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## Report highlights

- The impeached president Park Geun-hye left behind no notable political or economic legacy. Pressing challenges on both the domestic and external front were therefore passed onto the new president.
- Although the newly elected Moon Jae-in's resounding victory will provide the new administration with policy momentum and fresh political capital, he will still face a difficult parliamentary dynamic, at least until the next parliamentary elections in 2020.
- The Economist Intelligence Unit does not expect any onslaught against the country's predominant family-controlled business conglomerates (*chaebol*), as their contribution to the economy remains decisive. However, we believe that Moon Jae-in will make a significant breakthrough on this issue, with a host of amendments to the Monopoly Regulation and Fair Trade Act beefing up the regulatory framework around the *chaebol* and its enforcement.
- We believe that it will remain difficult for Moon Jae-in's government to strike a balance between finding new drivers of growth and supporting SMEs on the one hand, and avoiding hurting the export-oriented conglomerates on the other. The process will take longer than the new president's single five-year term. Much needed reform in the labour market will struggle to be passed.
- Moon Jae-in's diplomatic outreach to North Korea represents a real window of opportunity for change and is likely to obtain support from both the US and China. However, this attempt at engagement will still face serious hurdles.
- Getting the North to decommission its nuclear programme fully would require years of positive engagement and significant compromises from both sides. This remains a distant prospect. Despite this, we believe that the chances of military conflict on the Korean peninsula remain low as all parties are desperate to avoid nuclear war.



## Introduction

Five years ago, South Korea elected Park Geun-hye as its president. This now appears, in the light of her shameful fall from grace, to have been an historic mistake. She was impeached on March 10th, almost a year before the scheduled end of her single five-year term, on charges of abuse of power amid a wide-ranging corruption scandal. She was subsequently arrested on related bribery charges (which she denies). Park Geun-hye's rise to power stemmed mainly from a wave of nostalgia among the country's older generation for the economic boom years under the leadership of her father, Park Chung-hee, who was dictator from 1967 until his assassination in 1979. The conservative leader leaves behind no notable political or economic legacy. On the contrary, she will be remembered for myriad scandals and policy missteps.

The election as president on May 9th of Moon Jae-in, who ran and narrowly lost against Park Geun-hye in 2012, represents an interesting reversal of fortunes, as Moon Jae-in, a pro-democracy activist during the dictatorship years, was thrown in prison under the regime of Park Geun-hye's father. Beyond the story of political comeback and, to some extent, personal revenge, his election mainly reinforces the impression of time lost since 2012, especially since little has changed on either the economic or the diplomatic front over the past five years.

The long-standing tensions with North Korea have continued to grab international headlines, as the North's ballistic and nuclear capabilities have made progress under the leadership of Kim Jong-un. South Korea's new president, Moon Jae-in, gave clear signs during his campaign of his intention to re-engage with the North, in a departure from the hardline approach of Park Geun-hye. However, South Koreans are far more concerned about the domestic issues facing their country's mature economy. Addressing the economic anxieties of an electorate still reeling from the corruption scandal around Park Geun-hye, the new president's campaign policy platforms focused on job creation and a stronger push for corporate governance reform, targeting South Korea's family-controlled business conglomerates, or *chaebol*. Moon Jae-in's emphatic electoral victory (he received 41% of the total vote) will be a major asset as he faces a long list of economic and diplomatic challenges.



