THE POLITICAL ECONOMY OF TRUSTPOLITIK: WHAT IS AHEAD FOR NORTH-SOUTH TRADE AND INVESTMENT?

By Stephan Haggard

Abstract

Park Geun-hye’s Trustpolitik envisioned incremental, step-by-step exchanges, including economic ones, that would build trust. The strategy was disrupted by North Korean provocations during the first half of 2013 and had to be recalibrated. However, trade and investment have been limited not only by direct political constraints, but by the inherent risks South Korean firms face in operating in North Korea. The future of Trustpolitik therefore depends on two strategic questions for the South: the nature of North-South economic engagement it seeks; and the question of reciprocity, or what it expects in return. Given that large-scale investment projects are unlikely, two strategies are possible: an expansion of the “zone model,” exemplified by Kaesong, or a strategy of placing greater emphasis on purely commercial transactions with the North.
During the presidential election campaign of 2012, Park Geun-hye appealed to centrist voters by developing a new approach toward North Korea. The concept of Trustpolitik, outlined in some detail in campaign speeches and a widely-read Foreign Affairs article, sought to find middle ground between the open-ended engagement of the Kim Dae-jung and Roh Moo-hyun years and the more confrontational stance of the Lee Myung-bak presidency. Trustpolitik envisioned a set of small reciprocal steps that would gradually produce trust and provide the basis for a more wide-ranging political as well as economic relationship.

As with her predecessors, the Park administration quickly learned that the best laid plans ultimately depend on the behavior of North Korea. In quick succession in late-2012 and early 2013, candidate, president-elect, then president Park faced a successful North Korean satellite launch, a third nuclear test, and a particularly vituperative diplomatic and military response to the international condemnation that followed. In April, North Korea initiated a stand-off over the Kaesong Industrial Complex (KIC) by pulling the entire North Korean workforce out of the zone; it would take over five months for it to reopen.

In the wake of these challenges, the Park administration had to calibrate its conception of Trustpolitik, and drifted toward conditional engagement that looked to critics quite similar to the Lee Myung Bak approach. However, this assessment is not entirely accurate. Although Park Geun-hye threatened to close down Kaesong, she ultimately negotiated its reopening and endorsed ambitious plans to “internationalize” the zone by attracting foreign investment from beyond South Korea. She undertook modest humanitarian gestures and signaled that the post-Cheonan sanctions might be modified at the margins by allowing South Korean investment in Rason.

This overview of Trustpolitik begins with a brief portrait of North-South economic relations up to this point. The bilateral relationship has always combined three very different types of economic ties: purely commercial ones—which constitute a minority of trade and investment—the quasi-commercial relationships of Kaesong, and the aid component of the relationship. The mix of these forms of engagement correlates closely with politics in the South. A central issue looking forward is the mix between these different modalities of engagement and particularly their commercial component.

The second section reports on the results of a survey of South Korean firms doing business in North Korea and compares it with a similar survey of Chinese firms. South Korean firms operating in North Korea tend to be small and dependent on government support. With the exception of Hyundai, chaebols have shunned the country, and Kaesong has effectively become a kind of industrial policy for labor-intensive firms facing competitive pressures at home. The counterparties of South Korean—and Chinese—trade and investment have largely been state-owned entities in the North, calling into question some of the socializing effects that engagement might have. Yet the “zone strategy” has been one path through which a number of East Asian countries opened up to foreign investment, and it is likely to be the centerpiece of any deepening of the North-South economic relationship.

The final section tracks the difficult course of Trustpolitik during the first year of the Park administration and the prospects for it in the remainder of her administration. North Korea does not appear to be particularly anxious to expand the presence of foreign firms outside of tightly-controlled enclaves. Similarly, South Korean firms—outside of small ones engaged in the processing-on-commission and commercial trade—do not yet see particular advantages from entering North Korea outside of the zones. These constraints place limits on the relationship, quite apart from political developments between North and South.

Nonetheless, the fundamental problems facing Trustpolitik are political, and center on the question of reciprocity. During the current charm offensive, North Korea has shown surprising flexibility on family reunions even while joint US-ROK exercises were taking place. The prospects for deeper economic integration are bounded not only by North Korea’s interest in economic reform and opening but by their willingness to moderate their foreign policy behavior. The course of Trustpolitik in the medium-run is likely to focus on small-scale humanitarian assistance, Kaesong and a possible extension of the zone model to South Korean involvement in Rason. Over the longer-run, South Korea can encourage a more commercial approach on the part of the North by playing a more arms-length role toward North-South trade and investment than in the politicized Kaesong model.

