

Economic Ripple Effects of Stopping Inter-Korean Trade

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Since it was concluded that North Korea was responsible for the *Cheonan* incident, attention has been drawn to the South Korean government's decision to cease all inter-Korean commercial activities (with the exception of the Kaesong Industrial Complex) as part of its follow-up measures. Of particular interest are the estimates of financial losses which the two Koreas will have to pay for and predictions on the scale of economic damage.

However, because the scale of losses which the two Koreas will have to bear as a result of stopping trade is extremely complex, it is difficult to get an accurate estimate by simply adding up the various items. Particularly if this suspension continues long-term or becomes further aggravated by the closing of the Kaesong complex and increased military tensions, the direct and indirect damage to the South Korean economy may deepen.

In order to simplify the analysis, here I will focus on the direct, short-term ripple effects of ceasing all inter-Korean trade activities except for the Kaesong complex.

First, to examine the shock to the South Korean economy in general, let us look at what percent of the entire North and South Korean foreign trade is taken up by the now-terminated inter-Korean trade. As you can see in Figure 1, North Korean foreign trade will be reduced by 14.5%, while South Korean trade will remain virtually unaffected with only a 0.1% decrease.

<Figure 1: Percent of Inter-Korean Trade in North and South Korean Total Foreign Trade>

	2009 Foreign Trade	2009 inter-Korean trade (excluding Kaesong)	Percentage
North Korea	\$5.09 billion (includes inter-Korean trade)	\$0.74 billion	14.5%
South Korea	\$686.62 billion		0.1%

(Source: Korea International Trade Association, KOTRA, Ministry of Unification)

Next, to get a more concrete idea of the ripple effects, let us examine by category the amounts of general trade and consigned processing which have been suspended.

<Figure 2: 2009 Imports and Exports by Category>

	Imports (North->South)	Exports (South->North)
General Trade	\$245.2 million	\$10.9 million
Consigned Processing	\$254 million	s\$155.7 million

(Source: Ministry of Unification)

According to Figure 2, this measure will bring about a net import loss of \$234.3 million (from 2009 levels) in goods from North Korea as a result of the suspension of general trade. If we calculate 10% for incidental charges such as customs and cargo loading fees, freight charges, intermediary fees, etc., the loss of foreign currency revenue for North Korea amounts to an estimated 210.87 million

In the case of goods processed on consignment, the raw materials are exported to North Korea and finished goods are returned, so a processing fee amounts to North Korea's foreign currency intake. However the manufacturing costs vary greatly by product. In the case of low-cost items such as cigarette lighters, this may amount to no more than 1% of the total value, but in the case of a man's suit jacket it can go as high as 30% or more. Considering that for most items manufacturing amounts to somewhere between 10-15% of the total value, we can apply an average cost of 12.5%, and this yields an estimate for the total consigned processing revenue to North Korea in 2009 amounting to \$31.75 million.

If we add in the loss of income to North Korea from the ban on its shipping services, we can obtain an estimate of the direct, short-term loss of foreign exchange earnings to North Korea. The shipping ban includes a prohibition on passage through the Jeju straits, incurring an estimated increase in yearly expenses of about \$1 million; combined with an income from shipping inter-Korean trade goods of about \$9 million, North Korea will lose an estimated total income of \$10 million as a result of the shipping ban.

Put together, the direct short-term loss of foreign currency income for North Korea as a result of the measure to suspend inter-Korean trade amounts to an estimated \$252,620,000. Considering that, in the process of inter-Korean trade, South Korean businessmen unofficially bring a considerable sum of money into the North for use within the country and for the purpose of ensuring smooth business operations, the actual loss to North Korea may be slightly higher than the above estimate.



In the long-term, North Korea may make up for part of this loss by finding new avenues of income or acquiring new investors. However, as inter-Korean tensions are expected to rise and North Korea's image has been damaged by the *Cheonan* incident, it may not be easy for them to find trade partners to replace South Korea and if so the economic burden for North Korea may extend to the long-term. North Korea's environment for investment is poor, it faces fundamental difficulties attracting investors, and it will be difficult to find alternate trade routes for their agriculture / fisheries products and sand, which formed the core of inter-Korean trade.

On the other hand, the economic cost to South Korea will be relatively negligible compared to the total size of its economy.

Of course, for the companies involved in general trade and consigned processing there will be unavoidable problems. But due to the poor investment environment in the North and the stagnation of inter-Korean relations, structural investment and similar activities had already nearly ground to a halt, which will help to mitigate the loss. Nevertheless, depending on the situation, some companies may show greater loss than others, and there may be large disparities in their capacities to absorb the setback as well. Therefore in the political sphere it will be necessary to prepare appropriate measures to aid companies facing these problems. We can also predict a short-term rise in prices for those goods which previously depended in large part on North Korea, so measures will be needed for dealing with this as well.

