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# Can Japan and South Korea Build A New Economic Relationship? —Recent Changes in the Global Environment May Help to Repair Relations—

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## Summary

1. In 2015 Japan and South Korea marked the 50th anniversary of the normalization of relations. Although there has recently been progress toward the improvement of the relationship, it has deteriorated to an all-time low in the past few years. While issues relating to historical recognition have played a direct role in the changing relationship, we also need to focus on changes in their environment, including the collapse of the Cold War structure and the rise of China.
2. After the normalization of diplomatic relations, Japan provided economic assistance, and trade began to expand. There was also increased interaction in other areas, such as the establishment of joint venture companies and technical cooperation. A factor that has had a significant impact on the relationship between Japan and South Korea for many years is South Korea's trade deficit with Japan, which has ballooned with the expansion of trade. This trade deficit was one of the factors behind the breakdown of the Japan-South Korea Economic Partnership Agreement (EPA) talks.
3. While the historical recognition issue caused Japan-South Korean relations to sour, it is Japan's declining importance to South Korea that has hindered progress toward the improvement of the relationship. Japan's importance to South Korea first began to wane from a security perspective after the collapse of the Cold War structure, and then from an economic perspective due to the globalization of the South Korean economy. In contrast, China has become increasingly important to South Korea in both security and economic terms.
4. As a result, South Korea has gradually shifted to a foreign policy stance that is weighted more toward China. Evidence that South Korea is also moving closer to China in terms of economic foreign policy includes the fact that it has given higher priority to the establishment of an FTA with China than to the resumption of EPA talks with Japan.
5. However, as a result of this shift toward China, South Korea is not only strongly impacted by economic trends in China, but is also at risk of destabilizing its relationship with the United States. It is possible that Japan-South Korea relations are about to enter a new phase because of the South Korea's need to correct its excessive reliance on China, and also because of moves toward the formation of new economic blocs, such as the TPP.
6. Japan remains an important partner for South Korea. Japanese and South Korean companies are connected by supply chains, and progress toward the economic integration of Japan and South Korea would produce many benefits. The two countries also have common problems, such as demographic aging and falling birthrates, and could learn from each other in terms of both policies and activities. Given these common interests, Japan and South Korea should take advantage of recent environmental changes as an opportunity to develop a more mature relationship.

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President Lee Myung-bak's landing on Takeshima, the island known as Dokdo in South Korea, triggered a worsening of Japan-South Korea relations. Relations were expected to improve after both countries elected new governments, but instead there was a further cooling, as evidenced by the failure of the Japanese and South Korea leaders to hold a summit meeting until recently. The reason for this was President Park Geun-hye's insistence that any improvement of the relationship must begin with a correct recognition of history, and the inability of the two governments to bridge the gulf created by issues relating to the recognition of history, including the "comfort women" controversy and visits to Yasukuni Shrine.

In 2015, Japan and South Korea marked the 50th anniversary of the normalization of diplomatic relations. Normally such an event would have been celebrated by government-hosted events. In fact, commemoration of the anniversary of the signing of the Treaty on Basic Relations (June 22, 1965) was limited to speeches by the Japanese and South Korean leaders at events hosted by each other's embassies. However, the presence of the leaders at these events was seen as a sign of improvement in the relationship, since initially they were not expected to attend. In August Prime Minister Abe indicated his acceptance of the Murayama Statement made by then Prime Tomiichi Murayama on the 70th anniversary of the end of World War II. The South Korean government welcomed this. These events suggested that the conditions needed for a summit meeting were gradually being established, and on November 2, the leaders of Japan and South Korea held the first summit meeting in three-and-a-half years.

There have also been economic repercussions from the worsening of relations between Japan and South Korea. The cooling of the relationship coincided with weakening of the yen and strengthening of the won, and a slowdown in the South Korean economy. The dollar value of trade between the two countries has fallen year on year in three successive years since 2012, and there has also been a decline in the number of Japanese tourists visiting South Korea. Readers will recall that concern about this situation prompted the

Keidanren to issue a statement calling on Japanese and South Korean governments to organize a summit meeting as soon as possible.

While the original cause of the deterioration of relations between Japan and South Korea was the historical recognition problem, Japan's waning importance to South Korea has hindered progress toward the improvement of relations. Japan's importance declined first from a security perspective after the collapse of the Cold War structure, and then from an economic perspective due to the globalization of the South Korean economy. China has meanwhile become more important to South Korea, both economically and from a security viewpoint. This change is reflected in the increased weighting of South Korea's foreign policy toward China. We need to take a calm and logical look at the changes that are occurring in the environment surrounding Japan and South Korea.

In this article, we will trace developments affecting the economic relationship between Japan and South Korea, including the problem of the trade deficit with Japan since the normalization of relations, and the reversal of the relative importance of Japan and China to South Korea since the turn of the century. This will be followed by an analysis of the outlook for Japan-South Korea relations.

## **1. Cooling of Relations between Japan and South Korea in Recent Years**

In Japan the Abe cabinet took office in December 2012, while in South Korea February 2013 saw the inauguration of the Park Geun-hye administration. Despite hopes of an early summit meeting between these new administrations, no such meetings occurred until recently. This was because President Park made a "correct recognition of history" a prerequisite for the improvement of relations, and the two nations were unable to bridge the gap in their perceptions of history.

Deteriorating relations between Japan and

South Korea were paralleled by the proliferation of hate speech, attacking South Korea and Korean people and expressing prejudice. This activity may appear to have emerged overnight, but in fact it is a continuation of the *Kenkanryu* (hate Korea wave) movement that began in the mid-2000s<sup>(1)</sup>. Negative campaigns against South Korea also began to appear in some types of media, including claims, based on distortions of the actual situation, that the South Korean economy was about to sink or collapse.

Significantly, these activities have been reflected in a conspicuous decline in the affinity of Japanese people toward South Korea. In October 2014 the Cabinet Office (Public Relations Office, Minister's Secretariat) conducted an opinion poll on foreign policy (Fig. 1). The percentage of participants indicating that they felt a sense of affinity toward South Korea was 31.5%, a decline of about nine percentage points from the previous year's level, while the percentage who felt no affinity toward South Korea was eight percentage points higher at 66.4%. (Just over 2% gave "don't know" responses.)

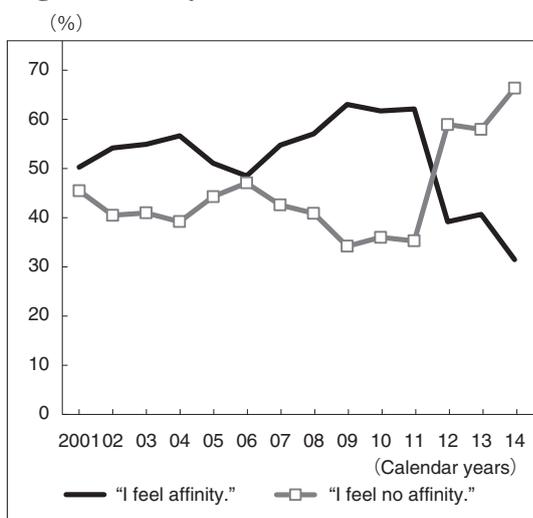
These results may be attributable in part to the influence of negative campaigns in some types of

media. However, we need to look at these results logically.

In dollar terms, trade between Japan and South Korea has shrunk in each of the past three years as a result of the combined effects of the deteriorating relationship and a weak yen/strong won trend (Fig. 2). The decline in South Korea's exports to Japan has been especially conspicuous. In the first nine months of 2015, South Korea exported more to Hong Kong and Vietnam than to Japan<sup>(2)</sup>. Until 2014, Japan was South Korea's third biggest export market after China and the United States, but it has now fallen into fifth place. There has also been a drop in the number of Japanese visiting South Korea, with year on year declines of 21.9% in 2013 and 17.0% in 2014. The first nine months of 2015 saw a 23.4% decline compared with the same period in 2014, although that was due in part to the MERS outbreak. There are no signs of a recovery. Japanese direct investment peaked out in 2012 and has been falling ever since, in part because of the correction of the super-strong yen and worsening business performance in South Korea.

