—32.3%).

In contrast, the percentage of respondents who felt no affinity rose from 35.3% (“I generally feel no affinity”—19.8% + “I feel no affinity”—15.5%) in 2011 to 59.0% (“I generally feel no affinity”—28.1% + “I feel no affinity”—30.8%) in 2012 and stood at 58.0% (“I generally feel no affinity”—31.7% + “I feel no affinity”—26.4%) in 2013.

Survey respondents are also asked to comment on the state of Japan-South Korea relations. In the 2013 survey, 21.1% saw the relationship as healthy (“I think that the relationship is healthy”—1.4% + “I basically think that the relationship is healthy”—19.8%). In contrast, 76% thought that the relationship was not healthy (“I basically think that the relationship is not healthy”—39.2% + “I think that the relationship is not healthy”—36.8%)\(^2\).

The election of new administrations in Japan and South Korea was initially expected to bring progress toward the improvement of the relationship. However, relations have remained cool, as evidenced by the fact that no summit meeting has yet been arranged. (In fact, there has been no summit meeting for two years.) The lack of motivation to repair the relationship is a serious problem. It would be fair to say that the relationship is near to a worst-case situation. In fact, when the Maeil Business Newspaper (매일경제신문) conducted a survey of 30 Japanese and South Korean experts in November 2013, 15 respondents indicated that the relationship had reached a worst-case situation, and the other 15 indicated that the state of the relationship was “quite poor.” Three of the participants attributed the deterioration of the relationships to factors on the Japanese side, and 27 to issues on both sides.

This worsening of the relationship with South Korea has been accompanied by the growing prevalence of hate speech against Koreans living in Japan. This trend may appear to have arisen suddenly, but in fact the Kenkanryu (“anti-Korean wave”) phenomenon\(^3\) can be seen as a continuation of the negative reaction to the so-called Kanryu (“Korean Wave”)\(^4\) in popular culture that emerged in the mid-2000s.

More recently, some sections of the media have run negative campaigns about South Korea. There have even been unrealistic claims that the South Korean economy is foundering. Similar behavior has also occurred in South Korea. The worsening of government-level relations also coincided with

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**Fig. 1 Affinity toward South Korea**

![Graph showing affinity toward South Korea over calendar years](image)

Source: Public Relations Office, Minister’s Secretariat, Cabinet Office of Japan, Gaiko ni Kansuru Yoron Chosa [Public Opinion Survey on Foreign Policy]

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\(^1\) Lee Myung-bak, then President of South Korea

\(^2\) The percentage of respondents who felt the relationship was healthy includes both respondents who “think that the relationship is healthy” and “basically think that the relationship is healthy.”

\(^3\) Kenkanryu refers to a wave of hate speech against Koreans living in Japan.

\(^4\) Kanryu refers to a popular culture trend that was influenced by negative reactions to Korean waves in Japan.
a fall in the value of the yen and a rise in the value of the won, leading to one-sided criticism of Japan or Abenomics, including statements by senior government officials and newspaper and magazine articles accusing Japan of starting a currency devaluation war. These emotional exchanges are indicative of the difficulty of repairing Japan-South Korea relations.

However, grass-root exchange activities by private citizens have continued despite the deterioration of relations. In fact, some have even been prompted by the situation to increase efforts to expand contacts. In 2005 the Japan-Korea Exchange Festival was launched to commemorate the 40th anniversary of the normalization of diplomatic relations between Japan and South Korea. Initially the event was held in Seoul, but since 2009 it has alternated between Seoul and Tokyo as an event created by both countries. The Festival was held in 2012 and 2013 and attracted large numbers of participants. This is an indication of the increasing maturity of civil society in both countries.

(2) Need for Caution over Changes in the Economic Relationship

Issues relating to historical perceptions, including the annexation of Korea, military “comfort women,” history textbooks, and visits to Yasukuni Shrine, have obviously played a direct role in the deterioration of Japan-Korea relations. However, the situation also appears to have been affected by changes in the environment in which Japan and Korea exist, and by social and political changes within South Korea. The importance of the Japan-Korea relationship from a security perspective has waned and relationships with socialist countries have expanded since the collapse of the Cold War structure. In addition, China has become increasingly important from both the security and economic viewpoints. Other factors include South Korea’s progress toward democratization since the second half of the 1980s.

To understand the current relationship between Japan and South Korea, we also need to look at economic changes resulting from globalization. First, South Korea has raised its profile in the international community by overcoming the currency crisis and embracing globalization in the 2000s. Second, Japan has gone through a lengthy period of economic stagnation. Third, these two factors have narrowed the gap in economic potential between the two countries and reduced Japan’s importance to South Korea. Japan’s declining importance has naturally been reflected in the South Korean government’s foreign policy stance toward Japan, and to waning interest in Japan within South Korean society.

There has been a marked rise in South Korea’s economic presence in the international community. South Korean companies have expanded their shares of world markets. For example, Samsung Electronics and LG Electronics are now the world’s biggest and second biggest producers of flat-screen TVs, while the Hyundai Motor Group is ranked fifth in the motor vehicle market. In addition, the Port of Busan and Incheon International Airport have become transportation hubs for East Asia.

The South Korean government has also worked to raise South Korea’s presence by political and diplomatic means. In November 2010, South Korea became the first Asian country other than Japan to host a G20 meeting, during which it promoted itself as a bridge between advanced and emerging countries. Since the 2000s, the South Korean government has stepped up its assistance to emerging countries. In addition to its official development aid, South Korea also actively shares knowledge and expertise based on its own development experience with emerging countries under the Knowledge Sharing Program, which it launched in 2004. There has been a steady increase in the number of emerging countries seeking to learn from South Korea’s example. This reflects the remarkable economic development achieved by South Korea over a short period after emerging from World War II as one of the poorest countries in the world. In addition, South Korea’s experience in such areas as poverty reduction and housing development can be used to solve the problems that currently confront emerging countries.

South Korea has also narrowed Japan’s lead in
South Korea has risen from 30th in the IMD’s international competitiveness rankings in 1997 to 22nd in 2013, while Japan has fallen from 17th to 24th (Table 1). Japan’s lower ranking reflects low scores for economic conditions and government efficiency.

Another key ranking, albeit not relating to international competitiveness, is based on the World Business Environment Survey (WBES), which has been carried out by the World Bank since 2003(8). South Korea has overtaken Japan in this ranking, which currently covers 183 countries. The top 10 countries in 2012 were Singapore, Hong Kong, New Zealand, the United States, Denmark, Norway, the United Kingdom, South Korea, Iceland and Ireland. Japan was ranked 20th.

Japan is ahead of South Korea in the other international competitiveness rankings, which are terms of economic power. Japan’s continuing economic stagnation since the collapse of the bubble has become known as the “Lost Two Decades.” In contrast, South Korea achieved growth averaging 4.5% per annum during the 2000s(7). As a result, South Korea’s per capita nominal GDP has risen from one-quarter of Japan’s figure in 1991 to around one-half in 2012. On a purchasing power parity basis, South Korea has increased its per capita GDP from 0.45 of Japan’s figure to 0.89 and is now almost level (Fig. 2).