**Patterns of Trade**

It is important to start with some understanding of the history of North-South economic relations, as they have been deeply politicized from the outset. Successive governments have had to make decisions about the balance between more purely commercial relations, joint projects that involve government support and guarantees, such as Kaesong, and outright aid. The Trustpolitik concept faces similar choices.

The opening of North-South trade is often associated with the Kim Dae-jung era and the summit of 2000, but it in fact had its origins in Roh Tae-woo’s Nordpolitik and concrete policy measures permitting North-South trade taken in 1988. Initially, chaebols took the lead, following Hyundai chairman Chung Joo-young’s efforts in 1989 to tie up a number of
lucrative investment opportunities, including with respect to Mt. Kumgang. Although other chaebols entered into preliminary discussions of ambitious projects, early trade was dominated by small traders and a handful of processing-on-commission ventures around Pyongyang.

In 1990—a full decade prior to the Kim-Kim summit—South Korea passed the Intra-Korean Exchanges and Cooperation Act and the Intra-Korean Cooperation Fund Act, the former establishing the legal basis for trade, the latter creating an important tool for direct assistance to the North and to firms and NGOs engaged with the DPRK. This phase of opening hit a highpoint with the signing of the so-called Basic Agreement in 1991, which had a substantial economic component.

The onset of the second nuclear crisis and the ambivalence of the Kim Young-sam administration led to a period of drift in commercial relations. Small-scale ventures continued, but none of the large-scale projects came to fruition. Rather, North-South economic exchange was dominated by the light-water reactor project, a product of the Agreed Framework settling the first nuclear crisis. Managed by the Korean Energy Development Organization (KEDO), the project constituted a very large aid commitment funded largely by the Korean and Japanese governments. It was subsequently abandoned—at great cost—following the onset of the second nuclear crisis.

The Kim Dae-jung summit opened up the decade-long era of engagement, the results of which can be seen most clearly in Figure 1. This figure focuses on South Korean exports to North Korea dividing them into four categories that reflect increasing levels of government involvement. The general trade and processing-on-commission trade are the most commercial forms of engagement, even if they involve official counterparties. South Korea ran a deficit on general trade, which was dominated by North Korean exports to small South Korean importers and a broadly balanced processing-on-commission account, mostly in the textile-apparel sector.

The most significant developments of the Kim Dae-jung and Roh Moo-hyun era, however, were two. The first was the beginning of large-scale food and fertilizer assistance, the overwhelming majority of the non-commercial trade. The second, following the opening of the Mt. Kumgang tourist area and the Kaesong Industrial Complex, was the trade associated with “economic cooperation projects.” In sum, trade grew...
During this period but it was not purely commercial in nature; indeed, aid dominated even the “cooperation projects” through much of the engagement era.

With the election of Lee Myung-bak, aid fell in two steps. From the outset, the administration reversed the commitment to large-scale and ongoing humanitarian assistance, arguing that it should be offered only in response to a clearly defined need. Moreover, other forms of development assistance should be conditional: they should follow, rather than lead, an improvement in the overall political relationship including progress on denuclearization. Following the sinking of the Cheonan in March 2010, the government announced the so-called “May 24 measures” that prohibited contact with North Koreans and blocked new investment in the North. As can be seen in Figure 1, the general and processing-on-commission trade operating outside of Kaesong dropped to virtually nothing, limited to a handful of firms operating with Chinese rather than North Korean counterparties. Kaesong survived and came to dominate bilateral exchanges prior to the sharp fall in trade associated with the shutdown of Kaesong in 2013.

These shifting approaches to engagement had an effect not only on North-South economic ties, but on the overall pattern of North Korea’s trade. These are shown in Figure 2 which uses Korea Trade-Investment Promotion Agency (KOTRA) data to show North Korea’s total trade with the five interlocutors in the Six Party Talks—the U.S., China, Japan, South Korea and Russia—for 2000 through 2011. Three developments are noteworthy. Prior to the onset of the second nuclear crisis in 2002, Japan had maintained quite extensive trade relations with North Korea despite the absence of formal diplomatic relations. Japan was the source of large remittances from the Korean-Japanese community and it responded with substantial aid following the onset of the famine. After 2002, Japanese policy gradually drifted toward a near-complete embargo.

Second, South Korea’s share of North Korea’s total trade rose after 2004 as a result of both aid and the growth of Kaesong trade. However, South Korea’s share fell during the Lee Myung-bak presidency. The result of China’s rapid growth, its proximity to North Korea, and the decline in the shares of Japan and South Korea was a dramatic increase in China’s role in North Korea’s foreign economic relations. Although the 70 percent estimate for 2011 is high, and some of the trade with Japan and South Korea has simply been re-routed through China, it is clear that North Korea is increasingly dependent on China.