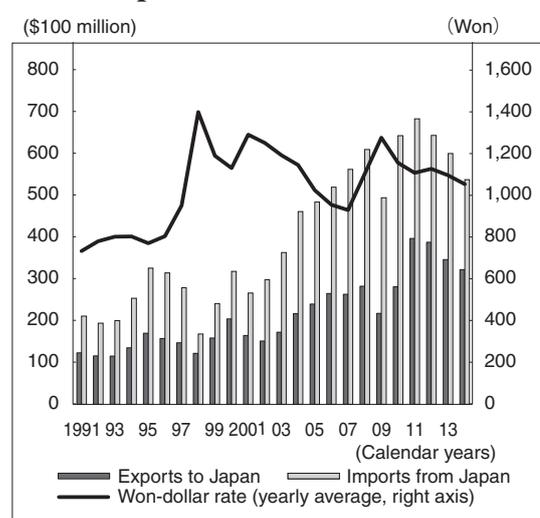
Because this deterioration of relations between Japan and South Korea has started to affect com-

**Fig. 1 Affinity toward South Korea**



Source: Cabinet Office (Public Relations Office, Minister's Secretariat), *Public Opinion Survey on Foreign Policy*

**Fig. 2 South Korea's Trade with Japan**



Source: Korean International Trade Association data base

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panies that do business between the two countries, there have been calls from the business sector for efforts to improve the relationship. The level of alarm in the business community about the current state of Japan-South Korea relations is apparent from the fact that Keidanren Chairman Sadayuki Sakakibara visited South Korea in December 2014 and again half-a-year later in May 2015 to lobby for a summit conference between the two countries.

While the deterioration of the relationship is the direct result of the controversy over perceptions of history, Japan's declining importance to South Korea has also played a role. Japan's importance waned first from a security perspective after the collapse of the Cold War structure, and then from an economic perspective with the globalization of the South Korean economy. With Japan's importance waning, there is less motivation for efforts to repair the relationship. In contrast with Japan, China has become more important to South Korea from both security and economic perspectives.

We will begin by tracing the history of the economic relationship between Japan and South Korea from the normalization of diplomatic relations down to the present day. As part of that analysis, we will examine how the relationship has been significantly impacted by South Korea's trade deficit with Japan, which became an issue after the normalization of diplomatic ties, and the globalization of the South Korean economy since the turn of the century.

## **2. Normalization of Diplomatic Relations and Emergence of Trade Deficit with Japan**

### **(1) 1965 — Normalization of Diplomatic Relations**

Japan and South Korea normalized diplomatic relations in 1965. On June 22, the two countries signed the Treaty on Basic Relations between Ja-

pan and the Republic of Korea, as well as agreements concerning the settlement of claims, economic cooperation, fisheries and the legal status and treatment of South Korean residents in Japan. These documents formed a basic framework for the subsequent development of the relationship between Japan and South Korea.

There are three aspects to the economic relationship that has evolved between Japan and South Korea since normalization: ① Japanese economic assistance to South Korea, ② business activities by private companies, and ③ policy responses to the trade deficit. All of these aspects have changed over time. For a considerable period after normalization, the main emphasis was on the first. That was because Japan provided economic cooperation under the agreement concerning the settlement of claims and economic cooperation. The first article of the agreement contained the following provisions.

- ① Japan shall provide the Republic of Korea, free of charge, with products of Japan and services of Japanese people with a current yen value equivalent to \$300 million over a period of 10 years from the date on which the agreement enters into force.
- ② Japan shall provide the Republic of Korea with long-term low-interest loans amounting to the current yen value equivalent of \$200 million over a period of 10 years. (These funds shall be provided at the request of the government of the Republic Korea for use in the procurement of products of Japan and services of Japanese people as required for the implementation of projects selected in accordance with the agreement.)
- ③ The aforementioned grants and loans must be used for the economic advancement of the Republic of Korea.

Japan also provided commercial loans with a value equivalent to \$300 million, although these were not based on the agreement. At this time, the focus of South Korea's industrialization policy was shifting from import replacement to export-oriented industrialization, and preparations for the development of heavy industries were also under way. The bottlenecks for industrialization

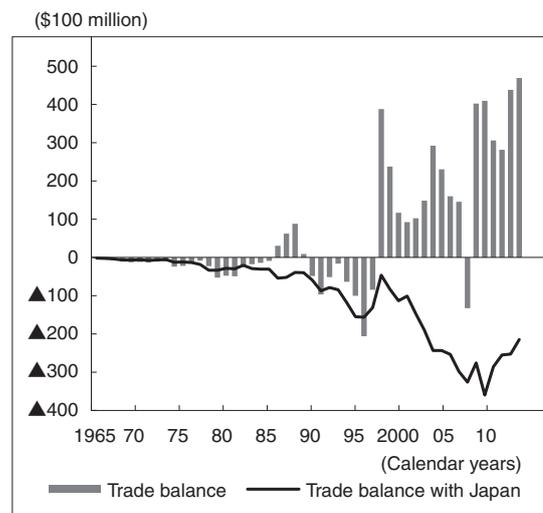
were technology and capital. Unlike his predecessor, Syngman Rhee, who had maintained a hard-line stance toward Japan, President Park Chung-hee opted for the normalization of relations. One reason for that was his recognition that Japanese economic cooperation was essential to the development of a self-sufficient South Korean economy. Much of the money obtained through the settlement of South Korean claims against Japan was used to build infrastructure, including dams and expressways, and to pay for the construction of core industrial facilities, including an integrated steelworks<sup>(3)</sup>. In addition, Japanese companies provided technical guidance in many areas.

What should not be forgotten is the extensive investment and assistance, including school construction and the provision of scholarships, provided by South Korean entrepreneurs based in Japan, including Su Kap-ho of Sakamoto Textiles and Takeo Shigemitsu (also known as Shin Kyuk-ho) of Lotte<sup>(4)</sup>. Lotte's contribution was especially significant. After the establishment of Lotte Confectionary in 1967, the group expanded into other areas, including hotels and department stores. Today it is the fifth biggest conglomerate in South Korea in terms of total assets<sup>(5)</sup>. After South Korea moved toward deregulation in the 1980s, entrepreneurs based in Japan founded the Shinhan Bank, which is now the hub of one of South Korea's big four financial groups.

Trade and investment by Japanese companies accelerated following the normalization of relations and the start of economic cooperation. A growing number of Japanese and South Korean companies began to form partnerships, including the establishment of joint ventures and technical cooperation. Toyota Motor formed a partnership with Shinjin Motors. Samsung established several joint ventures to manufacture white goods and consumer electronics, including Samsung-Sanyo Electric in December 1969, Samsung NEC in January 1970.

As trade expanded, South Korea's trade deficit with Japan also began to swell. In the early 1970s the trade deficit with Japan was equivalent to about one-half of the total deficit. Between 1976 and 1978 it exceeded the total deficit (Fig. 3).

**Fig. 3 South Korea's Trade Balance**



Source: Korea International Trade Association data base

This was because most of the goods needed for production (especially export production), such as key parts, high-quality materials and manufacturing equipment, were imported from Japan. With the world still locked into the Cold War structure, South Korea was forced to rely on the United States for security and as an economic partner (market), and on Japan for most of its production goods and capital goods.

While the trade deficit with Japan was the result of business activities based on economic logic<sup>(6)</sup>, the sheer size of the deficit led the South Korean government to view it as a problem.

## (2) The Trade Deficit as a Political Issue

The South Korean government attributed the trade deficit to market barriers in Japan and called on Japan to reduce tariffs and eliminate non-tariff barriers. This argument was similar to the position taken by the United States over trade friction with Japan. Japanese and South Korean perceptions of the trade deficit were radically different, and this gap could not be bridged easily. South Korea tried to reduce the deficit by restricting Japanese imports, and in 1978 it introduced the import diver-

sification system.

This system restricted imports of designated items from the countries with which South Korea had the biggest trade deficits, but in reality it was designed to limit imports from Japan. Imports were classified into free imports, restricted imports and diversified imports. Essentially it became impossible to import any product classified as a diversified import item. Among the Japanese items to be given this designation were cars, color televisions, home video cameras and machine tools (machining centers, NC lathes).

While this de facto restriction of imports from Japan helped to drive a shift to domestic production, it had a limited effect in terms of deficit reduction. The trade deficit with Japan shrank when exports slowed due to the second oil crisis in the early 1980s, but it began to expand again in the second half of that decade, and by 1991 it had reached a record high (Fig. 3).

South Korea's trade deficit became a problem for bilateral relations. At a press conference in January 1992, President Roh Tae-woo stressed that there could be no improvement in relations between Japan and South Korea without a solution to the trade deficit problem<sup>(7)</sup>.