South Korea’s rising presence in the international community is also confirmed by its international competitiveness ranking. One of the leading compilers of international competitiveness lists is the Swiss organization International Institute for Management Development (IMD), which publishes its rankings each year. Another is the World Economic Forum, which is also based in Switzerland. There are differences in the factors that make up competitiveness, and in the definitions used. The IMD defines competitiveness as the capacity to create and maintain an environment in which the potential of businesses can be maintained. It ranks countries on the basis of comprehensive criteria spanning the four areas of economic conditions, government efficiency, business efficiency and infrastructure.

Fig. 2  Per Capita GDP of Japan and South Korea

Per capita GDP (Nominal, dollar equivalent, South Korea)

Per capita GDP (Nominal, dollar equivalent, Japan)

Per capita GDP (Purchasing power parity, South Korea)

Per capita GDP (Purchasing power parity, Japan)

Notes: Purchasing power parity is based on 2005 dollars. Source: World Bank, World Development Indicators

Table 1 IMD International Competitiveness Rankings

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Source: www.imd.org/news/World-Competitiveness-2013.cfm

Notes: Purchasing power parity is based on 2005 dollars. Source: World Bank, World Development Indicators

South Korea has risen from 30th in the IMD's international competitiveness rankings in 1997 to 22nd in 2013, while Japan has fallen from 17th to 24th (Table 1). Japan’s lower ranking reflects low scores for economic conditions and government efficiency. Another key ranking, albeit not relating to international competitiveness, is based on the World Business Environment Survey (WBES), which has been carried out by the World Bank since 2003(8). South Korea has also overtaken Japan in this ranking, which currently covers 183 countries. The top 10 countries in 2012 were Singapore, Hong Kong, New Zealand, the United States, Denmark, Norway, the United Kingdom, South Korea, Iceland and Ireland. Japan was ranked 20th.
South Korea several ranks below Japan. During the controversy of the extension of the expanded currency swap deal between Japan and South Korea, a senior official of the Japanese government made comments to the effect that Japan was prepared to extend the arrangement if South Korea came cap in hand to request it. This naturally triggered an angry reaction from South Korea.

In Part 2 we will look at specific changes in Japan’s importance to South Korea as a result of the globalization of the South Korean economy.

2. Changes Resulting from Globalization

(1) Reduced Reliance on Japan for Trade

Since the 2000s, the Chaebol groups have led an accelerating trend toward business globalization through exporting and overseas production. This resulted from the shrinkage of domestic markets after the 1997 currency crisis, predictions of further market declines because of a rapidly falling birthrate and demographic aging, and the emergence of business opportunities resulting from sustained growth in emerging market economies.

Fig.3 confirms the role of exports and direct overseas investment in this accelerating globalization trend. The contribution of exports to gross domestic product (GDP) has risen from 30.6% in 2000 to 53.0% in 2012, compared with Japan’s ratio of just over 10%. Companies are investing aggressively in foreign markets, as evidenced by the fact that direct overseas investment expanded rapidly in the second half of the 2000s and remains high at present.

In the 2000s, there was a particularly rapid increase in investment in China, which joined the World Trade Organization (WTO) in 2001 and has continued to achieve high growth. The shift to production in China has induced exports of raw materials, production goods, including parts, and capital goods, such as machinery and equipment, from South Korea. Exports of consumer goods compiled by the WEF. The WEF defines competitiveness as “the set of institutions, policies, and factors that determine the level of productivity of a country.” It calculates rankings according to comprehensive scores across 12 categories: institutions, infrastructure, the macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication and innovation. The weighting assigned to each of these categories varies according to the level of per capita GDP. South Korea’s ranking rose from 23rd in 2001 to 11th in 2007 but then fell back to 19th in 2012 and 25th in 2013. The reasons given for the sharp fall in 2013 were continued low growth, and the increasingly unstable situation on the Korean Peninsula. Japan’s ranking rose from 21st in 2001 to 5th in 2006 but then slipped back to 9th in 2013.

Overall, the gap in economic power between Japan and South Korea tended to narrow during the 2000s. Shortly after his landing on Liancourt Rocks on August 13, 2012, President Lee Myung-bak invited the Speaker of the National Assembly and other key people to his office for lunch. During that lunch, he commented that Japan was not as influential in the international community as it had been in the past. The exact meaning of this comment is unclear, but we can surmise that the President was expressing pride in South Korea’s increased economic power and rising presence in the international community.

The real problem is Japan’s failure to recognize the full significance of changes that occurred in the 2000s. Even now, people are expressing views that are little more than preconceived notions based on an inadequate understanding of the realities. Examples include claims that the advances made by South Korean companies are attributable to the low value of the won, that the South Korean economy is dependant on imports from Japan and would be severely impacted by any interruption of those imports, that there is always a risk that the South Korean currency will collapse, and that Japan’s support is indispensable.

There is also a persistent tendency to position
have also increased with the expansion of domestic demand in China. Exports to China increased by over 30% per annum between 2002 and 2004, and in 2003 China overtook the United States as South Korea’s biggest export market (Table 2).

South Korea’s reliance on exports to China increased further after the Lehman shock. This reflects the recovery of exports to China as a result of China’s implementation of measures to boost domestic demand.

Japan’s presence as a trading partner for South Korea diminished further in the 2000s as a result of accelerating growth in China and other emerging market economies. South Korea’s reliance on exports to Japan has fallen from 11.9% in 2000 to 6.0% in 2010, although there was a temporary rise after the Great East Japan Earthquake. This reflects not only Japan’s economic stagnation, but also the fact that South Korean products, with a few exceptions, have not significantly penetrated Japanese markets. There are several reasons for this. First, the power of European and American brands gives them a competitive advantage in high-end markets, while price-competitive Chinese goods enjoy an advantage in low-end and medium-end markets. Second, South Korean products cannot readily compete in terms of prices or quality with the many products manufactured in Asia by Japanese companies and imported into Japan. Third, South Korean products are still viewed as cheap and inferior by people in certain age groups. Hyundai Motors first entered the Japanese market in the early 2000s, but subsequently withdrew because of poor sales. Because of the difficulty of penetrating Japanese markets, South Korean companies have instead focused their efforts on the development of markets in Europe, North America and emerging countries.

We also need to be aware that the decline in reliance on Japan is also manifested in imports. Japanese companies supply high-quality raw materials, key parts and manufacturing facilities to South Korean companies. For this reason, Japan remained South Korea’s biggest source of imports until 2006. However, it relinquished that status to China in 2007. South Korea is now importing increasing volumes of consumer goods, as well as production goods, especially general-purpose items, and capital goods from China.

Based on trends in production inducement coefficients of the inter-industry relations table for Asia, Kim [2010] shows that China has emerged

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Source: Bank of Korea, Economic Statistics System
as a source of production goods, for which South Korea relied on Japan and the United States until the 1990s.

(2) Production Goods and Capital Goods Also Affected by General Downturn

Statistics for January-November 2013 show that production goods and capital goods, including iron and steel, semiconductors, precision devices, manufacturing equipment and chemicals, occupy the top 15 places in the list of Japanese goods imported into South Korea (based on 6-digit HS codes) (Table 3). These categories, which are defined as “parts and raw materials” in South Korea, have been regarded as the main culprits behind South Korea’s trade deficit with Japan\(^\text{10}\).