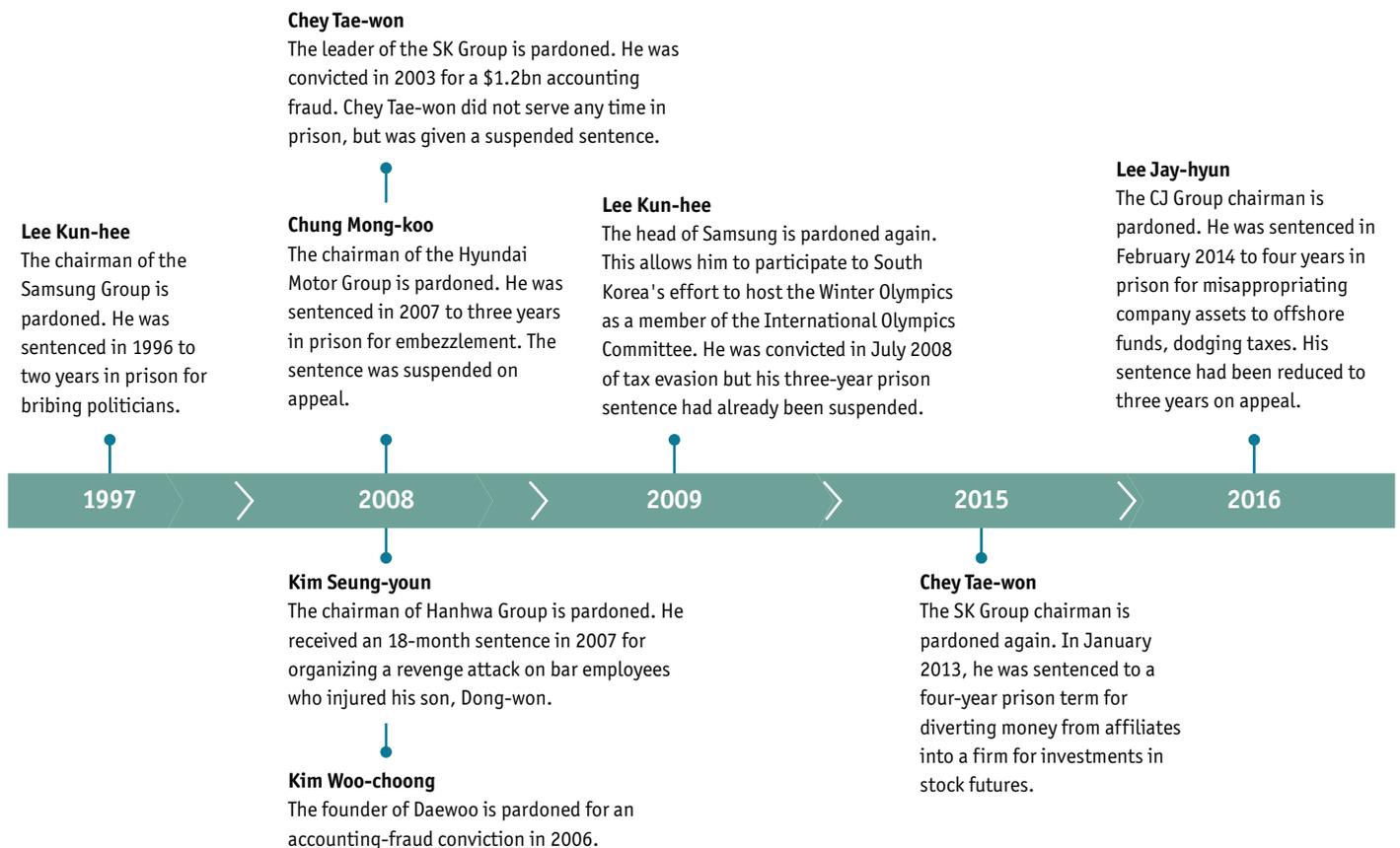
## Down with the *chaebol*: Curbing the conglomerates' influence

This is not the first time that reining in the influence of the *chaebol* has emerged as a major issue during the five-yearly transfer of presidential power in South Korea. Park Geun-hye, the impeached former president, successfully campaigned on *chaebol* reform, packaged as “economic democratisation”, in the 2012 presidential election. Her Saenuri Party (now known as the Liberty Korea Party, or LKP) initially achieved some success on this front by passing several amendments to the Monopoly Regulation and Fair Trade Act. An August 2013 amendment outlawed *chaebol* companies' practice of doing business with each other on preferential terms. A January 2014 amendment prohibited the formation of new cross-shareholdings involving three or more companies belonging to the same *chaebol*, with exceptions granted for mergers and acquisitions as well as for share swaps.

However, Park Geun-hye's administration changed the course of its economic policy halfway into her presidency, buckling under pressure from a prolonged economic slump that began in 2011. A highly symbolic policy turnaround by Park Geun-hye was when she jettisoned her promise to halt the practice of pardoning jailed tycoons. In August 2015 she pardoned Chey Tae-won, the twice-convicted chairman of SK Holdings, one of South Korea's largest conglomerates.

### Presidential pardons

(year granted, name of the conglomerate's leader)





This time, things could be different. Although high-level corruption cases have been a fairly regular occurrence, the scale and impact of the latest scandal is unprecedented. The conglomerates' role in Park Geun-hye's downfall has been dramatically highlighted by the arrest of the Samsung group's heir, Lee Jae-yong. He is accused of channelling millions of dollars in bribes to Choi Soon-sil, Park Geun-hye's long-time private confidante, in the hope of securing the government's backing for a merger of two Samsung affiliates in 2015.