At a Japan-South Korea summit meeting in June 1992, agreement was reached on an action plan to correct the trade imbalance between the two countries. As part of that plan, Industrial Technology Co-Operation Foundations were established in both countries (Table 1). The mission of these organizations included the improvement of the technological capabilities of medium-sized companies and SMEs. Their main activities are ① support and cooperation for human resource development in fields relating to industrial technology, ② support and cooperation for the improvement of productivity and quality, ③ the promotion of exchanges of industrial technology and person-

**Table 1 Eras in Japan-South Korea Relations**

Era	Japan-South Korea relations	South Korean economy	Society, etc.
—1960s— Export industrialization	June 1965: Normalization of relations Treaty on Basic Relations Agreement concerning the settlement of claims and economic cooperation, etc.	1967: Establishment of Hyundai Motor 1968: Establishment of Pohang Iron and Steel Company (POSCO) 1969: Establishment of Samsung Electronics	Miracle on the Han River
—1970s— Heavy industrialization	Emergence of trade imbalance with Japan 1978: <u>Import diversification system</u> (de facto restriction of Japanese imports)	1973: Heavy and Chemical Industrialization Declaration 1977: Samsung Electronics expands into semiconductor business	Saemaul (New Community) Movement 1972: Yushin (Restoration) System October 1979: Assassination of President Park Chung Hee
—1980s— Deregulation	Foreign policy toward Japan under post-Park administrations Emergence of history textbook controversy, rapid rise in investment from Japan after the Plaza Accord	Low growth and foreign debt problems after the Oil Crisis 1986-88: High growth resulting from “three lows” (low oil price, low interest, low won) 1988: Establishment of national pension scheme	1987: Democratization declaration, upsurge of activity by the labor movement 1988: Seoul Olympics 1989: Berlin Wall demolition
—1990s— Bloating of conglomerates Structural reforms	1992: Japan-Korea Industrial Technology Co-Operation Foundation established (to correct trade imbalances) 1997: Japanese support during currency crisis 1998: Japan-Korea Partnership declaration (future-oriented) June 1999: <u>abolition of import diversification system</u>	Implementation of real name system for financial transactions 1996: OECD membership Post-currency crisis structural reforms Kia absorbed by Hyundai Motor 1999: Daewoo conglomerate broken up	Adoption of <i>Nordpolitik</i> by President Roh Tae-woo 1992: Normalization of relations with China Ban on Japanese culture in South Korea lifted
—2000s— Globalization	2002: Co-hosting of Soccer World Cup December 2003: Start of Japan-South Korea EPA negotiations November 2004: Suspension of EPA negotiations 2012: President Lee Myung-bak lands on Takeshima (Dokdo) Island Deterioration of Japan-South Korea relations June 2015: 50th anniversary of normalization November: First Japan-South Korea summit in over three years	2000-02: Splitting of Hyundai Group 2001: Act on Special Measures for the Promotion of Specialized Enterprises, etc. for Component and Material Global expansion of Samsung and Hyundai Motor July 2012: FTA with EU provisionally in force March 2013: FTA with the U.S. in force June 2014: Formal signing of FTA with China	Korean boom in Japan Start of Japan-Korea cultural festivals Emergence of hate speech, <i>Kenkanryu</i> in Japan Growing anti-hate trend

Source: Compiled by JRI from various sources

nel, and ④ the organization of seminars and the promotion of research and publication. Human resource development activities in the area of industrial technology are provided under contract by companies and national research institutes in Japan. Technical personnel from middle-ranked companies and SMEs in South Korea and post-graduate students are invited to take part in training and research on special themes provided by these organizations. Knowledge about productivity improvements has been disseminated in South Korea by experts sent from Japan.

As cooperation between Japan and South Korea progressed in the 1990s, it became necessary to modify the import diversification system. This was because the easing of restrictions was a requirement for membership of the OECD (achieved in 1996), which was South Korea's next national goal after hosting the Olympics in 1988. The number of designated items was progressively reduced, and the system was completely abolished at the end of June 1999. This was followed by an increase in imports of various products from Japan, including video cameras with LCD monitors, widescreen LCD TVs, motor vehicles and machine tools. Sales of Japanese motor vehicles in South Korea resulted in the 2000s.

It is important to be aware of the conspicuous changes that occurred in the South Korean economy after the 1997 currency crisis, including domestic structural reforms<sup>(8)</sup>, accelerated globalization, and a shift to a positive trade balance as the investment rate fell below the savings rate.

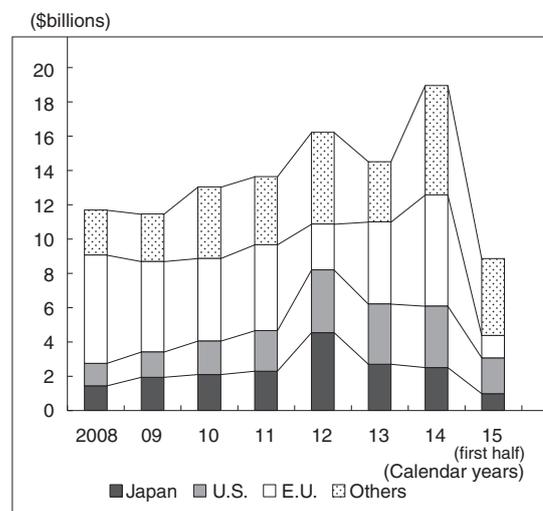
On the foreign policy front, Japan and South Korea issued a Joint Declaration on a New ROK-Japan Partnership for the 21st Century during a visit to Japan by President Kim Dae-jung in October 1998. Changes in the economic environment were reflected in a shift in the direction of efforts to correct South Korea's trade deficit with Japan toward strategies designed to achieve of an expanding balance, including ① support for technology development in South Korean parts and materials industries, ② the facilitation of exporting to Japan by South Korea companies, and ③ the attraction of Japanese companies to South Korea and the promotion of partnering between Japanese

and South Korean companies.

In 2001, the South Korean government passed the Act on Special Measures for the Promotion of Specialized Enterprises, etc. for Component and Material, the aim of which was to foster domestic production of parts and industrial materials for which South Korea was heavily reliant on imports from Japan. In 2005, 10 items, including liquid crystal displays (LCDs) and organic EL devices, were designated as "10 key strategic parts." In addition, the Lee Myung-bak administration established industrial parks specializing in parts and materials at locations that include Gumi and Pohang in Gyeongsangbuk-do, Iksan in Jeollabuk-do, and the Busan-Jinhae Free Economic Zone. The purpose of these industrial parks, which have become clusters of factories owned by major corporations, was to stimulate local production of parts and materials by attracting related companies from Japan.

In addition to South Korea's determined efforts to attract investment, the super-strong yen also provided impetus for the shift from imports to local production. Japanese investment in South Korea surged in 2012 (Fig. 4)<sup>(9)</sup>. Global expansion led to increased production by South Korean companies, which were able to achieve profit-

**Fig. 4 Foreign Direct Investment in South Korea (Declaration Basis)**



Source: Ministry of Trade, Industry and Energy

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ability even with local production. Other potential benefits included ① reduced production costs and shorter delivery times, ② the avoidance of cost increases caused by a stronger yen, ③ easier access to information from customers, and ④ the facilitation of joint development. Another positive factor was a trend toward sourcing from South Korea or the establishment of production sites in South Korea because of the need to spread risk after the Great East Japan Earthquake.

As these developments show, economic Relations between Japan and South Korea have thus been generally good since the turn of the century. However, this does not mean that the trade deficit problem has been resolved. The most obvious evidence of this is the fact that negotiations over an economic partnership agreement (EPA) remain stalled. Government-level negotiations started in December 2003 but were suspended after November 2004. An official visit to Yasukuni Shrine by then Prime Minister Koizumi played a role in this decision, but there was another reason.

South Korea has a higher average tariff rate than Japan. If it were to lower its tariffs, increased imports of Japanese manufactured goods would quickly cause the trade gap to expand. Estimates showed that South Korea would enjoy significant benefits in the long-term perspective<sup>(10)</sup>, but South Korea wanted to achieve short-term benefits as well and demanded access to Japan's market for agricultural and fisheries products. Since then there have been working-level talks aimed at restarting the negotiations, but so far this has not happened. Instead of focusing on the resumption of FTA negotiations with Japan, South Korea gave priority to the establishment of an FTA with China.

The trade deficit problem has influenced the Japanese and South Korean economies in various ways since the normalization of relations. The most important factor to take into account when analyzing the current state of the economic relationship between Japan and South Korea is the reversal of the relative importance placed on Japan and China by South Korea.

### **3. The 2000s — Changes Triggered by Globalization and the Emergence of China**

The historical acknowledgment question has had a direct impact on the cooling of Japan-South Korea relations in recent years. Another factor has been Japan's declining importance to South Korea because of the collapse of the Cold War structure and economic globalization.

#### **(1) The Collapse of the Cold War Structure**

Relations between South Korea and China have grown closer in recent years, but the formation of a friendly relationship is a recent development. Until the end of the 1980s, the two countries viewed each other with hostility under the Cold War structure. That relationship was shaped in particular by the Korean War, which erupted when the People's Democratic Republic of Korea (North Korea) attempted to invade the South. The People's Army of China intervened on the North Korean side, while United Nations forces led by the United States stood alongside South Korea.

After the ceasefire, the United States and South Korea signed a mutual defense treaty, which took effect in November 1953. South Korea was positioned as a "front-line base" for the forces of freedom, and U.S. forces stationed in South Korea began to play a pivotal role in the South Korean security. In addition to this security role, the United States also supported economic reconstruction by providing massive amounts of aid.