Three points emerge from this short history. First, any strategy of engagement must consider what type of economic
relations it seeks to promote with the North, ranging from more commercial ties, through cooperation projects to aid. Second, any strategy must decide what it ultimately seeks from North Korea in return for any assistance on offer; we return to this issue below. Finally, the Trustpolitik approach must assess the risk of not engaging, including with respect to China’s growing influence in the North.

**Evidence from Firm-Level Surveys**

It is often assumed that the main barriers to deeper North-South integration are political, and this is clearly true as we have seen. Yet we also need to understand how those political constraints operate at the level of the firm. Such insight can be gleaned from a survey of 200 South Korean firms doing business in North Korea that was conducted during November 2009 and March 2010, and comparisons with a similar survey of Chinese firms conducted in 2007. The design of the studies using these surveys included a comparison group of firms not doing business in North Korea so that we could compare some of the distinctive features of the firms doing business in the North.

The South Korean firms doing business in North Korea were engaged in importing, exporting, and investment through arm’s-length transactions, processing-on-commission trade, or the Kaesong Industrial Complex. In contrast to the Chinese sample, however, nearly all of the firms in the sample (94 percent) were involved in importing, either directly from North Korean counterparties (59 percent) or via some kind of processing relationship (33 percent). By contrast, less than half the sample—45 percent—were involved in exporting and the bulk of the exporting firms operated in the context of processing relationships (33 percent); only 12 percent sold to North Korean counterparties outside of such relationships. Of those firms that invested in North Korea, the large majority were in Kaesong.

These relationships alone suggest the perception of significant risk: imports—for example of undifferentiated raw materials or marine products—are easily settled in advance or on delivery. But exports and investment involve payment and expropriation risk. Firms hedge such risks through POC arrangements or through location in Kaesong.

When we compared the sample of firms doing business in North Korea with those that didn’t, we found that status as a small- or medium-sized enterprise (SME) was positively related to entry, confirming our observation that the larger chaebol groups have generally shunned North Korea. The most interesting finding, however, centered on the role of public policy. Access to public support, including in the form of lending, was a significant determinant of entry. Not only were firms doing business with North Korea small, but they relied on state support.

In sum, it appears that two types of South Korean firms have engaged in trade and investment with the North to date. Those operating outside the zone are more likely to be engaged in trade, less likely to be involved in manufacturing and rely less on credit. Those opting for Kaesong, by contrast, were almost all involved in manufacturing, were reliant on financing and actually had more negative assessments of the operating environment of North Korea than those operating outside the zone. These findings are important because they speak to the perceived risks of operating in North Korea. From the early opening of economic relations in the late 1980s through the imposition of sanctions in 2010, firms were free to take the risk of trading and investment in the North. But as both the trade data and our surveys show, risks are high and firms adjust their way of doing business with North Korea accordingly.

This pattern is very different than China-DPRK interactions. The Chinese firms engaging in cross-border trade are largely private, do not have substantial support from the Chinese government, if any, and have a limited belief in the ability of their government to protect them in the face of disputes. As a result, these firms are more likely to operate on commercial terms and exit if unprofitable. Contrary to one popular view, Beijing does not appear to be directing this engagement or using it to subsidize North Korea. The Chinese government seems to be sending a strong signal both to North Korea and to Chinese firms that it will not intervene to subsidize risk. However, this may change going forward as both the Chinese government and firms tire of the difficulty of doing business in the country. China is also exploring its own “enclave” options, for example in the development of the Rason and the Hwanggumpyong and Wihwa Island zones; we return to this “zone” strategy in more detail below.
The Twists and Turns of Trustpolitik

In her widely-read *Foreign Affairs* piece, Park Geun-hye sought to move the newly-named Saemuri party back to the political center on North Korean issues. As with Kim Dae-jung’s “sunshine policy,” Park made clear that a new government would not tolerate provocation nor close its eyes to the nuclear issue. But while arguing that engagement under Kim Dae-jung and Roh Moo-hyun didn’t work, she argued that “the governments in Seoul that have placed a greater emphasis on pressuring North Korea have not been able to influence its behavior in a meaningful way, either.”