Unlike previously accused *chaebol* leaders, Lee Jae-yong is not awaiting trial at liberty, and, if convicted, he is unlikely to be granted a presidential pardon on Liberation Day (August 15th) as senior *chaebol* leaders have been under previous administrations. Similarly, whereas South Korea's former presidents Chun Doo-hwan (1980-88) and Roh Tae-woo (1988-93) were arrested (in 1995) on corruption charges several years after they had stepped down, the investigation into the scandal engulfing Park Geun-hye actually forced her out of office. Her trial, along with those of Choi Soon-sil, Lee Jae-yong and other figures involved in the case, will take place in 2017-18, adding to political momentum to push for corporate governance reforms. This should help to contain the obstructive power of the opposition conservative camp in the National Assembly (NA, parliament).

## Overcoming parliamentary hurdles

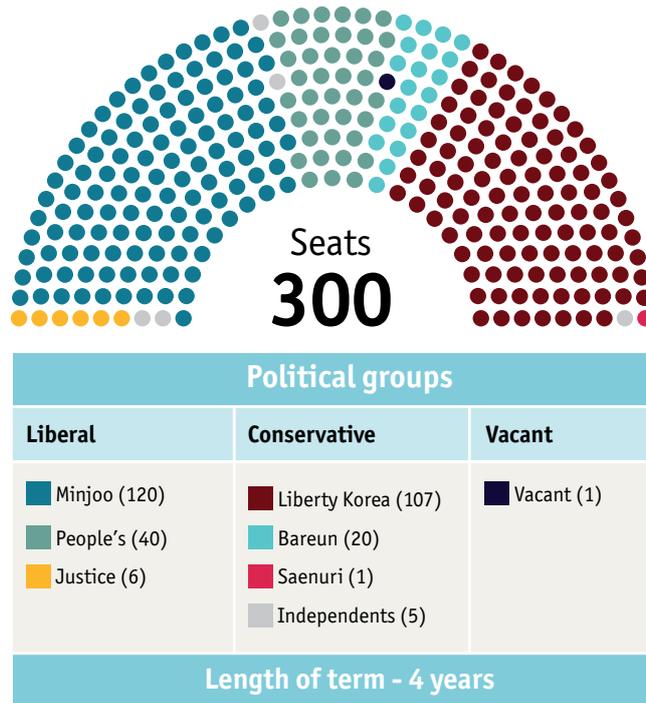
Although Moon Jae-in's resounding victory will provide the new administration with policy momentum and fresh political capital, he will still face a difficult parliamentary dynamic. For the first time in 20 years, South Korea has five influential parties in parliament. On the conservative side there are the LKP (formerly the Saenuri Party) and the Bareun Party (which split off from Saenuri). Meanwhile, the Minjoo Party, the People's Party (PP) and the Justice Party make up the liberal camp. With 120 of the 300 seats in the NA, the Minjoo Party lacks the three-fifths majority required to pass legislation unilaterally. Even if Minjoo manages to construct a liberal coalition in parliament, with the support of the PP and Justice Party legislators, it will still fall below the 180-seat threshold, with a combined total of just 166 seats.

In the wake of the "double whammy" of the corruption scandal followed by the impeachment of Park Geun-hye, the conservative camp to which she belonged was left in a complete shambles. However, the conservative candidate, Hong Joon-pyo of the LKP, made a remarkable political comeback during the presidential campaign in April 2017 and came second in the election, securing 24% of the votes. Hong Joon-pyo has managed to consolidate the conservative camp around the LKP's core views, such as its fierce opposition to engagement with North Korea. As a result, with 107 seats in the NA, the LKP will conceivably be able to act as an obstructionist opposition to the liberal camp led by the Minjoo Party—and all the more so as the LKP seems set to reunite with a large proportion of legislators from the Bareun Party, which has 20 seats.

With the next parliamentary elections not due until 2020, Moon Jae-in will therefore have to work around the constraints of his weak parliamentary majority in order to implement his policy agenda. Since taking office on May 10th he has taken steps towards consensus-building, meeting, for instance, the LKP floor leader in parliament, Chung Woo-taik. The LKP, despite its pro-business stance, will find it difficult to oppose strong curbs on the *chaebol's* influence. This issue will remain at the forefront of public debate, given the upcoming trials of the former president and her alleged accomplices in the corruption scandal.



Political forces in the National Assembly



Source: The Economist Intelligence Unit.

