

## Matthews Asia Perspective

### New Chapter for Korean Peninsula



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*President Trump and North Korea's leader Kim Jong Un held a long-anticipated summit meeting that marks a potential turning point for the Korean peninsula and the region at large. In this Q&A, Portfolio Manager Michael Oh discusses the longer term implications for investors.*

#### What positive outcomes do you see from the recent U.S./North Korea summit?

The summit was an important step toward greater understanding and cooperation on the Korean peninsula. Despite major issues left to resolve, the meeting showed how dialogue and communication can guide the road forward. One important outcome is a significant reduction in the risk of military conflict. Of equal importance is the opportunity for the two Koreas to potentially form closer economic ties over time. Increased trade with neighbors—such as China and South Korea—would improve the quality of life for North Korea's 25 million citizens. North Koreans could represent a large base of new consumers, workers and savers for many Asian companies. Thus, greater cooperation on the Korean peninsula can potentially benefit the entire region.

#### How were the talks different from past meetings?

As the first time a sitting U.S. president met with North Korea's top leader, the summit was an historic event. If Kim Jong Un can normalize diplomatic relations with the U.S., there would be significant benefits for the people of North Korea. Kim received part of his education in Switzerland and may have a more modern outlook than his father or grandfather. He has likely seen firsthand how a market-based economy can offer a better quality of life. If Kim feels politically secure, he might be more inclined to open his economy to more global trade. As a young leader in his 30's, Kim may potentially rule for another three decades. His prospects for a long reign could allow him to take a longer term view on economic development than his predecessors. Notably, Kim's father and grandfather were in their 50s and 60s when they met with South Korean leaders, so it may have been harder for them to focus on economic reforms as they had a much more immediate need for succession planning. There is obviously still a long way to go toward improved relations between North Korea and the rest of the world, but I remain optimistic that progress is possible.

#### What is the potential upside for South Korea's economy and equity market?

If North Korea slowly opens its economy, there would likely be attractive long-term economic benefits for South Korea. Manufacturers in South Korea are already turning to lower-wage countries, such as Vietnam, to expand their labor pool. If the two Koreas were to develop a cooperative framework for regulations and trade, North Korea could potentially attract new manufacturing jobs from South Korea's private sector. What's more, the North Korean literacy ratio for workers ages 15 and older is nearly 100%, providing access to a highly literate, lower-cost workforce for South Korean companies.

As military tensions ease, South Korea's stock market may also attract increased interest from both domestic and global investors. Stocks in South Korea historically have traded at lower valuations than equities in other similarly developed Asian markets. If investors feel more confident about South Korea's long-term national security, then the current discount in valuations associated with Korean equities may be reduced. The fundamentals of South Korean companies remain strong and we believe the equity market is attractive for long-term investors. Maintaining a long-term perspective is key, as any potential benefits from the summit will likely be long-term—rather than short-term—in nature.

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## What are some of the potential costs and risks for South Korea?

Economic reunification could present some fiscal costs for South Korea. Expansionary fiscal policies and fiscal transfers from South to North could widen fiscal deficits. The cost of an economic reunification is estimated to be 4% to 5% annual of South Korea's GDP for 20 years.<sup>1</sup> The overall cost would likely be spread out over a period of several decades, following a step-by-step process for building closer economic ties. North Korea's economy would probably need to rise to a higher level of GDP before the deeper political ties could be formed between the two Koreas. The Bank of Korea estimates that North Korea's per capita income, at US\$1,200, is less than 5% of South Korea's, using 2015 data.<sup>2</sup>

## What is your view on the relationship among China, North Korea and South Korea?

Playing a key role in the region, China has strategic interests in both North Korea and South Korea. China would like political stability for North Korea's current regime, while maintaining the security and stability of its own border with North Korea. China doesn't wish to deal with refugees from North Korea in the event of regime collapse. In South Korea, China sees an important trading partner, as well as an ally for maintaining peaceful relations on the Korean peninsula. The political relationship between China and South Korea has occasionally been strained, most recently due to the presence of U.S. anti-missile systems in South Korea, but trade relations between China and South Korea continue to improve.

<sup>1</sup> National Assembly Budget Office (2014), Economic Effect of the Reunification of the Korean Peninsula

<sup>2</sup> Warwick J. McKibbin (2017), Modelling the Economic Impacts of Korean Unification

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## For the two Koreas, what could the road forward look like?

A politically unified Korea would be a powerful economic and diplomatic presence in the region. We believe political reunification, however, would be a much longer process than an economic merger. The two Koreas could achieve greater economic unification through a series of small steps. Some benefits of stepping-stone initiatives could emerge quickly, while others would take longer to bear fruit. In the near term, we see stepping-stone initiatives as positive for investor sentiment toward South Korea equities and the South Korean won. Bringing North Korea's 25 million citizens fully into the global economy could take generations, but would likely yield social and economic benefits for both Koreas over time.

Within Asia, North Korea now has two examples it can follow of Communist regimes that have liberalized their economies without giving up political power. In the case of China, the government has introduced economic reforms over the past three decades that have reshaped economic growth. And in the case of Vietnam, the government has encouraged private enterprise over the past two decades, making the country an export powerhouse. So there may be a middle path for North Korea, where Kim Jong Un remains in power while simultaneously moving toward a private-sector economy. The experiences of China and Vietnam could inspire Kim and his ruling party to feel more confident about their prospects of staying in power while making economic reforms.