During the 1950s, South Korea used aid goods to develop import replacement industries, focusing in particular on what were then known as the "three white industries" (sugar refining, flour milling and yarn spinning). During this period, the Samsung Group founded by Lee Byung-chul laid the foundations for its future as a conglomerate by establishing the Cheil Jedang sugar refinery and the Cheil Mojik woolen mill.

The Hyundai Group, which was founded by Chung Ju-yung, achieved growth in this period by capturing demand for reconstruction projects and construction work relating to U.S. military bases. After the currency crisis it was split into several smaller groups, including the Hyundai Motor Group, the Hyundai Heavy Industries Group and the Hyundai Department Store Group.

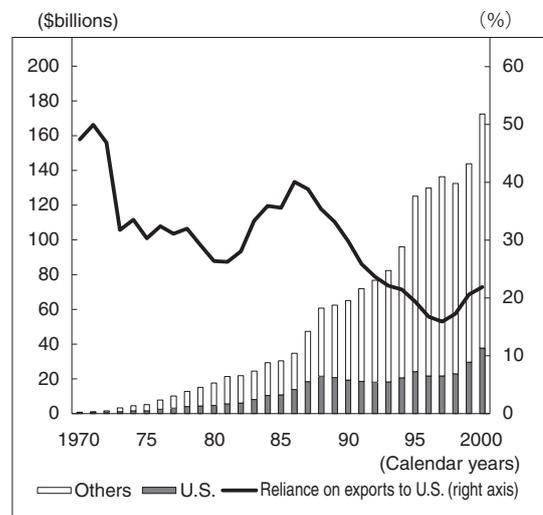
South Korea remained dependent on the United States after this period. However, during the Park Chung-hee administration (1963-79), the amount of aid received from the United States shrank as economic development started to move forward in earnest. The type of aid also changed from grants to loans, and from government loans to private sector loans. The former West Germany and Japan (after the normalization of relations in 1965) which were both achieving rapid growth, emerged as major providers of these private sector loans.

Faced with a massive fiscal burden as a result of its involvement in the Vietnam War, the United States announced the Nixon Doctrine in February 1970. This doctrine, which stated that countries were primarily responsible for their own defense, signaled the reduction of U.S. forces stationed in South Korea. The development of strong self-defense capabilities became a priority for South Korea as a result of this change. This was the primary reason for efforts to accelerate heavy industrial development in the 1970s. (Economically, heavy industries developed through the growth of export industries in the 1960s.)

The importance of the United States to the South Korean economy is apparent from the fact that South Korea's reliance on exports to the United States (exports to the United States/total exports) reached almost 50% in the early 1970s (Fig. 5). Reliance on exports to the United States subsequently fell below 30% but had climbed back to 40.0% by 1986 due to increased exports of South Korea Korean goods to the United States as a result of accelerating economic growth in the United States during the first half of the 1980s, as well as the rapid strengthening of the yen after the Plaza accord. This situation would eventually result in pressure to revalue the won.

Within South Korea, movements calling for

**Fig. 5 South Korea's Exports to the United States and Reliance on Exports to the U.S.)**



Source: Korea International Trade Association data base

democratization were suppressed under the authoritarian regimes of Park Chung-hee and Chun Doo-hwan. Because these authoritarian regimes were backed by South Korea's security-centered alliance with the United States, popular anti-U.S. sentiment grew every time the democratization movement was suppressed.

At the same time, hostility toward China continued under the Cold War structure. However, the situation began to change gradually after China switched to a reform and open-door policy in 1979. In the second half of the 1980s, South Korea began to trade with China indirectly through Japan and Hong Kong, even though it still had no diplomatic relations with China. In 1991, China and South Korea opened private sector trade representative offices with consular functions in Beijing and Seoul respectively.

South Korea's relationships with the United States and China changed significantly under the Roh Tae-woo administration (1988-93), which took office after the Democratization Declaration<sup>(11)</sup>. As if anticipating the collapse of the Cold War structure, President Roh Tae-woo worked to improve relations with former communist bloc countries under his *Nordpolitik*

program<sup>(12)</sup>. He first established better relations with Hungary and then with other Eastern European countries, including Poland, Yugoslavia, Czechoslovakia, followed by the former Soviet Union in September 1990. The aims of *Nordpolitik* were to improve South Korea's international position by building better relationships with China and the Soviet Union, and to negotiate reunification under South Korean leadership while gaining an advantage over North Korea. Another goal was to expand economic relationships with these countries. In fact, there was an increase in exports to Eastern European countries, especially in the areas of electronic products, motor vehicles and machinery. The conglomerates actively expanded their business operations. Daewoo, for example, established a motor vehicle factory in Poland and a parts factory in Hungary (although overly ambitious business expansion would eventually lead to financial problems for the Daewoo Group, which was broken up after the currency crisis).

The culmination of the *Nordpolitik* program was the normalization of relations with China in August 1992. Stability in East Asia was a vital priority for China, which had started to speed up its reform and open-door policy. It also hoped that investment from South Korea would help to drive industrialization. South Korea hoped that an improved relationship with China, which also meant the severing of ties with Taiwan, would not only lead to the end of the Cold War structure, but would also bring economic benefits, including trade expansion and access to labor resources. In fact, these expectations were borne out by subsequent developments. We will look next at these changes.

## (2) Globalization and Growing Reliance on China

Since the turn of the century, major South Korean companies, especially the conglomerates, have accelerated their global expansion through exporting and overseas production. The rapid pace of globalization since the start of the 21st century

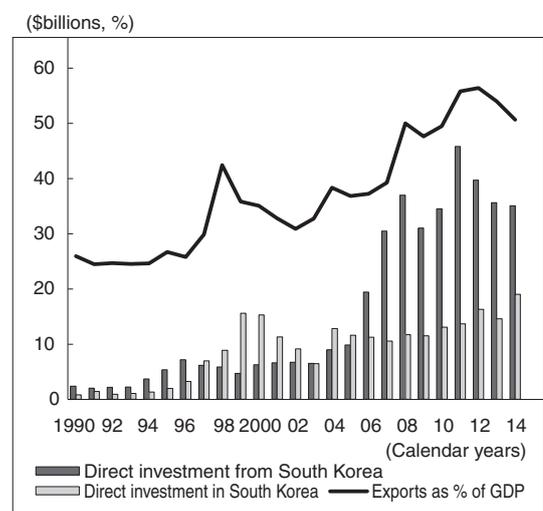
is apparent from trends in exports and direct overseas investment (Fig. 6).

Reasons for this pattern include the contraction of domestic markets after the currency crisis, predictions that domestic markets would dwindle in the future because of a rapid trend toward demographic aging and a falling birthrate, and the appearance of business opportunities created by continuing growth in emerging countries. In addition to the weakness of the won, the gains made by South Korean companies were also aided by improvements in quality and designs, and the development of products to meet local needs, allowing them to raise their presence in world markets. For example, Samsung Electronics and LG Electronics were ranked first and second in terms of their shares of the market for flat-screen televisions, while the Hyundai Group rose to fifth place in the motor vehicle market.

Now reliant on global expansion by major companies, the South Korean economy continued to achieve export-led growth in the 2000s. In 2010, there was an increase in positive views of the South Korean economy in the Japanese media<sup>(13)</sup>.

The strengthening of economic relations with China was occurring during this process of globalization. In particular, China's achievement of

**Fig. 6 Exports and Direct Investment**



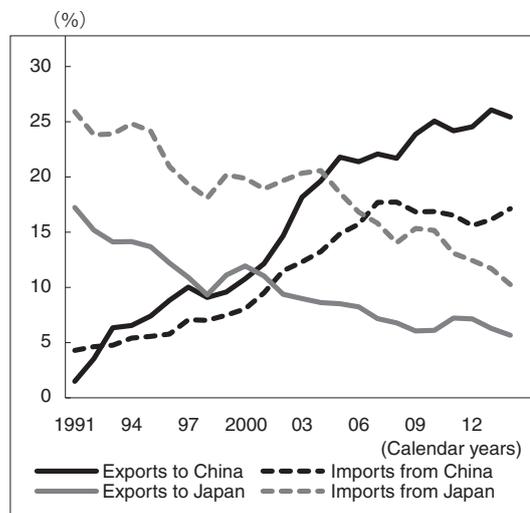
Source: Bank of Korea, Economic Statistics System

**Table 2 Key Countries' Shares of South Korea's Exports and Imports**

	Exports			Imports		
	U.S.	Japan	China	U.S.	Japan	China
1991	25.8	17.2	1.4	23.2	25.9	4.2
96	16.7	12.2	8.8	22.2	20.9	5.7
2000	21.8	11.9	10.7	18.2	19.8	8.0
01	20.7	11.0	12.1	15.9	18.9	9.4
02	20.2	9.3	14.6	15.1	19.6	11.4
03	17.7	8.9	18.1	13.9	20.3	12.3
04	16.9	8.5	19.6	12.8	20.6	13.2
05	14.5	8.4	21.8	11.7	18.5	14.8
06	13.3	8.2	21.3	10.9	16.8	15.7
07	12.3	7.1	22.1	10.4	15.8	17.7
08	11.0	6.7	21.7	8.8	14.0	17.7
09	10.4	6.0	23.9	9.0	15.3	16.8
10	10.1	6.0	25.1	9.5	15.1	16.8
11	10.1	7.1	24.2	8.5	13.0	16.5
12	10.7	7.1	24.5	8.3	12.4	15.5
13	11.1	6.2	26.1	8.1	11.6	16.1
14	12.3	5.6	25.4	8.6	10.2	17.1

Source: Bank of Korea, Economic Statistics System

**Fig. 7 South Korea's Export and Import Reliance on China and Japan**



Source: Bank of Korea, Economic Statistics System

World Trade Organization (WTO) membership in 2001 was followed by a rapid increase in investment in China. The shift to production in China was accompanied by induced exports of production goods, including raw materials and parts, and capital goods from South Korea, while expanding demand in China was reflected in increased exports of consumer goods. Between 2002 and 2004, exports to China increased by over 30% annually, with the result that in 2003 China overtook the United States to become South Korea's biggest export market. South Korea's reliance on exports to China (exports to China/total exports) rose from 12.1% in 2001 to an all-time high of 26.1% in 2013 (Table 2).