While South Korean politics is likely to remain conflict-ridden overall, these factors augur well for the bills on corporate governance reform that are currently stuck in parliament. The Economist Intelligence Unit does not expect any onslaught against the *chaebol*, as their contribution to the economy remains decisive. However, we believe that Moon Jae-in will make a significant breakthrough on this issue, with a host of amendments to the Monopoly Regulation and Fair Trade Act beefing up the regulatory framework around the *chaebol* and its enforcement. Moon Jae-in's first nominations for posts in his administration also indicate his will to deliver on his campaign pledges. In mid-May he appointed Kim Sang-jo, an economics professor at Seoul's Hansung University and a vocal critic of the *chaebol*, as the new chief of the Fair Trade Commission (South Korea's corporate watchdog).

**Up with jobs: A fairer labour market**

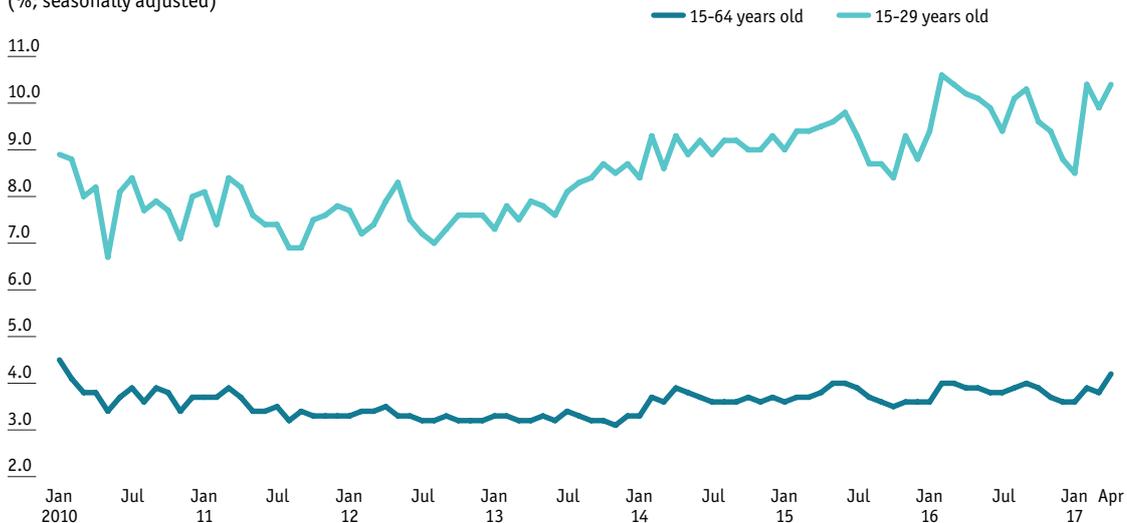
Another immediate priority for the new government will be the implementation of the new president's promises on labour market reform. These include job creation and a minimum wage increase. Despite the great need for change, progress on this area has been slow, primarily because the previous administration was perpetually embroiled in scandals and crises. Various deregulation bills aimed at eliminating unnecessary red tape, setting up business havens nationwide and liberalising large swathes of the services sector became stuck in the legislative pipeline, unable to break through the parliamentary deadlock. Reform bills seeking to create a more flexible labour market were held hostage by resistance from opposition lawmakers in the fragmented legislature.



Despite South Korea's overall low unemployment rate of 3.7% in 2016, which compares with an OECD average of 6.3%, the local job market suffers from structural issues whose effects are increasingly visible. The country's labour market has become increasingly divided into a rigid dual system consisting of a privileged segment of regular workers and a less protected set of irregular workers. This segmentation is hurting young people, who often struggle to find regular work—or indeed any work at all. Youth unemployment rose to a record 10.7% in 2016. This figure is likely to underestimate the problem, as many young graduates are employed in precarious low-paid irregular positions while hunting for career opportunities. More broadly, there is growing discontent with a work culture that puts the onus on long hours and seniority. Unsurprisingly, young people supported Moon Jae-in by a wide margin in the recent election.

### Rising youth unemployment rate

(%; seasonally adjusted)



Source: Haver.

It is not just young people who struggle, however. A significant share of all the country's workers has jobs in the less privileged segment, as non-regular employees or in-house subcontractors, without much protection under labour laws or social insurance schemes. These vulnerable workers include elderly people and women of child-bearing age.

Labour reform could also address the inequalities between employment in the *chaebols* and that in small and medium-sized enterprises (SMEs). These are related to a dual economic structure between the two types of businesses that mirrors and feeds the segmentation of the labour market. The conglomerates are capital-intensive, export-oriented businesses. Innovative, competitive and well-connected politically, they can attract the best workers by offering them regular employment with generous benefits and strong labour standards. On the opposite side of the market, SMEs are traditionally service providers and subcontractors for the *chaebol*, and must compete on cost against other SMEs to maintain their links with the conglomerates. This translates into harsher conditions for SME workers, with non-regular, insecure employment, lower wages and levels of social protection, limited training and poorer career prospects.