As shown in the following analysis, South Korea’s overall reliance on imports from Japan in the areas of production goods and capital goods is falling. This can be attributed to the following three factors.

First, accelerating globalization has been accompanied by a shift in import sources. Reasons for this appear to include (1) a decline in the advantage of Japanese products, (2) the entry of European and American companies into South Korean markets after the currency crisis, leading to a shift to sourcing from Europe and North America, (3) the South Korean government’s active efforts to conclude free trade agreements (FTAs), with the result that it is more advantageous from a tariff viewpoint to import goods from countries with which FTAs have been signed.

Second, South Korea is working to strengthen its parts and raw materials industries, leading to a shift to domestic production of these items. In 2001, South Korea established a law providing for special measures to foster companies specializing in parts and raw materials\(^{11}\), of which particularly large quantities are imported from Japan. Since then, an annual budget of approximately 300 billion won has been provided to improve the technology of private sector companies. In 2005, 10 items, including LCDs and organic EL products,

### Table 3  South Korea’s Top Imports from Japan (Based on 6-Digit HS Codes)

<table>
<thead>
<tr>
<th>HS Code</th>
<th>Commodity</th>
<th>Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>720449 Other ferrous waste and scrap</td>
<td>Iron and steel</td>
</tr>
<tr>
<td>2</td>
<td>854232 Memories</td>
<td>Semiconductors</td>
</tr>
<tr>
<td>3</td>
<td>900120 Sheets and plates of polarizing material</td>
<td>Precision devices</td>
</tr>
<tr>
<td>4</td>
<td>854140 Photosensitive semiconductor devices, including photovoltaic cells,</td>
<td>Individual semiconductors</td>
</tr>
<tr>
<td></td>
<td>whether or not assembled in modules or made up into panels; light</td>
<td></td>
</tr>
<tr>
<td></td>
<td>emitting diodes</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>392073 Other plates, sheets, film, foil strips of cellulose acetate (non-cellular)</td>
<td>Crude chemicals</td>
</tr>
<tr>
<td>6</td>
<td>270730 Xylole</td>
<td>Chemicals</td>
</tr>
<tr>
<td>7</td>
<td>290250 Styrene</td>
<td>Chemicals</td>
</tr>
<tr>
<td>8</td>
<td>848620 Machines and apparatus for the manufacture of semiconductor devices or of electronic integrated circuits</td>
<td>Semiconductor fabrication equipment</td>
</tr>
<tr>
<td>9</td>
<td>854231 Processors and controllers , whether or not combined with memories, converters, logic circuits, amplifiers, clock and timing circuits, or other circuits</td>
<td>ICs</td>
</tr>
<tr>
<td>10</td>
<td>700490 Other glass</td>
<td>Glass</td>
</tr>
<tr>
<td>11</td>
<td>290243 P-Xylene</td>
<td>Chemicals</td>
</tr>
<tr>
<td>12</td>
<td>720839 Flat-rolled products of a thickness of less than 3 mm (iron and steel)</td>
<td>Thin sheets (iron and steel)</td>
</tr>
<tr>
<td>13</td>
<td>720851 Flat-rolled products of a thickness exceeding 10 mm (iron and steel)</td>
<td>Thin sheets (iron and steel)</td>
</tr>
<tr>
<td>14</td>
<td>848630 Machines and apparatus for the manufacture of flat panel displays</td>
<td>Panel manufacturing equipment</td>
</tr>
<tr>
<td>15</td>
<td>720712 Other semi-finished products of iron or non-alloy steel of rectangular (non-square) cross-section</td>
<td>Iron and steel</td>
</tr>
</tbody>
</table>

Notes: Commodities labeled as “other” have been omitted.
Source: Korea International Trade Association database
were designated as major strategic parts and materials. In addition, the Lee Myung-bak administration established several industrial parks specializing in parts and materials in Gumi City (Gyeongsangbuk-do), Pohang City (Gyeongsangbuk-do) and other locations. South Korea has since worked actively to attract companies involved in parts and materials to these industrial parks.

A third and related factor is the shift to local production in South Korea by Japanese companies in recent years. Local production offers a number of advantages, including (1) easier communication with customers, (2) the facilitation of joint development, (3) the avoidance of currency fluctuation risk, and (4) reduced production costs. Furthermore, South Korea’s emergence as an FTA hub has enhanced its attractiveness as an export production base.

We will now use case studies relating to specific items to examine changes in the value of imports from Japan and reliance on imports from Japan.

1 Automotive Parts

One of the categories in which there has been a marked decline in South Korea’s reliance on imports from Japan is automotive parts. The main reason for this decline is a shift in import sources as a result of globalization. This relates to the first of the three factors outlined above.

An analysis of trends since the 2000s shows that the total value of imports and the value of imports from Japan both followed upward trends until 2010, but that reliance on imports from Japan declined (Fig. 4). Of particular significance is the fact that both the value of imports and reliance on imports from Japan have fallen sharply over the past three years.

This probably resulted in part from a shift to import sources other than Japan after supply chains were disrupted by the Great East Japan Earthquake. However, other factors appear to have driven the downward trend, including (1) the establishment of operations in South Korea by foreign-owned parts manufacturers (12), (2) increased imports of maintenance parts from Europe due to expanding sales of European vehicles in the South Korea market, (3) an increase in imports from Europe and North America due to tariff reductions resulting from the signing of FTAs (Table 4), and (4) the fact that Japanese motor vehicle manufacturers replaced some of their exports from Japan with exports from their factories in the United States (also leading to increased imports of maintenance parts).

An analysis of actual trends shows that while imports from the United States and EU members increased, there was particularly dramatic growth in imports from China, and South Korea’s reliance on imports from China rose from 11.2% in 2005 to 34.5% in 2013. By 2012, China had overtaken Japan to become the biggest source of imports. In 2013, China was the leading source of imports, followed by Japan, Germany, the United States, Mexico, Austria, Australia and France.

Details of the companies importing from China are unclear, but we can surmise that many are companies with production operations in China. (Hyundai Motors is already operating three plants, and key parts suppliers, such as Hyundai Mobis, are also producing in China.)

2 LCD Panels

We will look next at LCD panels. In the past South Korea imported most of the LCD panels used in computer displays and flat-screen televisi-
leading glass manufacturers. Polarization plates are manufactured by Cheil Industries, a member of the Samsung Group, and LG Chem.