A key feature of the Trustpolitik approach was economic. In an important campaign speech in November 2012, Park drew on a variety of past initiatives to present a range of opportunities to the North. At the broadest level, these included initiatives such as a “Northeast Asian Peace and Cooperation Initiative” modeled on the Organization for Security and Cooperation in Europe (OSCE or Helsinki) process, a “Eurasian” or “Silk Road” initiative that would reconnect North-South rail links, and multilateral economic support for the North. More modest proposals included a resumption of humanitarian assistance, the creation of North-South Exchange and Cooperation Offices in Seoul and Pyongyang, and more North-South special economic zones.

The fundamental dilemma facing the Park administration has been the question of reciprocity. The initial strategy was to start with very limited exchanges that could be tightly calibrated, with the larger projects as longer-run inducements. For example, appropriate humanitarian assistance might be offered in the context of a resumption of family visits, which the South always defined as an humanitarian issue. With progress on these issues, more ambitious ones could follow. For example, progress on the nuclear issue could open the door to the large-scale Vision Projects consisting largely of investment in much-needed infrastructure.

The problem that the policy faced from the outset, however, was what to do in the face of North Korean failure to reciprocate or even manifest provocations? Would it be politically possible to sustain the Trustpolitik approach in the face of the tensions of the first part of the year? Would the concept of reciprocity need to be abandoned? In fact, the approach was modified to allow for unrequited steps, particularly with respect to humanitarian assistance. Even as relations were starting to unravel in March 2013, the Park administration authorized modest humanitarian aid. But the military provocations of the post-test period and the North Korean decision to pull workers out of Kaesong tested the limits of unrequited measures, and forced a rethink of the strategy.

Even the Lee Myung-bak administration had kept Kaesong open. As the negotiations over the industrial park entered their endgame, Park Geun-hye showed unusual resolve, backed by overwhelming public support. She signaled that in the absence of a more forthcoming and institutionalized approach to the zone—including stronger guarantees against further political manipulation—she would draw on an insurance fund against political risk to pay out firms in the zone and shut it down completely. This prospect proved too much even for the hardliners in Pyongyang. By August there were already signs of a larger political thaw and a settlement was reached that ultimately allowed the zone to reopen in September.

In October, the Ministry of Unification began circulating a pamphlet that provided a restatement of the Trustpolitik concept. Although the document made reference to the significance of making progress on the nuclear issue, that linkage would not be tight; “it would not be feasible,” the pamphlet noted, “to relate every inter-Korean issue to the North Korean nuclear program.” An important signal buried in the document was also the willingness to abide by inter-Korean agreements, presumably including the 2000 and 2007 summit documents that the North has always championed as the keystone of the North-South relationship. The 2007 document in particular contained a variety of quite ambitious joint development projects.

The core approach, however, remained the one outlined prior to Park’s assumption of the presidency: to begin with small steps that would hopefully build into an overall improvement in the political climate. Humanitarian assistance and the reopening of Kaesong were followed by on again, off again process with respect to family reunions, which were ultimately held in February 2014. The Park government also subtly relaxed the May 24 measures following the Park-Putin summit in November 2013 to permit indirect investment in the rail project connecting Rason to Russia.

The Trustpolitik approach now faces two central challenges. The first is the difficult choice the South has to make between different modalities of economic exchange with the North. At one end of the spectrum of choice is a more hands-off, commercial approach that permits trade and investment but leaves firms to make their own economic decisions. A similar approach could be taken with respect to NGOs: allow them to function as they wish, but without state support. This approach would require the politically difficult move of lifting the May 24 sanctions, but has the important advantage of forcing North Korea to make choices about policy toward trade and investment; to use Kim Dae-jung’s felicitous phrase, it separates economic and politics. It also has the advantage that investments made will reflect North Korea’s comparative advantage rather than a more purely political logic.
The drawback is that Pyongyang is unlikely to see such a purely commercial approach as yielding adequate gains to the regime. Indeed, it is unlikely to see such a gesture as much of a concession at all, despite the regime’s continual complaints about sanctions. Rather, Pyongyang will seek its own form of political and economic linkage: tying economic progress to a political agenda, involving the South Korean government in joint projects such as Kaesong and demanding outright assistance.

The second modality of economic engagement might be called the “zone model.” Given that firms are hesitant to invest in the absence of infrastructure and guarantees, the only way to get trade and investment going is to effectively subsidize it and insure against political risk. The bet of this approach is that the zones will be the leading edge of a more gradual reform not only of the external sector but of the domestic economy as well. In both export-oriented capitalist countries, including South Korea, as well as socialist regimes such as China and Vietnam, export-processing zones became an important way station on the road to greater economic openness and integration.