Imports from China have also expanded. In 2007, China overtook Japan to become South Korea's biggest source of imports. Today China is South Korea's biggest trading partner and the country with which South Korea has the biggest trade surplus. This reversal of the relative importance of Japan and China in the area of trade occurred during the 2000s (Fig. 7).

### (3) China's Growing Importance

In recent years, South Korea has weighted its foreign policy toward China. This reflects China's increasing importance, not only economically, but also from a security perspective (especially in the relation to the stabilization of Korean Peninsula).

This emphasis on China is apparent from fact that China was the second country, after the United States, that President Park Geun-hye visited after taking office on February 25, 2013. In a joint statement released in June of that year, China and South Korea pledged to improve their strategic cooperation partnership by ① strengthening strategic communication in the areas of politics and security, ② further expanding economic and social cooperation, and ③ fostering various forms of private sector exchange through active measures to strengthen human and cultural ties.

In addition to the joint statement, China and South Korea also announced a "Strategic Cooperation Partnership Improvement Plan." In relation to expansion of economic and trade cooperation, this plan called for the achievement of total trade of \$300 billion by 2015, the signing of a compre-

hensive high-level free trade agreement and the expansion of two-way investment, and future-oriented cooperation in such areas as technology development, energy conservation, monetary policy, and measures relating to the environment and aging.

In July 2014, Chinese President Xi Jinping visited South Korea and held a summit meeting with President Park. At that meeting President Xi proposed ① the expansion of political and security cooperation, ② the expansion of mutually beneficial cooperation on economic and trade matters, ③ the acceleration of cultural and people-to-people exchanges, and ④ closer cooperation on regional and international issues. Both leaders said that in order to achieve the goal of increasing bilateral trade to \$300 billion by 2015, China and South Korea would cooperate in strategic emerging industrial sectors, such as new energy, data communications, intelligent manufacturing, the environment, high-tech, and green low-carbon industries, and that they would welcome increased investment in central and western China by South Korean companies. In the joint statement issued on the day of the meeting, the two leaders agreed to build a stronger relationship based on cooperation and mutual benefit.

In November 2014, FTA negotiations between South Korea and China resulted in a substantive agreement, and the South Korean and Chinese governments formally signed the FTA on June 1, 2015.

However, the level of freedom in this agreement is generally low compared with FTAs signed previously by South Korea. The normal track, which calls for the elimination of tariffs within 10 years, will cover 79.2% of items and 77.1% of import value on the South Korean side, and 71.3% of items and 66.2% of import value on the Chinese side. Tariffs will be removed immediately on 49.9% of items and 51.8% of import value on the South Korean side, and 20.1% of items and 44.0% of import value on the Chinese side. Because of these low liberalization ratios, an estimate by the Korea Institute for International Economic Policy indicates that the increase in real GDP over the 10-year period will be only 0.96%, which is sub-

stantially lower than the 2.3-3.0% figure predicted when the negotiations began in 2012.

The national interests of China and South Korea are reflected in the somewhat ambiguous content of the agreement. South Korea succeeded in excluding most of its key agricultural products from the scope of concessions, while China set a 10-year deadline for removing tariffs on ethylene, LCD panels and some types of cold-rolled steel sheets, for which it aims to establish domestic production, while excluding other items, such as some types of petrochemicals, motor vehicles and hot-dip galvanized steel sheets (Table 3).

This contrasts with South Korea's FTA negotiations with the EU and the United States. In those cases, South Korea compromised on agricultural products in exchange for the reduction of tariffs on motor vehicles (and the immediate elimination of tariffs on automotive parts). South Korea agreed to exclude motor vehicles from its FTA with China for two reasons. First, a high percentage of South Korean vehicles are produced locally in China. Second, South Korea was worried that foreign manufacturers would export vehicles pro-

**Table 3 Main Provisions of the South Korea-China FTA**

	Concessions by South Korea	Concessions by China
Removal of tariffs within 10 years (normal track)	<ul style="list-style-type: none"> <li>• 79% of items</li> <li>• 77% of import value</li> </ul>	<ul style="list-style-type: none"> <li>• 71% of items</li> <li>• 66% of import value</li> </ul>
Removal of tariffs within 20 years (sensitive track)	<ul style="list-style-type: none"> <li>• 92% of items</li> <li>• 91% of import value</li> </ul>	<ul style="list-style-type: none"> <li>• 91% of items</li> <li>• 85% of import value</li> </ul>
Exclusion (highly sensitive items)	<ul style="list-style-type: none"> <li>• 614 agricultural items (including rice, garlic, onions, beef, pork, apples, pears)</li> <li>• Motor vehicles</li> </ul>	<ul style="list-style-type: none"> <li>• Paraxylene, terephthalate, ethylene glycol</li> <li>• Some of types of hot-dipped galvanized steel sheets, organic EL products, etc.</li> <li>• Motor vehicles</li> </ul>
Others	<ul style="list-style-type: none"> <li>• Certification of products from an industrial park in North Korea's open zone (North-South joint project) as South Korean products</li> </ul>	

Notes: Items and import values based on 2012 data.  
Source: Ministry of Trade, Industry and Energy, Republic of Korea, and other sources

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duced in China to South Korea.

Supplementary negotiations about the trade in services will commence within two years of the date on which FTA came into force and are expected to conclude within two years after that. These negotiations are expected to result in expansion (investment) from both sides in such areas as entertainment, construction, Internet commerce, travel and finance.

#### **(4) The Significance of Japan's Declining Importance to South Korea**

China's growing importance to South Korea has resulted in a relative decline in Japan's importance. The fall in South Korea's reliance on trade with Japan has been especially conspicuous (Fig. 7 above). Japan had long been South Korea's biggest source of imports, but in 2007 it lost that position to China. In 2012, China also overtook Japan to become South Korea's biggest source of automotive parts.

However, it would be somewhat misleading to link this fall in reliance on trade with Japan to a decline in Japan's importance. Japan's share of trade will naturally shrink in step with the rapid expansion of trade with China, but we also need to be aware of the following three factors.

First, the globalization of business activities is eroding the significance of analyses based on bilateral trade. The motor vehicle industry is an obvious example. With the growth of local production, exports are now playing a secondary role. In fact the majority of vehicles sold in China are now manufactured in China.

As noted earlier, the value of South Korea's exports to Vietnam has exceeded the value of its exports to Japan since the start of 2015. This is because the expansion of local production in Vietnam by Samsung Electronics and other South Korean Companies has induced increased exports of production goods and capital goods from South Korea. This shows that changes in business supply chains can change trading relationships between countries.

In this sense, we need to look at bilateral trade between Japan and South Korea from a global perspective. Because of rising costs, labor shortages and other problems affecting production in Japan, most Japanese parts manufacturers produce parts in China or ASEAN countries once the mass-production stage is reached. Products imported by South Korea from third countries may include products sourced from these Japanese manufacturers.

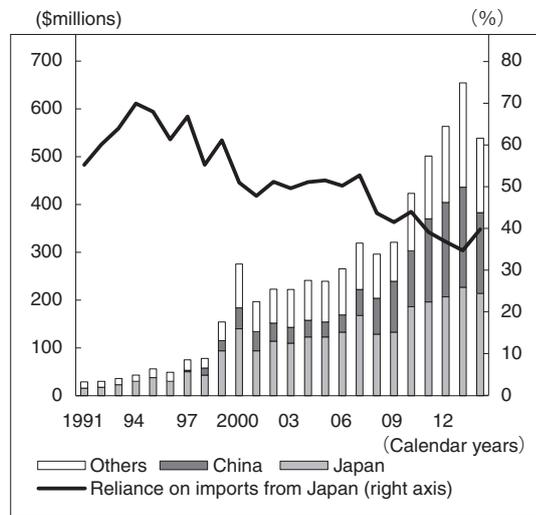
This situation is illustrated by the trade in laminated ceramic chip capacitors, which consist of ceramic dielectric substances and metallic electrodes combined together in layers to provide large capacity in a compact form. They are widely used in electronic equipment, especially smartphones. Until a few years ago, the main producers of laminated ceramic capacitors were Japanese firms, such as Murata Manufacturing and Taiyo Yuden. South Korean and Chinese companies then began to produce these devices, while some Japanese companies started to produce them locally in South Korea. These shifts naturally caused changes in trading relationships.