“A glass factory belonging to Samsung’s joint venture with Corning is located very close to Samsung’s ultramodern factory. Glass from the joint venture is delivered to the Samsung factory, which produces color filters in-house. LG produces not

Table 4  Main Provisions of Motor Vehicle-Related FTAs between South Korea and Europe and South Korea and the United States

<table>
<thead>
<tr>
<th></th>
<th>FTA with the EU</th>
<th>FTA with the U.S.A.</th>
</tr>
</thead>
</table>
| Passenger cars | • South Korea and the EU will abolish tariffs on medium and large vehicles (cylinder capacity over 1,500cc) within three years of the effectuation of the agreement.  
• South Korea and the EU will abolish tariffs on small vehicles (1,500cc and under) within five years of the effectuation of the agreement. | • South Korea will reduce the tariff (8%) to 4% immediately after the effectuation of the agreement, maintain it at that level for four years, and then abolish it.  
• The United States will maintain the tariff (2.5%) for four years after the effectuation of the agreement and then abolish it. |
| Freight vehicles| • South Korea will immediately abolish the tariff on buses and freight vehicles of 5 tons or less, and the tariff on vehicles over 20 tons within five years.  
• The EU will abolish tariffs on buses immediately, on freight vehicles of 5 tons or less within five years, and on freight vehicles over 20 tons within three years. | • South Korea will abolish the tariff (10% in principle) immediately after the effectuation of the agreement.  
• The United States will maintain the tariff at its present level of 25% for seven years after the effectuation of the agreement, then reduce it in equal installments from the eighth year onwards, and fully abolish it in the 10th year after effectuation. |
| Automotive parts| • Both parties will abolish tariffs immediately after the effectuation of the agreement. | • Both parties will abolish tariffs immediately after the effectuation of the agreement. |

Source: Various

Fig.5  Imports of South Korean LCD Panels

Source: Korea International Trade Association database

Notes: HS code: 852990

Leading glass manufacturers. Polarization plates are manufactured by Cheil Industries, a member of the Samsung Group, and LG Chem.

“A glass factory belonging to Samsung’s joint venture with Corning is located very close to Samsung’s ultramodern factory. Glass from the joint venture is delivered to the Samsung factory, which produces color filters in-house. LG produces not
around 80% could be procured within South Korea. The shift to local production has advanced still further since then. In fact, imports of panel fabrication equipment declined sharply between 2011 and 2012. However, reliance on imports from Japan remains high (Fig.7).

One reason why manufacturers of fabrication equipment began to shift to local production in South Korea (local assembly of products imported from Japan) was the need to respond quickly to the needs of customers.

Panel manufacturers have gathered companies in related industries around their plants (15). This clustering strategy has also encouraged foreign-owned companies to start up local production operations.

Several Japanese companies, including Asahi Glass and Nippon Electric Glass, are producing glass substrates locally in South Korea. This shift to local production has been prompted in part by the rising cost of transportation from Japan because of the increasing size of glass substrates. Companies in the fields of photomasks and color resists have also shifted to local production.

Japanese companies are playing a major role in the area of films, including polarizing and optical films. Until recently South Korea was also almost entirely reliant on imports from Japan, and that pattern remains largely unchanged. However, the shift to local production has resulted in a decline in imports from Japan (Fig.6).

There has also been a shift to domestic production of panel fabrication equipment. According to Mitarai [2011], while South Korea was still reliant on Japan for key components of exposure equipment and fabrication equipment, South Korean companies were producing around 50% of these items domestically by the end of 2009. Mitarai estimated that if products assembled in South Korea by Japanese companies were also included, only color filters but even polarization plates in-house. (14)

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Table 5 LCD Panel-Related Investment by Foreign Companies

<table>
<thead>
<tr>
<th>Foreign Company</th>
<th>Start of Occupancy, Location</th>
<th>Field</th>
<th>Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merck</td>
<td>2002, Pyongtaek, Gyeonggi-do</td>
<td>LCDs</td>
<td>Liquid crystal compounds</td>
</tr>
<tr>
<td>Chisso</td>
<td>2005, Pyongtaek, Gyeonggi-do</td>
<td>LCDs</td>
<td>Overcoats, alignment films</td>
</tr>
<tr>
<td>Sumitomo Chemical</td>
<td>1998/2002, Pyongtaek, Gyeonggi-do</td>
<td>LCDs</td>
<td>Color resists/color filters</td>
</tr>
<tr>
<td>NHT</td>
<td>2005, Pyongtaek, Gyeonggi-do</td>
<td>LCDs</td>
<td>Glass substrates</td>
</tr>
<tr>
<td>HOYA</td>
<td>2005, Pyongtaek, Gyeonggi-do</td>
<td>PDPs</td>
<td>Polarizing films</td>
</tr>
<tr>
<td>Nitto Denko</td>
<td>1999/2004, Pyongtaek, Gyeonggi-do</td>
<td>PDPs</td>
<td>Glass substrates</td>
</tr>
<tr>
<td>Nippon Electric Glass</td>
<td>2005, Paju, Gyeonggi-do</td>
<td>LCDs</td>
<td>Photomasks</td>
</tr>
<tr>
<td>Photronics (PKL)</td>
<td>1993, Cheonan, Chungcheongnam-do</td>
<td>CCL</td>
<td>Color resists</td>
</tr>
<tr>
<td>JSR</td>
<td>2003, Ochang, Chungcheongnam-do</td>
<td>PDPs</td>
<td>Glass substrates</td>
</tr>
<tr>
<td>Central Glass</td>
<td>2005, Ochang, Chungcheongnam-do</td>
<td>LCDs</td>
<td>PDPs</td>
</tr>
<tr>
<td>Toshiba (Harison)</td>
<td>2003, Ochang, Chungcheongnam-do</td>
<td>LCDs</td>
<td>PDPs</td>
</tr>
<tr>
<td>Asahi Glass</td>
<td>2004, Gumi, Gyeongsangbuk-do</td>
<td>LCDs</td>
<td>PDPs</td>
</tr>
<tr>
<td>3M</td>
<td>1996/2005, Hwaseong, Gyeonggi-do</td>
<td>LCDs, PDPs</td>
<td>Optical films, thermal management film</td>
</tr>
</tbody>
</table>

Notes: Shaded areas indicate Japanese-owned companies. Source: South Korea Display Industry Association

![Fig.6 South Korea’s Film Imports](image-url)

Notes: HS code: 392073, 2013: January-November Source: Korea International Trade Association database

There has also been a shift to domestic production of panel fabrication equipment. According to Mitarai [2011], while South Korea was still reliant on Japan for key components of exposure equipment and fabrication equipment, South Korean companies were producing around 50% of these items domestically by the end of 2009. Mitarai estimated that if products assembled in South Korea by Japanese companies were also included, around 80% could be procured within South Korea. The shift to local production has advanced still further since then. In fact, imports of panel fabrication equipment declined sharply between 2011 and 2012. However, reliance on imports from Japan remains high (Fig.7).

One reason why manufacturers of fabrication equipment began to shift to local production in South Korea (local assembly of products imported from Japan) was the need to respond quickly to the needs of customers.

The decline in reliance on Japan in the LCD field can thus be attributed both to increasing do-
mestic production by South Korean companies, and to a shift to local production in South Korea by Japanese companies. Although South Korea is still reliant on Japan for raw materials and core parts of fabrication equipment, domestic production is increasing steadily.

As South Korean companies expand their production, the traditional supply chain, under which products were exported to South Korean companies by Japanese companies, is shifting to a new pattern in which South Korean companies are supplied both by exports from Japanese companies and also by domestically produced goods from South Korean companies.