The wage and productivity gaps between SMEs and *chaebol* provide an indication of this duality. According to the Korea Small Business Institute, the average monthly pay cheque for workers at SMEs in 2016 stood at ₩3.23m (US\$2,880)—only 62.9% of the ₩5.13m (US\$4,580) monthly pay provided by conglomerates. Meanwhile, in 2014 labour productivity at SMEs was only about 30% of that at the conglomerates. While such gaps exist in many countries, South Korea is in both cases an outlier. According to the same source, in 2014 wages at SMEs as a proportion of those at large companies stood at 76% in the US, while in Germany SMEs' productivity was 61% of that at large businesses.

In South Korea there is a clear hierarchy between employment at the *chaebol* and that at SMEs in terms of salary, benefits and job security—but also in terms of social prestige. In an extremely competitive society where great emphasis is placed on education, obtaining employment in a *chaebol* is both the culmination of intense academic efforts and a guaranteed path towards other, related social benefits such as improved marriage prospects.

With SMEs making up around 99% of all businesses and employing 88% of South Korea's workers in 2014, according to the Small and Medium Business Administration, the situation is clearly problematic. It is therefore unsurprising that Moon Jae-in dubbed himself “president of jobs” during his campaign. His list of promises, which he announced would be financed by a ₩9trn (US\$8.8bn) stimulus plan, includes creating 810,000 jobs in the public sector as well as raising the minimum wage from ₩6,470 (US\$5.70) per hour to at least ₩10,000 per hour. The government will also sponsor new hires in SMEs. The president is likely to struggle to get these measures passed in the NA, as the main opposition party, the conservative and pro-business LKP, is unlikely to back them. However, major structural reform in the labour market will be a necessary condition if the government's industrial policy shift is to work.

## Onwards with the “fourth industrial revolution”: Nurturing new drivers of growth

An even more formidable task for the new president will be finding new drivers of growth for the maturing economy. Since the 1960s the country has been aggressively building a capital-intensive, export-oriented sector that has become its main engine of growth. South Korea is now one of the world's most industrialised economies. In 2016 shipbuilding, steel and petrochemicals accounted for 20% of the value of exports.

However, over 2016, these industries have undergone a significant government-sponsored restructuring process as they have struggled with high levels of debt and revenue shortfalls. This has reflected the outgoing administration's tough approach, which was in stark contrast with the state-sponsored credit lines and bail-outs that had previously been prevalent. Park Geun-hye's administration became more willing to turn off credit lines to large companies, thereby forcing them to restructure. This was exemplified by the case of Hanjin, a shipping company. Acknowledging the extent of the difficulties faced by what used to be one of the ten biggest shipping firms in the world, the government-owned Korea Development Bank refused to provide additional financing to the debt-ridden company. In February 2017, the dramatic collapse of the giant culminated in Hanjin's being declared bankrupt by a South Korean court and liquidated.



The Economist Intelligence Unit expects Moon Jae-in to take up the challenge of engineering a paradigm shift for the economy, following which it would be driven by innovation and creativity rather than export-oriented manufacturing. Already at the heart of the 2012 presidential race, this policy orientation appeared again in repackaged form in 2017 as the “fourth industrial revolution”. Launched in January 2016 at the World Economic Forum by the German economist Klaus Schwab, the concept seeks to encompass the economic potential of things as diverse as artificial intelligence, the “internet of things”, autonomous vehicles, 3-D printing and nanotechnology. The nebulous concept, which became intensely popular in South Korea, will probably translate into raised public spending on research and development, as well as increased investment in innovative SMEs through government-owned financial institutions. The previous government had already started to shift its policy focus and funding towards encouraging innovation and the development of new industries. However, the new administration will first focus on accelerating the current effort to restructure SMEs. In order to achieve this goal over the next five years, a W8trn fund was announced in April 2015 by the last administration. State-run financial institutions will contribute W4tn to the fund, while the rest will be raised by the private sector.

While this policy focus overlaps nicely with the renewed push to curb the economic and political influence of the conglomerates, we do not expect the new administration to hurt significantly the *chaebol*’s activities, which the South Korean economy still relies on for its export performance. Moreover, with the economy showing only fragile signs of recovery, we continue to believe that, like the previous government, the new administration will accord a high priority to supporting export-oriented industries.