Until the second half of the 2000s, imports from Japan accounted for around one-half of total imports in value terms. However, South Korea's reliance on Japan has since fallen, despite a growth trend in the value of imports from Japan. The reason for this is an increase in the value of imports from China (Fig. 8).

There is no detailed information about the sources of imports from China. However, the Samsung Group is producing them in China, and Murata Manufacturing also has a production site in China, so it is likely that substantial quantities are being procured from companies such as these. The fact that the overall value of imports from Japan has also risen (except in 2014) suggests that users are importing higher-quality products (more compact, higher capacities) from Japan.

Second, as noted above, Japanese companies have increasingly switched to local production in South Korea over the past few years, with the result that imports from Japan are being replaced with products sourced within South Korea. South Korea used to import LCDs for use in flat-screen

**Fig. 8 South Korea's Imports of Laminated Ceramic Capacitors**



Notes: HS Code: 853224  
Source: Korea International Trade Association data base

televisions and computer displays from Japan. However, imports have been replaced with local production in step with expansion of LCD television production in South Korea. Rising demand has also driven a gradual shift to domestic production of other parts, such as color filters, glass substrates, polarization plates and film (thin-film materials manufactured from synthetic resins and other materials). This change has resulted from production by companies in the Samsung and LG Groups, as well as local production by foreign-owned companies. Japanese companies producing glass substrates in South Korea include Asahi Glass and Nippon Electric Glass. (One reason for the growth of local production is rising transportation costs due to the increasing size of substrates.) South Korea was almost entirely reliant on film imported from Japan, but imports from Japan have now started to shrink due to the start of local production.

The division of labor among Japan, South Korea and China has continued to change dynamically. For example, with the shift of flat-screen television production to China, LCD panel production facilities have also been relocated there, while production in South Korea now centers on organic

**Table 4 South Korea's Top Import Items from Japan in 2014 (Based on 6-Digit HS Codes)**

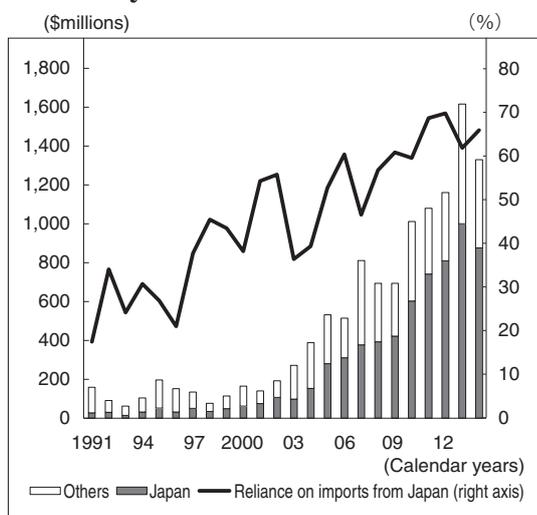
	HS Code	Item	Category
1	854231	Processors and controllers, whether or not combined with memories, converters, logic circuits, amplifiers, clock and timing circuits, or other circuits	ICs
2	720449	Other ferrous waste and scrap	Iron and steel
3	900120	sheets and plates of polarising material	Precision equipment
4	848630	Machines and apparatus for the manufacture of flat panel displays	Panel manufacturing equipment
5	270730	Xylole	Chemicals
6	392073	Other plates, sheets, film, foil, strips of cellulose acetate (non-cellular)	Crude chemicals
7	854232	Memories	Semiconductor fabrication equipment
8	290250	Styrene	Chemicals
9	720851	Flat-rolled products of iron or non-alloy steel of a thickness exceeding 10mm	Iron and steel sheets
10	870323	Motor cars and other motor vehicles with a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc	Iron and steel sheets
11	854140	Photosensitive semiconductor devices, including photovoltaic cells whether or not assembled in modules or made up into panels light emitting diodes	Semiconductor fabrication equipment
12	720839	Flat-rolled products of iron or non-alloy steel, of a thickness of less than 3mm	Iron and steel sheets
13	720712	Semi-finished products of iron or non-alloy steel of square not rectangular cross-section	Iron and steel
14	290122	Propene (propylene)	Chemicals
15	700490	Other glass	Glass

Notes: Items labeled as "other" have been excluded.  
Source: Korea International Trade Association data base

EL devices for smartphones.

Third, although overall reliance on imports from Japan has fallen, South Korea still imports high-grade materials, key parts and manufacturing equipment from Japan. The top 15 items imported from Japan to South Korea in 2014 (based on 6-digit HS codes) include iron and steel, semiconductor, precision equipment, manufacturing equipment and chemicals (Table 4). As we have already seen, South Korea is working toward domestic production of parts and materials. However, the data show that it still imports many items

**Fig. 9 South Korea's Imports of Styrene**



Notes: HS code: 290250  
Source: Korea International Trade Association data base

from Japan, indicating that Japan has a comparative advantage in these areas. In 2014, South Korea was the biggest importer of Japanese iron and steel products, followed by China and Thailand. The main export markets for semiconductor fabrication equipment are Taiwan, the United States and South Korea.

One of South Korea's top imports from Japan is styrene, which is used exclusively as polymerization monomer, and especially as a synthetic resin raw material. The value of imports from Japan is increasing overall, and reliance on imports from Japan is also rising (Fig. 9). Reliance on Japan for numerically controlled lathes is also extremely high. Local production of these items would be difficult, since they are manufactured in small quantities and require advanced technology, and because most are manufactured by small and medium-sized companies.

Although South Korea's reliance on trade with Japan has fallen overall, Japanese companies are still important to South Korea as suppliers of core production goods and capital goods.

## 4. Toward a New Relationship between Japan and South Korea

As is clear from the preceding discussion, changes in the international environment are having a major impact on relations between Japan and South Korea. These changes, which include the China Shock resulting from China's transition to its "new normal", as well as the Trans-Pacific Partnership Agreement (TPP), have created the potential for a new phase in the relationship between Japan and South Korea.

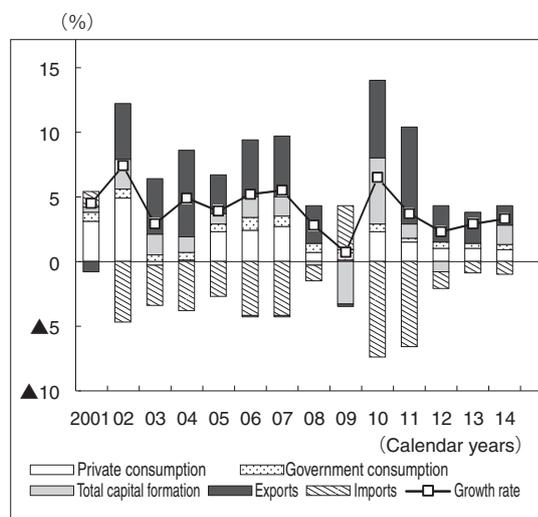
### (1) Increased Reliance on China, the China Shock

This strengthening of South Korea's relationship with China has made the South Korean economy more vulnerable to trends in the Chinese economy. It has also left South Korea with the difficult task of balancing its relationships with the United States and China from a foreign policy perspective. As we have already seen, South Korea's economic reliance on China grew as a result of a continuing trend toward economic globalization during the 2000s. The growth model formed during this period was characterized by ① global expansion by major corporations, especially the conglomerates, ② proactive government support for major corporations, including corporate tax rate cuts, cheaper electricity charges, and the negotiation of FTAs, and ③ export-led growth.

In fact, from the early 2000s to the middle of the decade, exports and export-related investments became the driving force for growth (Fig. 10). South Korea enjoyed a "China bonus" resulting from China's high growth during this period, as evidenced by the rapid expansion of exports to China (Fig. 11).