③ Laminated Ceramic Capacitors

We will look next at laminated ceramic capacitors, which are used in electronic equipment. Mobile telephones contain many of these chip capacitors, which combine compact designs with large capacities thanks to the layering of ceramic dielectric bodies and metallic electrodes. Interestingly, reliance on imports from Japan is declining, despite growth in both total imports and imports from Japan (Fig.8).

Laminated ceramic capacitors are manufactured in South Korea by the Samsung Group, and Taiyo Yuden has also established a local production operation. The continuing growth of imports despite the emergence of local production appears to be driven either by rapid demand growth resulting from the expansion of smartphone production, or by reliance on imports of high-quality products with smaller designs and higher capacities.

While reliance on imports from Japan is falling, reliance on imports from China is rising. The source of these imports is unknown, but Murata Manufacturing has a production base in China, and it is possible that capacitors are being supplied from there. If that is the case, the decline in reliance on imports from Japan can be attributed to globalization.

④ Machine Tools

We will look specifically at numerically controlled lathes. In the 2000s, total imports of these products increased until 2010 but declined year on year in both 2011 and 2012. This resulted from a downturn in capital investment. Reliance on imports from Japan declined in some years but has generally remained extremely high (Fig.9).

Japan is the world’s biggest exporter of machine tools. Machine tools are regarded as the key to competitive manufacturing, and their production requires a high level of technology. Because they are manufactured in small quantities, small
areas in which South Korea relies on imports from Japan, and (2) that while some products may not be imported from Japan, they are still sourced from Japanese companies with production operations in South Korea. Clearly South Korea (and South Korean companies) remains heavily reliant on Japan (Japanese companies) in a number of areas, including core parts and high-quality materials, which are vital to the performance of finished products, as well as fabrication equipment. However, the importance of these goods is not generally recognized because they are traded between companies.

(3) South Korea’s Growing Importance to Japan

In contrast with the decline in South Korea’s reliance on exports to Japan and imports from Japan during the 2000s, Japan’s reliance on exports to South Korea rose from 6.3% in 2001 to 8.1% in 2010 (Fig.11). Reliance on exports to South Korea fell in 2011 because of the effects of the Great East Japan Earthquake but climbed back to 7.7% in 2012 and 8.2% in the first half of 2013. South Korea is Japan’s third biggest export market after China and the United States, and exports to South

and medium enterprises account for the majority of production. In addition, a high percentage of machine tools are manufactured domestically in Japan.

⑤ Organic Chemicals

Chemicals, including organic chemicals (HS codes starting with “29”) and plastics (HS codes starting with “39”) rank alongside iron and steel among the top items imported by South Korea from Japan. Organic chemicals are a wide-ranging category that includes alcohols, ketones, acetic acid and acetic esters and monomers. Films, which were discussed earlier, and plastics also belong to this category.

The following analysis will focus in particular on styrene (used exclusively as a polymerization monomer, and especially as a synthetic resin raw material). Imports from Japan have increased at a faster pace than total imports, with the result that reliance on imports from Japan has risen (Fig.10). This is an indication of Japan’s comparative advantage in the area of organic chemicals.

While we can conclude from the preceding analysis that overall reliance on imports from Japan is declining, we can also reach several other conclusions, including (1) that there are still many
many manufacturers of production goods and capital goods can only generate earnings by supplying those products to the companies that use them. In the 2000s, a global decline in the presence of Japanese manufacturers of finished goods was paralleled by a rise in the presence of South Korean manufacturers of finished goods. South Korean companies also appear to have strengthened their position in negotiations with suppliers because of their selling power in world markets. This reversal of negotiating power may be one of the reasons for the increase in investment in South Korea by Japanese companies.

Direct investment from Japan to South Korea has expanded in recent years and doubled year on year in 2012 (Fig.12). This is indicative of a shift from exporting to investment. One reason for this trend is the determined efforts made by central and local governments in South Korea to attract investment by Japanese companies, including the hosting of seminars. Other countries engage in similar activities, and there is little variation in the incentives offered. What is important is growing awareness of the advantages of investment in South Korea for Japanese companies. These include (1) easier communication with customers, (2) the facilitation of joint development, (3) the avoidance of currency fluctuation risks, and (4) reduced production costs.

Korea are worth more than exports to the Eurozone.

A number of facts can be put forward as evidence of South Korea’s high importance to Japan. For example, South Korea has been Japan’s biggest market for exports of iron and steel products over the past few years, followed by China and Thailand. Products exported to South Korea include hot-rolled sheets and heavy and medium plates (Table 3 above). The top three export markets for plastics in 2012 were China, South Korea and Taiwan. Moreover, semiconductor and FPD fabrication equipment sales statistics published by the Semiconductor Equipment Association of Japan show that the top three markets are North America, Taiwan and South Korea. Sales to South Korean companies are a core source of earnings for some manufacturers.

Japan’s increasing reliance on exports to South Korea is thus explained by two factors. First, South Korean companies have increased their domestic production as a result of global business expansion. Second, this has resulted in increased exports of production goods and capital goods from Japan.

Japanese companies are generally believed to enjoy an advantage in trading in items that only Japanese companies can produce because of their technology and production expertise. However,
(including lower effective corporate tax rates and electricity charges). Another factor is South Korea’s growing attractiveness as an export base thanks to the South Korean government’s determined efforts to sign FTAs. In addition, escalating global competition is reflected in increased pressure from customers to reduce costs, shorter delivery lead times and hold frequent meetings. This is what is meant by the aforementioned “reversal of negotiating power.”

As shown in the preceding analysis, there has been a major change in the economic relationship between Japan and South Korea since the 2000s. This is a key factor that needs to be taken into account when considering the relationship between the two countries.

3. Japan-South Korea Relationship Starting to Appear Shaky

(1) Foreign Policy Stance More Focused on China than Japan

In recent years, there has been a cooling of the relationship between Japan and South Korea. At the same time, the South Korean government has shifted to a foreign policy stance that focuses more on China. Evidence of this shift includes the fact that after first holding a summit meeting with the United States, President Park Geun-Hye decided to have her second summit meeting with China.

This emphasis on China reflects China’s importance from both the security perspective, especially with regard to the stability of the Korean Peninsula, and also from an economic viewpoint.

From an economic perspective, China is, as noted above, South Korea’s biggest trading partner and also the country with which South Korea has the biggest trade surplus. South Korea’s trade surplus with China shrank in the mid-2000s but has been expanding continuously since 2009 (Fig.13). Increased exports of production goods and capital goods to China are contributing to this trend.

In contrast, the incentives to strengthen the economic relationship with Japan appear to have become progressively weaker for several reasons. First, the Japanese government refused to provide improved access to agricultural and fisheries markets, which was one of the requests put forward by South Korea in negotiations over a Japan-South Korea FTA (initiated in December 2003, suspended since November 2004). Second, Japan has become less important as an export market. Third, South Korea’s deficit in trade with Japan continued to expand until 2010 before shrinking in two consecutive years because of increased exports to Japan after the Great East Japan Earthquake.

