

# RESEARCH NOTE

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## North Korean Crisis—Implications for Australian Trade

North Korea's decision to immediately withdraw from the Nuclear Non-Proliferation Treaty on 10 January 2003 emphasises the importance of the Northeast Asian region to Australian trade and security interests.

### Implications for South Korea

Despite the continued sporadic tension since the armistice ending the Korean War in 1953, South Korea has developed into the 13th largest economy in the world. However, the North Korean regime is increasingly a factor in the consideration of South Korea's long-term economic growth prospects.

The nuclear crisis has refocused international attention on North Korea following the perceived stabilisation after the 2000 Leader's Summit meeting between Kim Jong-Il and Kim Dae-Jung.

South Korean domestic business activity generally has remained resilient to events involving North Korea such as the July 2002 naval clash in which five South Korean

naval personnel lost their lives. However, the increased level of threat brought about by the nuclear crisis may affect business and consumer activity.<sup>1</sup> An authoritative measure of business confidence, the Federation of Korean Industries (FKI) business survey index (BSI) has fallen to a 14-month low. Compilers cited geo-political uncertainty as one of the possible reasons.

The crisis may also deter foreign investment. In December, the Bank of Korea attributed a contraction in foreign investors' net purchase position to the dampening of investor confidence following the unstable international circumstances.<sup>2</sup> South Korea's credit rating may be affected, with Moody's Investor Service due to conduct a review in January.

### Implications for Australia

Northeast Asia<sup>3</sup> remains Australia's most important export region despite declining growth trends. In 2001–2002 it accounted for 40.7 per cent of Australia's merchandise exports compared to 12.9 per cent

and 12.8 per cent for Europe and the Americas respectively.

Any disruption to the stability of Northeast Asia could adversely affect Australia's trade. Japan, China and South Korea rank amongst our top five trading partners. South Korea is Australia's third largest export market. With stability, South Korea will maintain its importance, given its estimated real

GDP growth rate of 5.4 per cent in 2003.<sup>4</sup>

In the short-term, the current crisis may dampen Australian business confidence in South Korea, harming the potential diversification of the economic relationship towards the services and investment sectors.<sup>5</sup>

### Unification Scenarios and Trade

A 1999 study by the Rand Corporation<sup>6</sup> put forward four possible scenarios for the resolution of the Korean stalemate—peaceful unification; collapse and absorption; unification through conflict; and external intervention.

### Scenario 1—Peaceful Unification

This scenario assumes the planned unification of the Korean peninsula. By building a stronger North Korean economy a 'soft landing' could be engineered to avoid pitfalls such as the economic dislocation which occurred after German unification. The unification timeframe would depend upon the speed of North Korea's economic transformation. Central to this scenario is the provision of economic assistance, increased humanitarian cooperation and confidence building measures.

Under this scenario Australia could be expected to expand its healthy trade relationship. The complementary relationship based on the export of raw materials and the import of consumer goods would expand into services and investment. Australian exports of raw materials would increase as North Korean infrastructure expanded. Increased cooperation in areas such as biotechnology, e-commerce and health services could be expected as a 'peace-dividend' spurred consumer and investor confidence in the economy.



## Scenario 2—Collapse

The Rand study suggests two distinct phases. The first phase would include a period of atrophy and prolonged instability in North Korea as the regime attempted to cling to power. The second phase would be marked by more rapid political change followed by regime and state collapse.

Australian interests under this scenario would be adversely affected by the strain placed on the South Korean economy. The cost of unifying under such a scenario has been estimated to be between US\$260 billion and US\$3.2 trillion. German unification was financed by public transfers from West to East of approximately four per cent of GDP in the 1990s, inevitably affecting the economy. The economic disparity between the two Koreas is considerably greater.

The cost to the South Korean economy could affect Australian exports in the short to medium term. The effects of the Asian economic crisis on South Korea, which resulted in a real GDP contraction of 6.6 per cent in 1998, led to a 23 per cent drop in Australian exports. Further, the recovery period adversely affected Australia's tourism and education sectors.

The collapse of North Korea would have a much graver economic effect over a longer period of time. Estimates of the recovery period range from 10 to 20 years.

## Scenario 3—Conflict

The third scenario—unification through conflict—would have the greatest negative effects. To avert imminent collapse and ensure regime survival, the North may initiate limited conflict.

Any reduction in South Korean infrastructure and industrial capacity brought about by conflict would affect Australia's principal

## Australian Exports to South Korea

	1997	1998	1999	2000	2001
Value (US\$ million)	4978	3852	4046	4742	4929
Export Market Share (%)	7.9	6.9	7.2	7.5	7.8

Source: DFAT APEC Region Trade and Investment 2002

exports of coal, iron ore and crude petroleum. In 2001, South Korea accounted for approximately 15 per cent and 12.9 per cent of Australia's iron ore and coal exports respectively.

Damage to the South Korean economy would also affect Australia's major export partners—Japan and the United States. In 2001, South Korea accounted for approximately seven per cent of Japan's exports. Decreased demand in Japan's already stagnant economy would affect the same key Australian exports of iron ore, coal and crude petroleum.

Economic costs would also be borne by Australia's second largest export market, the United States. The US economy, already confronting the possible rebuilding of Iraq would be put under further pressure by a conflict in Korea. The US has 37,000 troops stationed in South Korea and would be integral in any conflict and its aftermath.

Conflict on the peninsula also holds the potential to affect China's relationship with the US and Australia, resulting in possible disruption to Australia—China trade. China is currently Australia's fourth largest export market with growth rates far exceeding other major markets.

## Scenario 4—Intervention

China currently contributes substantial food and energy aid to the North. The Rand study suggests that given its historical role<sup>7</sup> there is significant potential for Chinese intervention.

Chinese intervention might aim to prop up an alternative North Korean

regime resulting in short-term instability and longer term stability. By assuming a greater military and financial role, China would avert both uncontrolled refugee flows and humanitarian crises on its border.

Under this scenario trade would continue and expand as the 'alternative peace' continues. The scenario might also entail more rapid reform towards a state directed market economy.

Alternatively, Chinese intervention might upset the regional strategic balance, precipitating obstacles to economic growth, thereby affecting Australian trade interests. Tension could result from international uncertainty over the legitimacy of a Chinese backed North Korean regime, mass political opposition to intervention in South Korea, or a regional military build up in response to increased tension.

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1. Hans Greimel, *S Korean Economy Faces Nuke Threat*, Associated Press Newswire, 8 January 2003.
2. Bank of Korea Press Release, *Financial Markets Trends*, January 2003.
3. Northeast Asia comprising of China, Hong Kong, Japan, ROK, DPRK, Macau, Taiwan and Mongolia.
4. Economic Intelligence Unit (EIU) Estimate, 7 January 2003.
5. The diversification of the Australia—Korea trade relationship has been a government priority since 1999. See Trade Minister Vaile Press Release *Expanding and Strengthening the Australia-Korea Economic and Trade Partnership*, 17 July 2002.
6. J. D. Pollack and C. M. Lee, *Preparing for Korean Unification*, Rand, 1999.
7. China supported the North in the Korean War 1950–1953. See Allen S. Whiting *China Crosses the Yalu*, Stanford University Press, 1968.