The *chaebol*—and notably the Samsung group, LG and Hyundai—are also already well positioned to take advantage of the so-called fourth industrial revolution. A thorough realignment of the economy will thus require more than just additional funding for SMEs. We believe that it will remain difficult for Moon Jae-in’s government to strike a balance between finding new drivers of growth and supporting SMEs on the one hand, and avoiding hurting the export-oriented conglomerates on the other. The process will take longer than the new president’s single five-year term.

## Dealing with the nuclear threat

One key challenge facing Moon Jae-in is the tense stand-off with North Korea. Over the past year, North Korea has conducted two nuclear tests and various missile launches. This led the former president, Park Geun-hye, to take a tough stand against the North, as is traditionally the wont of conservative politicians. She not only indefinitely closed down the jointly operated Kaesong Industrial Complex (KIC) at the border, but also decided to deploy the US-built Terminal High Altitude Defence (THAAD) system. The situation of heightened tensions has only worsened in 2017, with the new US government led by Donald Trump adopting a much more aggressive rhetorical stance towards the rogue state than the previous administration. The US has also channelled its diplomatic efforts towards China in a bid to persuade the administration there to tighten economic sanctions against North Korea.



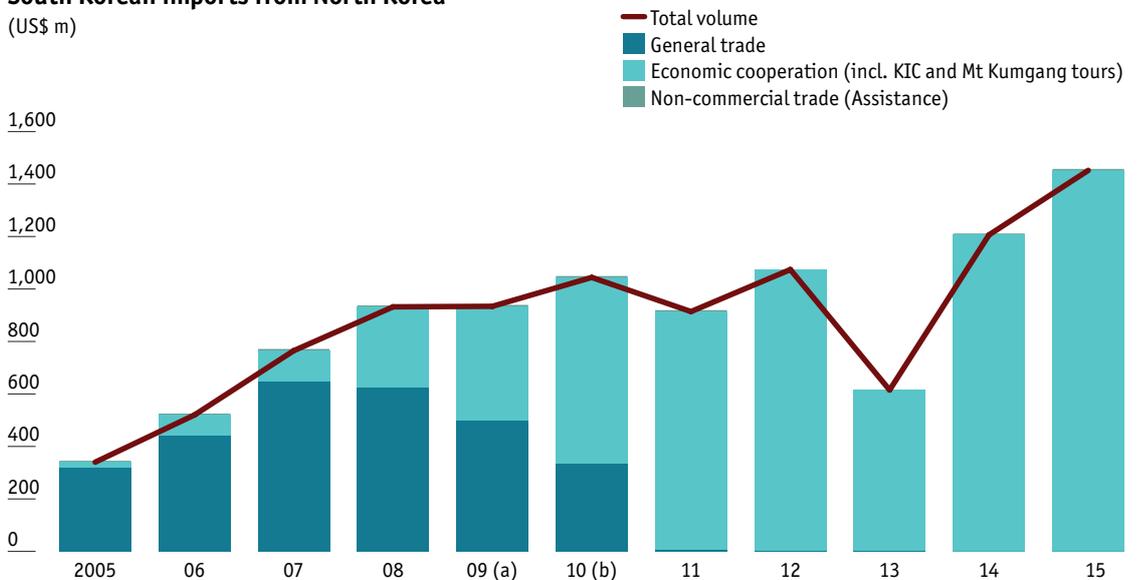
## Back to the “sunshine” policy?

The domestic political crisis and leadership vacuum in early 2017 left South Korea largely voiceless in diplomatic terms: during the impeachment process, the acting president and prime minister, Hwang Kyo-ahn, lacked any mandate to refashion South Korea’s foreign policy, even as the country was faced with heightened international tensions around North Korea. Under Moon Jae-in, however, we expect a recalibration of inter-Korean relations. A long-time advocate of reunification in the peninsula,