In fact, South Korea gave priority to the FTA negotiations with China ahead of efforts to bring about the resumption of negotiations with Japan. Negotiations over a South Korea-China FTA commenced in May 2012, and the two countries reached basic agreement on modality in early September 2013. The agreement is expected to result in the removal of tariffs on 90% of trade goods accounting for 85% of the value of imports. The level of liberalization is not especially high when compared with South Korea’s FTAs with the EU and the United States, which cover 98.1% and 98.3% respectively of trade items. Despite this, South Korea appears to have concluded that it could gain an advantage in access to Chinese markets by signing an FTA with China before Japan.
The emphasis on China in South Korea’s economic foreign policy has also been manifested in developments relating to currency swap agreements. The currency swap agreement between Japan and South Korea was expanded from $13 billion to $70 billion when the value of the won plummeted in the wake the European debt crisis. This increase expired at the end of October 2012 and was not extended (Fig.14). Nor was the central bank’s share of $3 billion extended from the expiration date of July 3, 2013. The remaining $10 billion will expire in February 2015.

This situation resulted from the fact that South Korea did not seek an extension of the swap agreement, while the Japanese government adopted the position that the swap agreement would not be extended unless there was a request from South Korea. South Korea’s decision not to seek an extension may have been prompted by the reduced risk of a collapse of the won\(^{(16)}\), but there can be no doubt that the decision was also influenced by the deterioration of Japan-South Korea relations, and also by a heated confrontation in 2012 triggered by hints from then Finance Minister Shinichiro Azumi that Japan would refuse to extend the currency swap agreement as a sanction in response to former President Lee’s landing on Liancourt Rocks.

In June 2013, the Bank of Korea agreed to a three-year extension of the currency swap agreement with China (64 trillion won, expiring in October 2014). However, this does not mean that South Korea is becoming more reliant on China or turning itself into a vassal state, since the Bank of Korea subsequently signed currency swap agreements with Indonesia, the United Arab Emirates (UAE) and Malaysia. All are based on local currencies. The amounts involved are 10.7 trillion won ($10 billion) with Indonesia, 5.8 trillion won ($5.4 billion) with the UAE, and 5 trillion won ($4.7 billion) with Malaysia.

(2) Combination of Worsening Relations and Low Yen/High Won Trend

We cannot be certain of the extent economic activity has been impacted by the deterioration of the relationship between Japan and South Korea. However, there are indications that overlapping of a trend toward a lower yen and higher won with the worsening of the relationship is starting to have a negative impact on the economic relationship as well. South Korea has seen its currency rise rapidly against the yen since the autumn of 2012. From around 1,500 won per 100 yen in October 2012, the won-yen rate climbed to around 1,200 in December, around 1,100 in January 2013, and around 1,000 in May (Fig.15).

The won’s rise was attributable to the expansion of South Korea’s current account surplus, mainly because the investment ratio was substantially lower than the saving ratio (Fig.16), while the yen’s fall was the result of bold monetary measures implemented as part of Abenomics. In view of these background factors, the South Korean government and media should have reacted more calmly to the situation.

However, exports were slowing down and the economic outlook appeared increasingly uncertain, and the yen’s fall and the won’s rise also coincided with the worsening of relations between Japan and South Korea. For these and other reasons, the trend triggered increased criticism of Japan in South Korea, as is apparent from claims that Japan had launched a currency war.

One indicator of the economic impact is a fall
in the number of Japanese visitors to South Korea (Fig.17). The rate of year on year decline has slowed recently, but this is simply because the previous year’s level was lower, and there are still no signs of a recovery. While the decline in visitor numbers from Japan has been offset by an increase in the number of tourists from China, shops that cater mainly to Japanese tourists have been severely impacted.

The effects have also been manifested in some areas of trade and investment. After the Great East Japan Earthquake of March 11, 2011, South Korea’s exports to Japan expanded, causing the trade deficit to shrink in both 2011 and 2012 (Fig.13 above). This resulted from accelerating growth in South Korea’s exports to Japan as Japanese companies expanded their procurement of items ranging from petroleum products to mineral water from South Korea, and from a decline in Japan’s exports to South Korea due to the disruption of supply chains. The “Korean wave” boom helped to boost exports of other items, including smartphones, *makgeolli* (rice wine) and cosmetics.

However, this trend did not continue. In 2012, the rate of increase in South Korea’s exports to Japan fell to minus 2.2% (compared with minus 1.3% for all exports). This was attributable to a reactionary downturn after the rapid growth recorded in the previous year, and to the won’s appreciation against the yen from the autumn of that year onward. The downtrend continued in 2013 (Fig.18), and in the first 11 months of that year the rate of increase in exports to Japan was sharply lower than the 1.7% overall rate of increase at minus 10.5%. Other factors behind this decline in South Korea’s exports to Japan included the end of the “Korean wave” boom, and the deterioration of South Korea’s image in Japan, as described at
and the Japanese government’s participation in the Trans-Pacific Partnership (TPP) negotiations. In fact some companies are now postponing investments\(^{(17)}\), and future trends will need to be monitored closely\(^{(18)}\).

In addition, other problems have started to affect the business activities of Japanese companies in South Korea. All relate to court rulings in South Korea. One such ruling, handed down by the Supreme Court of South Korea, broadens the definition of what constitutes basic wages. Basic wages are the standard used when calculating overtime and other payments. If basic wages rise, there will also be increases in other payments, such as overtime and severance payments. The traditional policy of the South Korean government has been that standard wages do not include bonuses. However, on December 18, 2013, the Supreme Court ruled that the fixed portion of bonuses should be included in basic wages.

Another ruling, this time from a high court in South Korea, ordered compensation payments for conscripted workers. Historical issues, which have previously been limited to the political and diplomatic spheres, are now starting to impact on economic activity. That is why the business community is also exerting strong pressure for efforts to improve the relationship with South Korea.

**4. Japan-South Korea Relationship at a Crossroads**

(1) Growing Concern in the Japanese Business Community

Until now worsening government-level relations between Japan and South Korea have not had a significant impact on the economic relationship. At the heart of the economic relationship between the two countries are the relationships between South Korea’s major corporations, which are becoming increasingly active globally, and major Japanese corporations, as suppliers of materials and parts. These companies build relationships of trust through business activities, while fostering closer ties through business organizations, such as
the Japan-Korea Economic Association. In fact, it would be no exaggeration to state that these ties have become stronger at times when intergovernmental relations have deteriorated.

However, a situation has arisen recently that has been causing concern to Japanese companies. As previously mentioned, high courts in Seoul and Busan have handed down verdicts in lawsuits brought by South Korean workers conscripted during World War II, requiring Japanese companies to pay compensation. These verdicts are based on an opinion issued by the Supreme Court of South Korea in May 2012, to the effect that the right of individuals to claim compensation was not nullified by the signing of the 1965 “Agreement Between Japan and the Republic of Korea Concerning the Settlement of Problems in Regard to Property and Claims and Economic Cooperation” (hereinafter referred to as the “Agreement on Economic Cooperation andProperty Rights”).

The basic legal framework for Japan-South Korea relations was established in 1965, which was also the year in which diplomatic relations between the two countries were normalized. This legal framework consists of the “Treaty on Basic Relations Between Japan and the Republic of Korea”, the “Agreement on Economic Cooperation and Property Rights”, the “Agreement Between Japan and the Republic of Korea Concerning the Legal Status and Treatment of the People of the Republic of Korea Residing in Japan,” and the “Agreement Between Japan and the Republic of Korea Concerning Fisheries” (abbreviated titles).