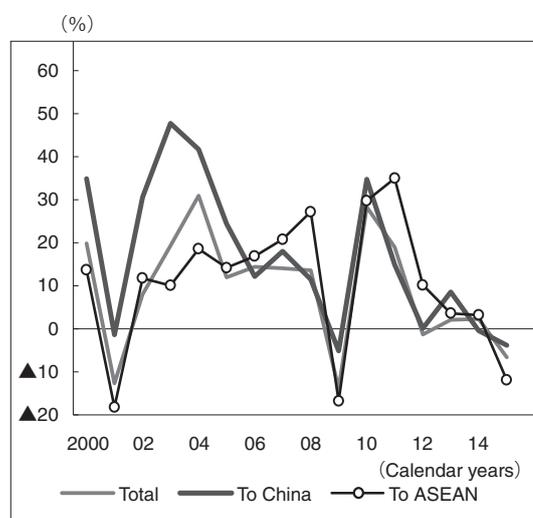
However, growth that relied on the global expansion of the *chaebol* conglomerates contributed little to improvement in the living standards of most South Koreans. Instead the deregulation

**Fig. 10 Real GDP Growth Rate, Contribution from Demand Items**



Source: Bank of Korea, Economic Statistics System

**Fig. 11 South Korea's Exports Growth Rate (Customs-Cleared Basis)**



Notes: January-September for 2015

Source: Korea International Trade Association data base

that occurred during the Lee Myung-bak administration increased the concentration of economic power in the hands of the big conglomerates, leading to increasing public criticism of the *chaebol*. This situation was responsible for a shift to a policy emphasizing harmonious co-existence between large corporations and small- and medium-sized enterprises during the second half of President Lee Myung-bak's term of office, and for the adoption of economic democratization as a key policy by President Park Geun-hye<sup>(14)</sup>.

Even more significant is the fact that the economic growth rate has fallen to the 2-3% level in the past few years and is expected to remain in the high end of the 2% range in 2015. While this figure is not extremely low, it clearly represents a significant slowing of growth compared with the 4.4% average growth rate in the 2000s. This growth slowdown indicates that the traditional growth mechanisms are no longer functioning. Evidence of the spreading impact of China's growth slowdown include not only stagnating exports to China, which is South Korea's largest export market, but also a recent slump in exports to ASEAN (Fig. 11).

China's transition to the "new normal" (the pri-

oritization of structural reforms aimed at a 7% growth rate) is good for sustainable growth in China, but it has created an effect known as the "China shock" that has caused growth rates to slow in other countries. In addition to the slowdown in exports to China due to the decline of China's growth rate, there are also the following three issues.

First, reduced demand for resources is reflected in slower growth in resource-producing countries. While China was achieving double-digit growth, expanding demand for resources caused primary product prices to soar. Income transferred from resource-importing countries to resource-exporting countries caused consumption to expand in resource-producing countries. Investment also expanded, supported by strong consumption, continuing resource development and infrastructure projects, expectations of sustained growth, and other factors. A virtuous circle in which increased trade with resource-producing countries and China, progress on development projects and other factors drove increased demand for marine transportation, ships and mining machinery. This virtuous circle was pushed into reverse by China's growth slowdown. This had a major impact on

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South Korean industries, including marine transportation and shipbuilding.

Second, the situation has also been affected by over-production in China. After the global financial crisis, China undertook large-scale public investment as part of economic stimulus measures. Through this investment, China aggressively expanded production of raw materials, such as iron and steel and petrochemicals, with the result that the subsequent demand slowdown left industries burdened with excessive production capacity. With inventory levels rising, cheap Chinese products began to overflow into overseas markets<sup>(15)</sup>.

Third, there has been a shift to local production in China, and products manufactured by Chinese companies have also emerged onto markets. In addition to iron and steel, shipbuilding and petrochemicals, Chinese products have also become significant presence in such areas as LCD panels and smartphones. One of the reasons for the decline in the operating income of Samsung Electronics is its loss of market share to competitively priced products manufactured by Chinese companies, such as Lenovo, Huawei Technologies and Beijing Xiaomi Technology.

To achieve sustainable growth, South Korea will first need to shake off the effects of the China shock.

## **(2) Correcting Excessive Reliance on China a Priority**

To achieve sustainable development, South Korea needs to make changes on both the external and internal levels. Externally, it needs to correct its excessive reliance on China, while internally it needs to achieve a growth pattern based on a balance between domestic and external demand, while also improving welfare.

After completing its 2015 Article IV Consultation with South Korea, the International Monetary Fund (IMF) Executive Board advised South Korea to correct its excessive reliance on export-driven growth, and to aim for growth based on a balance between domestic and foreign demand<sup>(16)</sup>. The

IMF identified productivity improvement in service industries as the key to achieving this goal. In connection with this advice, the IMF was also generally positive in its assessment of the government's efforts to increase latent growth potential, including labor market reforms, the development of promising small and medium enterprises, and the reinforcement of competitiveness.

However, the government has been slow to implement measures that would lead to the creation of a development model to replace South Korea's traditional growth model. In addition, its policy priorities have shifted as a result of changes in the economic environment<sup>(17)</sup>.

South Korea's policy framework finally took shape at the end of February 2014, a year after the inauguration of the new administration, with the formulation of the Three-Year Plan for Economic Innovation. This plan consists of three main elements. The first is the reinforcement of fundamentals, including the reform of inefficient public enterprises, the correction of market inequalities, private sector reform through labor market reform, and the reinforcement of social safety nets. The second is growth through economic innovation, especially the realization of a creative economy, future-oriented investment, including research and development, and the development of overseas markets. The third is development based on balance between domestic and foreign demand, including the expansion of consumption, investment, and employment of women and young people. Initiatives relating to the creative economy include the establishment of creative economy innovation centers in major cities, and the establishment of venture companies based on collaboration among local governments, large corporations, research institutions and other organizations. However, it is likely to take a considerable period of time before these efforts start to bear fruit.

Furthermore, as discussed later in this article, South Korea is expected to become an aged society by 2018 in an environment of continuing low economic growth. There is growing pressure for government expenditure, especially on pensions and welfare, and securing revenue sources will remain a challenging task<sup>(18)</sup>.

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South Korea's shift towards China has created problems not only on the economic front, but also from a foreign policy perspective. The South Korean government has made no clear decision regarding the deployment of the THAAD land-based missile interception system, but it has also announced its intention to participate in the Chinese-led Asian Infrastructure Investment Bank (AIIB). President Park's presence at a Chinese military parade in September further strengthened U.S. concerns about South Korea's lean towards China. Moreover, consideration for China's position was one of the reasons why South Korea delayed the announcement of its intention to join the TPP.

An excessive focus on China could damage South Korea's relationship with the United States, and South Korea is now in a situation that will require determined efforts to achieve a balance between the United States and China in its foreign policy.

Two factors explain South Korea's economic and foreign policy shift toward China. First, China has become a massive and extremely important economic presence. Second, China has become increasingly important from a security perspective. We need to be aware that South Korea's position is the result of pragmatic decisions based on actual national interests and is therefore subject to change. This means that South Korea will modify its foreign policy stance if the international environment changes.

South Korea needs to correct its excessive economic reliance on China. At the same time, the formation of new economic blocs, such as the ASEAN Economic Community and the TPP, has become a real possibility. South Korea has already indicated its intention to join the TPP and is expected to strengthen its involvement in economic blocs other than China. This will have the additional effect of reducing its excessive reliance on China.

Prime Minister Abe has meanwhile faced criticism in Japan and internationally over historical revisionism, as well as growing concern from the United States concerning cracks in the relationship between Japan and South Korea. During

his speech on the 70th anniversary of the end of World War II, Mr. Abe said that Japan would remain basically committed to the content of the Murayama Statement. Developments such as these could signal the start of a new phase in the relationship between Japan and South Korea.

### **(3) Renewed Awareness of Common Interests**

Recent changes in the environment surrounding Japan and South Korea are expected to provide the impetus for efforts to repair the relationship between the two countries. Yet clearly there are still issues that will be difficult to resolve, such as the question of historical recognition.

What will it take to improve relations between Japan and South Korea? Kan Kimura [2014] observes that Japan is still important to South Korea, and that persistent efforts will be needed to inform not only the elite, but also the general public in each country why Japan is important. Furthermore, Yutaka Onishi [2014] has suggested that both Japan and South Korea are facing similar problems with elusive solutions. He further says that while different people may have different views of South Korea, before reaching conclusions we need to ensure we are looking at a true picture.

Both of these viewpoints deserve our attention. Right now Japan and South Korea need to strengthen their mutually beneficial relationship based on a renewed awareness of their common interests. The first of these common interests is economic cooperation. Experience has shown us that an economic slowdown in South Korea has a negative impact on the Japanese economy, and that economic stagnation in Japan adversely affects South Korea. This is because Japan and South Korea, or Japanese and South Korean companies, are linked by supply chains. Given the interdependence of their real economies, both countries would benefit from institutionalized economic integration. South Korea's announcement of its intention to join the TPP has raised the

possibility of a resumption of negotiations over a Japan-South Korea EPA.

The importance of cooperation in the area of energy was demonstrated after the Great East Japan Earthquake, when petroleum products were imported from South Korea to offset shortages in Japan.