### Composition of inter-Korean trade

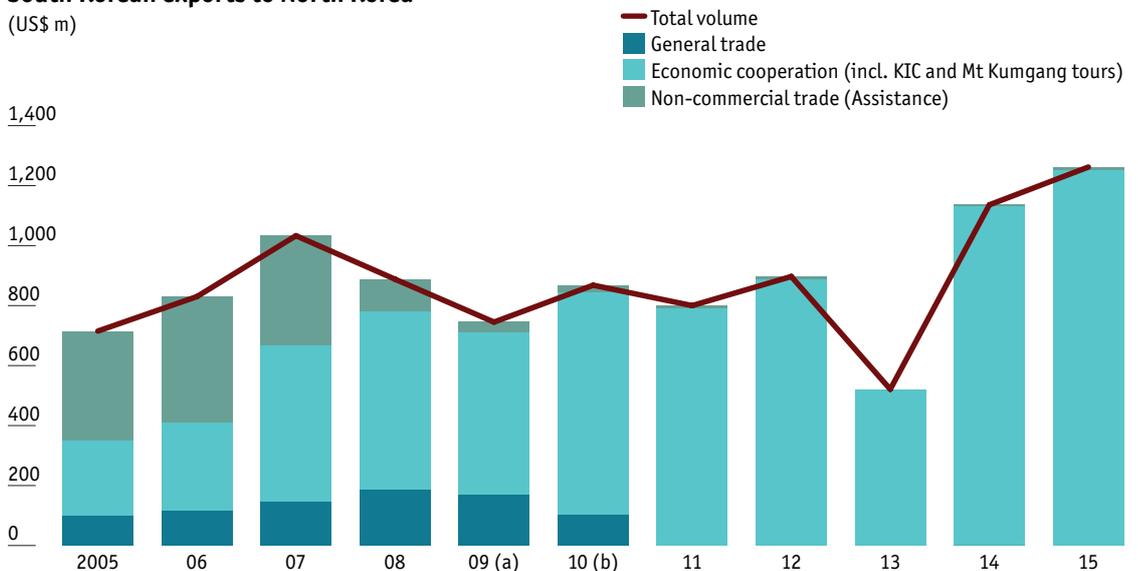
#### South Korean imports from North Korea

(US\$ m)



#### South Korean exports to North Korea

(US\$ m)



(a) Closure of Mt Kumgang tourist zone

(b) End of “sunshine” policy with North Korean military aggressions on the South

Source: South Korean Ministry of Unification.



Moon Jae-in argued throughout his campaign for a balanced stand of greater diplomatic engagement with North Korea, including visiting Kim Jong-un in the North's capital, Pyongyang, while maintaining the threat of sanctions. Moon Jae-in has experience with this dovish line, as he was involved in the "sunshine" policy, a previous engagement effort towards North Korea that was pursued between 1998 and 2008. He had a significant role in this effort: working under Roh Moo-hyun, the president from 2003 to 2007, as his chief of staff, he served as the chairperson of the promotion of the second inter-Korean summit in 2007.

Any attempt to rekindle the "sunshine" policy, which would likely be quickly renamed the "moonshine policy", does, however, face serious hurdles. Contrary to the situation in 1998-2008, North Korea is now subject to serious international sanctions. In re-establishing significant economic relations with the North, with the reopening and expansion of joint operations such as the KIC or the Mount Kumgang tourism zone (which was closed in 2009), South Korea could go against existing UN sanctions which curb financial flows to North Korea. South Korean payments to North Korean workers, channelled via the Northern regime, would be under suspicion of being used to fund prohibited activities. Such engagement would also dramatically undermine the international pressure on China to enforce these sanctions. An even more obvious constraint on engagement is the growing inevitability of recognising North Korea as a nuclear state.

On this point, the North's leader, Kim Jong-un, has shown no inclination to negotiate. Should an inter-Korean agreement (or possibly an international one) be reached whereby a moratorium or slowdown in the nuclear programme is exchanged for economic favours, such an outcome would be only a short-term solution. Getting the North to decommission its nuclear programme fully would require years of positive engagement and significant compromises from both sides. This remains a distant prospect.

## Unchanged friends and foes

Moon Jae-in's proactive approach to the inter-Korean impasse will also impact South Korea's relationships with the US and China. South Korea has entrenched security ties with the US, which we expect Moon Jae-in to maintain. However, we believe that the new South Korean president will also try to mend relations with China, which have been under stress owing to the latter's intense opposition to the deployment of THAAD. China argues that the anti-missile system represents a security threat on its doorstep and fuels tensions in the Korean peninsula. While acknowledging the growing economic importance for South Korea of its ties with China, its main trading partner, the new government's diplomatic outreach to the Chinese leadership will be limited by China's imposition of mild sanctions against South Korea in response to the deployment of THAAD. Chinese criticism of THAAD has progressively escalated into retaliatory economic measures that include curbing Chinese tourism to South Korea, blocking South Korean cultural exports such as television dramas and singers' performances, and harassing South Korean businesses established in China over regulatory concerns. This, however, has not impacted overall bilateral merchandise trade, which has continued to record year-on-year growth on a monthly basis since late 2016. Although China has long been an advocate of inter-Korean talks, the diplomatic spat over THAAD has probably made it an unlikely security partner in the near future.