We will not delve too deeply into the negotiating process or the content of agreements between Japan and South Korea concerning rights to claim compensation. However, we need to be aware of three points in particular. First, instead of a direct settlement of the compensation issue, as initially sought by South Korea, it was decided that the compensation would be addressed on an “economic cooperation” basis (a “political settlement”). Second, the decision to opt for a “political settlement” resulted from the fact that the South Korean administration led by President Park Chung-hee was pursuing economic development using funds provided by Japan, and the fact that the Japanese side wanted to “settle” the question of responsibility for its colonial rule (apology and compensation) by that means. Third, there was pressure from the United States to normalize relations between Japan and South Korea so that a security framework could be established in East Asia.

Section 1 of Article 2 of the “Agreement Between Japan and the Republic of Korea Concerning the Settlement of Problems in Regard to Property and Claims and Economic Cooperation” states that “The High Contracting Parties confirm that the problems concerning property, rights, and interests of the two High Contracting Parties and their peoples (including juridical persons) and the claims between the High Contracting Parties and between their peoples, including those stipulated in Article IV(a) of the Peace Treaty with Japan signed at the city of San Francisco on September 8, 1951, have been settled completely and finally.” This provision is the basis for the Japanese government’s position that the question of claims has been “resolved”.

Tadashi Kimiya (Kimiya [2012]) believes that with its recent opinion, the Supreme Court of South Korea approached differences in the historical perspectives of Japan and South Korea from a judicial standpoint, and that through its opinion the Supreme Court effectively called for a re-examination of the political settlement of issues that was achieved with the normalization of diplomatic relations between Japan and South Korea.

If the high court verdicts (dismissal of appeals) are upheld by the Supreme Court of Korea, Japanese companies will be forced to decide whether or not to comply and provide compensation. Any decision to pay compensation would run counter to the position of the Japanese government and would likely to trigger a flood of similar lawsuits. If Japanese companies refuse to pay, their assets in South Korea could be seized. In that event, the Japanese companies would probably seek international arbitration.

The South Korean government has also been forced to deal with difficult issues. Setting aside the “comfort women” question, the South Korean government has until now taken the view that the
issue of compensation for conscripted workers has been resolved. There will be several consequences if this traditional viewpoint is changed in accordance with the court decision. First, the “Agreement Between Japan and the Republic of Korea Concerning the Settlement of Problems in Regard to Property and Claims and Economic Cooperation” would become meaningless, shaking the very foundations of the Japan-South Korea relationship. Second, Japanese companies will lose confidence in the South Korean government, and their business activities in South Korea would be impacted. Third, by breaking an international agreement, South Korea could damage its reputation in the international community. Conversely, if the South Korean government intervenes in a judicial verdict, it would compromise the independence of the judiciary and could trigger a public backlash.

Among concerns about the impact of these issues on business with South Korea, the three major Japanese business organizations and the Japan-Korea Economic Association issued an unprecedented statement expressing their fears that the compensation issue could damage good relations between Japan and South Korea, and calling for a solution to the problem. South Korean newspapers, such as Chosun Ilbo and JoongAng Ilbo, have published articles criticizing this statement. However, media reports indicate that the South Korean Ministry of Foreign Affairs has shown a certain level of understanding and has interpreted the statement as indicating a wish to continue developing bilateral economic relations (Nihon Keizai Shimbun, November 8, 2013).

To begin to solve the concerns that exist between Japan and South Korea, including the issue of compensation for conscripted workers, the two countries need to hold a summit meeting as soon as possible (22), but so far no such meeting is on the horizon. Concerning efforts to improve relations between Japan and South Korea, President Park Geun-hye has adopted a basic policy calling for “a future-oriented approach based on a correct understanding of history.” This reflects a major gulf between the two countries in terms of their understanding of history. In this sense, the relationship between Japan and South Korean now stands at a crossroads.

**Mechanisms not Working to Repair the Relationship**

The following four factors are hindering mechanisms that might otherwise work to repair the relationship. First, the environment surrounding the two countries is changing. The importance of relations between Japan and South Korea from a security perspective has declined since the collapse of the Cold War structure. During the Cold War era, South Korea, the U.S. and Japan needed to stand together against the Communist Bloc of China, the Soviet Union and North Korea. However, the collapse of the Cold War structure weakened the forces that held that cooperative relationship together. The importance of Japan to South Korea has also decreased in economic terms. The waning importance of the relationship has made it difficult for processes that might work to repair it to operate.

Conversely, as described earlier in this article, the South Korean government has begun to focus its foreign policy more on China in response to its growing importance in the areas of security and the economy.

Second, there has been a decline in the influence of Japan school and Korea school officials on key decision-makers in the fields of politics and foreign policy. In the past powerful conservative politicians in both countries were a major force driving efforts to repair the relationship, but this is no longer the case. In addition to a generational shift, this also reflects the aforementioned decline in the importance of the Japan-South Korea relationship. In contrast with the ascendancy of China school officials in South Korea’s foreign policy administration, the influence of Japan school, Japanophile officials with experience of study in Japan is waning.

The third factor is democratization and advances in information technology, and the resulting decline in the effectiveness of information control mechanisms. South Korea made progress toward democratization in the late 1980s. Increased pub-
public awareness and a growing tendency to demand the disclosure of information made it difficult for the government and bureaucracy to control information, and diplomatic documents relating to past talks between Japan and South Korea began to be released. This has triggered a public re-examination of issues that previous governments had ignored. It was in this context that the controversies over “comfort women” and unpaid wages for workers conscripted during wartime arose. More recently, pressure from public opinion has led to judicial decisions that have started to destabilize the Japan-South Korea legal framework that was formed in 1965.

The fourth issue relates to the political beliefs and stances of the current leaders of both nations. President Park Geun-hye has made “a correct awareness of history” a condition for a summit meeting and has taken every opportunity to raise concerns about the stance of the Japanese government in the international community. Prime Minister Abe, on the other hand, regards efforts to change historical perceptions as a matter of political belief and has basically adhered to the traditional stance. He also takes issue with the idea of setting conditions for a summit meeting. In addition, at the end of 2013 Mr. Abe visited Yasukuni Shrine amid opposition from South Korea and China. The United States also issued a statement expressing “disappointment” at an action that would heighten tensions in East Asia. Following China’s establishment of the East China Sea Air Defense Identification Zone on November 23, 2013, people in South Korea were starting to express the view that the relationship with Japan should be rebuilt. Prime Minister’s Abe’s visit to Yasukuni Shrine cast cold water on that opinion shift.

When these factors are taken into account (Fig.19), it becomes evident that the task of repairing the relationship will not be an easy one.

(3) Renewed Awareness of Common Interests Needed

As long as the Japanese and South Korean governments remain committed to these fundamental principles, they are unlikely to achieve any immediate improvement in their relationship. While it will be difficult to agree on what constitutes the “correct recognition of history”, it should be possible to reduce the perception gap, and efforts should focus on that goal.