Another area in which Japan and South Korea have common interests is social cooperation. In addition to persistently low economic growth, South Korea is expected to become an aged society (a society in which 14% of the total population is 65 or older) by 2018 (Fig. 12). Since it became an aging society (one in which 7% of the total population is aged 65 or older) in 2000, it will have made the transition in just 18 years, which is the shortest time of any country in the world.

In South Korea employers will be required to have retirement ages of 60 or higher (from 2016 onwards in the case of large corporation), in part because of an increase in the minimum age for pension payments. In parallel with this change, employers are also introducing the wage peak system<sup>(19)</sup>. South Korea is now facing the same problems that Japan has encountered in the past.

Both Japan and South Korea share the common

problems of falling birthrates and demographic aging<sup>(20)</sup> and should be able to learn from each other in terms of both policies and actions. Further progress toward economic integration would pave the way for reciprocal provision of living support services for the elderly. Social cooperation could rank alongside economic cooperation as a factor linking Japan and South Korea together.

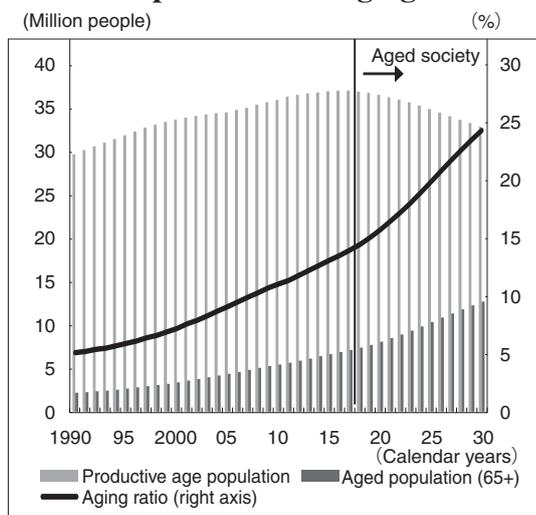
## Conclusions

The period since the normalization of relations between Japan and South Korea has seen enormous changes in the environment surrounding the two countries, including the collapse of the Cold War structure, democratization in South Korea, economic globalization and the emergence of China. Naturally these developments have also led to changes in the relationship between Japan and South Korea.

We need to analyze the circumstances that have led to this situation calmly and logically, and to renew our awareness of common interests between Japan and South Korea so that those interests can be realized. Recent developments in the environment around Japan and South Korea can be expected to provide the impetus for the repair of Japan-South Korea relations. These environmental changes should be used as opportunities to form a mature relationship based on common interests.

(This article was created by making substantial additions and changes to part of *Gurobaruka de Henka Suru Nikkan Keizai Kankei* [Japan-South Korea Economic Relationship Changing with Globalization] in *RIM*, 2015 Vol.15 No.57.)

**Fig. 12 South Korea's Productive Age Population and Aging Ratio**



Notes: Medium estimates

Source: Korea Statistical Information Service

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## End Notes

1. The *Kenkanryu* movement began with the publication of a comic book of the same name written by Sharin Yamano and published by Shinyusha in 2005. *Kenkanryu* was criticized for its lack of a factual basis in *Kenkanryū no Koko ga Detarame — Fumō na Kenkan to Hannichi ni Shūshifu wo* [This is Why Kenkanryu is Nonsense — Put an End to Pointless anti-Korean and Anti-Japanese Sentiment], which was edited by Park II and published by Commons in 2006. In recent years, hate books have been criticized within the publishing industry itself. In 2015, Mitsunori Oizumi, Naoki Kato and Yukihiko Kimura wrote *Saraba Heitobon, Kenkanryu Bumu no Uragawa* [Goodbye Hate Books — Behind the Kenkanryu Boom] (Korocolor, 2015). In the same year, Jinbun Shoin published Kei Nakazawa's *Anchi Heito Diarogu* [Anti-Hate Dialog].
2. The rapid growth of exports to Vietnam reflects the fact that South Korea manufacturers, such as Samsung Electronics and LG Electronics, have made Vietnam a major production base. Samsung Electronics in particular has established a key smartphone production facility in Vietnam and will soon start to produce organic EL panels there. Items exported from South Korea include related parts and integrated circuits.
3. Initially South Korea planned to use foreign loans to raise the funds needed to build an integrated iron and steel works. However, various countries, including the United States and the former West Germany, expressed doubts about the profitability of the project, and the South Korean government therefore switched to a policy of using funds claimed from Japan. The Japanese government agreed to this and promised that three iron and steel companies would cooperate. See Nagano, S. [2008], Chapter 7 for a discussion of this aspect.
4. References include Nagano, S. [2010] and Park II [1999] and [2015]. Yanagimachi, I. [2005] points out (p.84) that Japanese in Japan and South Koreans in South Korea ultimately see only one aspect of the relationship between Japan and South Korea. See Han, J. [2010] for a discussion of the business activities of South Korean companies in Japan.
5. Coincidentally, the 50th anniversary of the normalization of Japan-South Korea relations was also marked by a dispute between the eldest and second sons of the founder of Lotte over control of the company. This dispute also highlighted the complex capital relationships that exist between Japan and South Korea. For an analysis of this situation, see *Rotte, Hasha no Gosan, Nikkan Matagu Bocho no Fukusayo* [Lotte — the Victor's Miscalculation, Side Effects of Bloated Expansion in Japan and South Korea] in *Nippon Keizai Shimbun*, September 28, 2015.
6. See Mizuno, J., ed. [2012] for a discussion of the trade deficit with Japan. Mizuno takes the view that the technology choices of South Korean companies, which adopted strategies targeting high-tech Japanese products, have induced Japanese imports.
7. Although the “Comfort Women” issue was in the news at this time, most of the discussion at Japan-South Korea summit meetings in the early 1990s was about economic matters. See Kimura, K. [2014], p.160.
8. The structural reforms, which were carried out with IMF support, included ① the structural adjustment of companies (e.g., increased transparency, improvement of financial structures, industry specialization), ② financial reform (disposal of non-performing loans, restructuring and mergers of financial institutions), ③ labor market reform (introduction of redundancy and temporary worker systems), and ④ public sector reform (downsizing of government sector, privatization).

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9. However, Japanese investment in South Korea has been shrinking since 2013, in part because of the correction of the super-strong yen.
  10. For a detailed analysis, see IDE-JETRO [2000].
  11. The main elements of a political statement made by Roh Tae-woo, a former presidential candidate and representative committee member of the Democratic Justice Party, were as follows. ① The constitution will be amended, based on agreement among the ruling and opposition parties, to provide for direct election of the president to ensure a peaceful change of government in February 1988. ② The Presidential Election Law will be amended to ensure fair elections. ③ Political prisoners associated with the democratization movement, including Kim Dae-jung, will be pardoned and rehabilitated. ④ Human rights guarantees will be strengthened, including an expanded right of *habeas corpus*. ⑤ Steps will be taken to guarantee strengthen freedom of speech, including the abolition of the Basic Speech Law. ⑥ Regional self-government and freedom of education will be realized. ⑦ A political culture based on dialog and compromise will be created through guarantees for the activities of political parties. ⑧ A community based on mutual trust will be created through social clean-up measures, the elimination of false rumors, and the dissipation of regional prejudice.
  12. However, it is important to note that sporting and economic exchanges had begun under the Chun Doo-hwan administration, which preceded Roh Tae-woo's presidency. This led to the participation of former communist-bloc countries in the 1988 Seoul Olympics.
  13. On March 4, 2010, the *Nippon Keizai Shimbun* featured an editorial with the headline *Sekai ni Yakushin Suru Kankoku Kigyo ni Manabe* [Learn from the Global Success of South Korean Companies]. In its April 13 edition in the same year, the *Shukan Ekomisuto* magazine ran a special feature entitled *Saikyo! Kankoku* [South Korea — The Strongest!].
  14. See Mukoyama, H. [2013] for an analysis of this point.
  15. This aspect is discussed in an article entitled *Ajia ni Afuredasu Chugoku Kozai — Indo nado Tota no Nami* [Asia Flooded with Cheap Chinese Steel—India and Other Producers Swept Aside] in the October 17, 2015 edition of *Nippon Keizai Shimbun*.
  16. Republic of Korea: 2015 Article IV Consultation-Staff Report, Press Release, and Statement by the Executive Director for the Republic of Korea, IMF Country Report No.15/130.
  17. See Mukoyama, H. [2015] for a discussion of the policies of the Park Geun-hye administration.
  18. This point is examined in Mukoyama, H. [2014c]. Yutaka Onishi observes that burdens on the public, such as tax increases, will inevitably become a problem in the future. See Onishi, Y. [2014 p.246].
  19. See Mukoyama, H. [2015].
  20. The joint statement issued at the 47th Japan-Korea Business Council meeting in May 2015 calls for long-term, wide-ranging cooperation on urgent aging-related priorities in Japan and South Korea, including medical services, care, businesses relating to equipment for these fields, and the recruitment of care providers.

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