## A diplomatic solution with a dim outlook

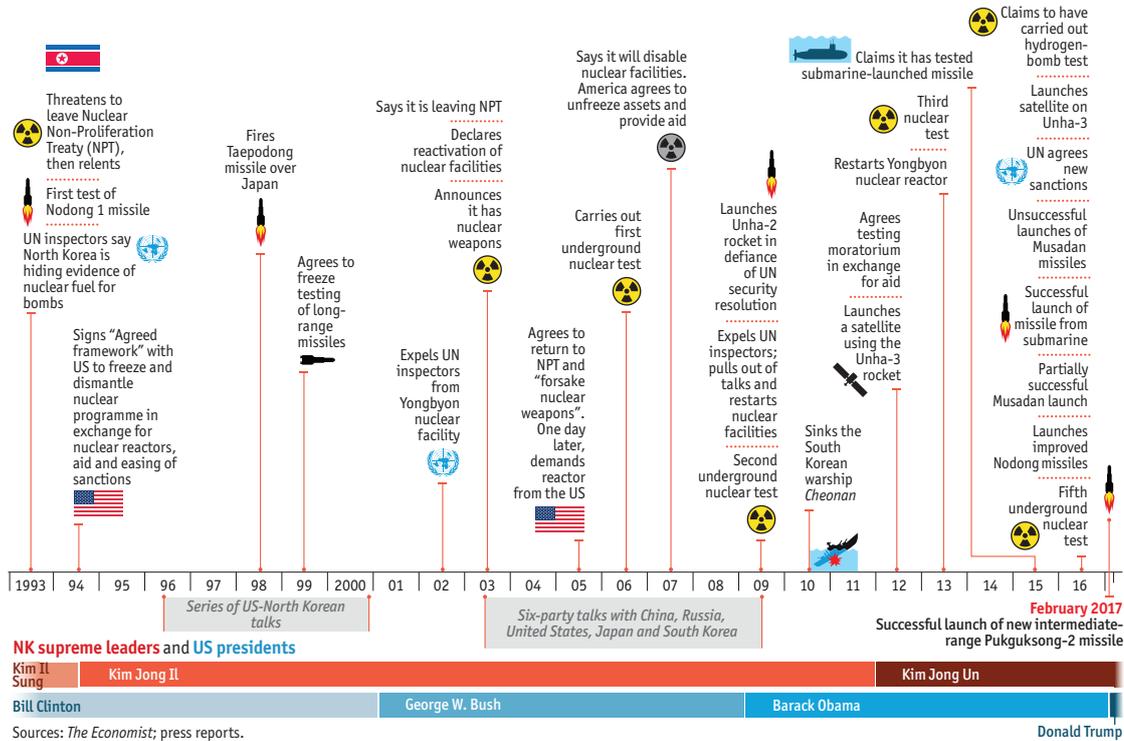
We believe that the chances of military conflict on the Korean peninsula remain low. Nuclear war is the outcome that all parties are desperate to avoid. The consequences of nuclear states attacking each other are almost unthinkable: significant loss of life, vast tracts of land rendered uninhabitable, economic chaos, regime change and the displacement of millions of people would all be somewhere between possible and guaranteed. This is the strongest conceivable motivation for all parties to exercise restraint—even the North, where the Kim regime maintains itself through the *songun* (military-first) policy of readiness for war.

International negotiations on North Korea's nuclear programme broke down in 2009, after the North conducted a failed satellite launch that was denounced around the world. Moon Jae-in's election and his diplomatic outreach to North Korea represent a real window of opportunity for change. This engagement is likely to benefit from the support of the international community. Greater diplomatic engagement with the North is also a development that China would view favourably. Mr Trump, too, has at times expressed a willingness to engage with Kim Jong-un directly, under what he has termed "the right circumstances".

However, two main obstacles are likely to derail this diplomatic push. First, policy cohesion between South Korea, the US and China will be hard first to achieve and then to maintain as each actor pursues different goals in the potential negotiations. South Korea in particular maintains the objective of a reunification that, implicitly, would be under its leadership. This aim is unlikely to be shared by the North, and would also not be favoured by the Chinese leadership, for which a reunified peninsula allied to the US is an unacceptable scenario. Second, for North Korean interests to be satisfied by a potential bargain, this would require concessions, such as recognising it as a fully nuclear state and allowing the regime to continue—hardly a palatable option to the US and South Korean leaderships. The current outlook for future negotiations is therefore dim.



## North Korea's nuclear path (until February 2017)



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