Japan and South Korea need to renew their awareness of their common interests and work to strengthen their mutually beneficial relationship. Their common interests can be summed up as follows.

First there is economic cooperation. Japanese and South Korean companies are linked by supply chains. As we have seen in this article, South Korean companies are reliant on Japanese companies for substantial percentages of key components, high-quality materials, raw materials and manufacturing equipment. This is apparent from the continuing efforts made by KOTRA to attract Japanese companies (23). At the same time, South Korean companies with their powerful marketing capabilities in global markets are important customers for Japanese companies.

Japanese and South Korean companies have formed tight-knit supply chains in East Asia. Since some companies are already starting to build cross-border parts procurement networks, further economic integration would be beneficial for both countries.

![Fig.19 Environment for Japan-South Korea Relations](image-url)
Mutual cooperation in energy sector is also vital, as demonstrated by the fact that imports from South Korea offset shortages of petroleum products in Japan following the Great East Japan Earthquake. As Kan Kimura emphasizes in Asaba, Kimura, Sato [2012], this kind of cooperation is possible because Japan and South Korea are neighbors.

Another common interest is cooperation on social issues. Japan and South Korea have a number of problems in common, including demographic aging, a falling birthrate, informal labor, and widening inequality, and it is possible for each country to learn from the other’s policies and areas of activity. Further economic integration would allow Japan and South Korea to provide each other with assisted living services for the elderly.

**Conclusions**

In 2015, Japan and South Korea will commemorate the 50th anniversary of the normalization of diplomatic relations. Those 50 years brought major changes in the environment of the two countries, including the collapse of the Cold War structure, democratization in South Korea, economic globalization, the emergence of China, and advances in information technology. Naturally, there have also been changes in the positioning of Japan from South Korea’s perspective and South Korea from Japan’s perspective.

The cooling of Japan-South Korea relations has now started to impact on the economy. We need to analyze the factors behind this situation calmly and logically so that we can achieve a renewed understanding of the shared interests of the two countries. Emotional exchanges of criticism will benefit neither country. Japan and South Korea should work to build a future-oriented relationships in line with the spirit of their joint declaration of 1998, which called for “A New Japan-Korea Partnership towards the Twenty-first Century.”
7. However, living standards did not improve in step with growth. This aspect is discussed in Mukoyama [2012b] and [2013b].

8. The establishment of this survey was prompted by the view that a vigorous private sector in which companies invest, leading to job creation and improved productivity, stimulates growth and expands opportunities for the poor. The business environment is a quantitative indicator of conditions affecting domestic small and medium enterprises in relation to business establishment, building approvals, electric power, real estate registration, financing, investor protection, taxation, trade, contract performance and bankruptcy regulations.

9. However, in recent years, some South Korean companies have responded to labor shortages and rising wage levels in China by seeking to reduce their “excessive reliance on China.” For example, companies have established production bases in other locations or raised the percentage of production carried out in countries other than China. Exports to ASEAN countries are expanding, and in 2011 and 2012 these showed higher growth than exports to China. See Mukoyama [2013b] for a discussion of this aspect.

10. See Mizuno, J. ed. [2011] for an analysis of the vagueness of this concept and issues concerning South Korea’s trade deficit with Japan.


12. Foreign companies moved into South Korea to supply products to the Hyundai Group, which is expanding its production, and to export to their own countries or third countries. (U.S.-based parts manufacturers were also influenced by GM’s move into South Korea.) They expanded their presence in South Korea by buying up numerous South Korean parts manufacturers that had been weakened by worsening business performance after the currency crisis.

13. LCD production is divided into the array and cell processes (front-end processing) and assembly (post-processing). Currently, the former processes are carried out in South Korea and the latter overseas.

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**End Notes**

1. In August 2011, the South Korean Constitutional Court ruled that the South Korean government had infringed the rights of former military “comfort women” and violated the constitution by failing to engage in diplomatic negotiations with the Japanese government over the issue. Then President Lee Myung-bak made a strongly worded demand for action by the Japanese government to resolve the problem. Then President Lee is thought to have made his decision to land on Liancourt Rocks after then Prime Minister Noda simply reiterated the Japanese government’s existing position.

2. There has also been a decline in affinity toward Japan in South Korea. According to a story in the December 23, 2013 edition of Chosun Ilbo, affinity toward Japan is at the same level as that toward North Korea.

3. The backlash against the “Korean wave” in popular culture, which is characterized by negative views of South Korea, began with Sharin Yamano’s Kenkanryu (“Anti-Korean Wave”) comic published by Shinyusha. Park [2006] criticizes this publication for its lack of proper factual content.


5. Priority was given to security concerns during the Cold War and while South Korea remained under an authoritarian regime and historical issues rarely came to the fore. As a result of democratization, however, society has started to re-examine issues that were ignored by past governments. This has led the emergence of concerns about military “comfort women” and wages owing to workers conscripted during World War II.

6. Evidence of Japan’s reduced presence can be found in the fact that in 2012 a diplomat specializing in China was appointed to head the Northeast Asia Bureau of South Korea’s Ministry of Foreign Affairs and Trade (now the Ministry of Foreign Affairs). Previously this post had always been occupied by officials with a background in the “Japan School.”
22. According to an opinion survey conducted jointly by the Japanese non-profit organization Genron NPO and the East Asia Institute, a South Korean think tank, in March-April 2013, more than 70% of people in both countries responded that a summit meeting was necessary.

23. At the end of a presentation at a South Korea investment seminar in Tokyo on December 4, 2013, Mr. Ki-won Han showed slides depicting scenes in which citizens worked together cooperatively and Japanese and South Korean athletes praised each other for their strenuous efforts. This was a tacit call for efforts to rebuild the relationship.


15. Examples include Samsung Electronics at Cheonan and Tangjeong, and LG Display at Gumi and Paju. Pyongtaek, where a cluster of related industries has formed, is located midway between Tangjeong and Paju. Shintaku [2008] provides a very interesting description of the situation at the Tangjeong plant.

16. The risk has been reduced by (1) a sustained current account surplus, (2) a build-up of foreign currency reserves and (3) the reduction of short-term external debt. Short-term external debt ratio has fallen from 79.1% of foreign currency reserves at the end of September 2008 (when the Lehman shock occurred) to 36.6% at the end of June 2013.

17. This is based on interviews carried out at the Seoul Branch of the Sumitomo Mitsui Banking Corporation on November 1, 2013.

18. Results from a survey of overseas direct investment conducted each year by the Japan Bank for International Cooperation shows that the percentage of respondents voting for South Korea as a promising business location has fallen from 6.1% (11th) in fiscal 2011 to 4.5% (12th) in fiscal 2012 and 5.7% (13th) in fiscal 2013. These results cannot be seen as an indication of increased caution about investment in South Korea, in part because the survey attracts responses from only around 500 companies.

19. Nippon Steel & Sumitomo Metal and Mitsubishi Heavy Industries have both faced lawsuits.

20. This is discussed in Takasaki [1996] and Ota [2003] among others.

21. These funds were used to build facilities for Pohang Steel (now POSCO) and in expressway construction. For details on how the claim money was used in the economic development of South Korea, see Chapters 6 and 7 of Nagano [2008].
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