Yet this may not be the case in North Korea, at least in the short run; rather, the quest for foreign investment may be a substitute rather than a complement to domestic reforms. As of this writing, this appears to be the case. The incremental but nonetheless serious economic reforms discussed during Kim Jong-un’s first year in office have all but evaporated while attention has shifted to attracting FDI, particularly in the wake of the execution of Jang Song-thaek.

The other disadvantage of this approach is that its socializing effect may be limited. A central dilemma of the entire engagement approach is that the North Korean regime exercises direct control over foreign investment and trade; only indirectly are such ties promoting the process of marketization. The regime exercises strong control over the zones as well; indeed, the zones precisely permit such control, particularly over labor. Payments go not to North Korean firms and workers, but directly to the government. Does this particular form of engagement encourage marketization and opening—as it arguably did in South Korea and China—or freeze the status quo in place? The pursuit of the zone strategy by both South Korea and China might be seen not as a signal that North Korea is changing, but rather an admission that it is not.

Finally, there is the question of exactly how much aid and of what sort to provide. There is no question that humanitarian aid had positive effects on the welfare of North Korean citizens. But to date, such aid has been extremely modest and is by no means large enough to leverage reform of the agricultural sector that would be needed to improve productivity and reduce dependence on food aid.

“At one end of the spectrum of choice is a more hands-off, commercial approach that permits trade and investment but leaves firms to make their own economic decisions.”

To its credit, the Park administration has shown no interest in a return to ongoing large-scale food and fertilizer assistance, to which the North Korean regime responded by simply cutting commercial imports and diverting resources to other uses.

Large-scale infrastructure investments—particularly if publicly financed—face the same moral hazard problems. They will not yield their expected social returns in the absence of complementary reforms. Rather, they will be white elephants, as KEDO’s light-water reactor proved to be and the current North-South rail links remain. Moreover, the scale of these projects will inevitably require private participation. Particularly in the case of large fixed and immobile investments such as pipelines and rail, private actors will be highly reluctant to engage without public guarantees that could land on the doorstep of the South Korean government. South Korean participation in the rail project connecting Rason to Russia may work because of the ability of Russia to act as an effective guarantor. Purely bilateral projects run much larger political risks for both the South Korean government and international investors. It is not coincidental that few of the Korean chaebol have been willing to pursue the North Korean market.

These observations about the modality of exchange take us to the second and closely related problem with the Trustpolitik approach: that its shape will ultimately depend on choices made by the North. The North Koreans may well see the entire Trustpolitik approach as a trap. If it generated an internal consensus in South Korea on North Korea policy, it could erode the North’s leverage. At a deeper level still, it is no doubt difficult for the North Korean leadership to decide exactly how much trade and investment it actually wants from the South and on what terms. Outside of the zones—and even in them—such trade could have highly corrosive effects as North Koreans see the South Korean alternative not via smuggled DVDs but in large-scale joint projects, the factory floor and an expansion of NGO contact.
Conclusion: The Likely Way Forward

At present, it appears that the most likely course of Trustpolitik over the next two years will be precisely the sort of incremental steps that the initial approach envisioned. One cluster of initiatives will center on the quid-pro-quo’s already outlined: modest humanitarian assistance for family visits. If these steps make progress, they will raise the difficult question of the reopening of the Mt. Kumgang tourist resort, at which a South Korean tourist was killed by a North Korean soldier in 2007. Given that the North Koreans have shown little willingness to provide public assurances with respect to safety—and have even formally expropriated the property—these negotiations will be difficult.

The second locus of cooperation will continue to be Kaesong. In reopening Kaesong, North Korea has agreed to a complex set of governance arrangements that appear to shift authority over the zone to a binational commission. However, as the South learned in 2013, there is little it can do with respect to a zone that sits on North Korean territory; the new structures have not been tested. Nonetheless, North Korean willingness to abide by these new rules, including a dispute settlement mechanism, could provide the basis for a South Korean effort to internationalize and even expand the zone. A key question that will be asked, particularly on the right in South Korea, is what the Park administration gets in return for efforts that increase the flow of foreign exchange to the North Korean regime. This is not an easy question to answer.

The third area of possible cooperation is Rason. After languishing for years, the zone is on the verge of meeting at least some of its promise. The Chinese have surfaced the dirt road linking Hunchun with Rason, reportedly upgraded the road from Rason to Chongjin, and are now investing in power lines to the zone. The Russians have finished the first phase of refurbishing the rail link; the Park administration has signaled a willingness to allow the state-owned Korea Railroad Corporation to participate in this project, although such participation is by no means assured. There is plenty left to do at Rason, including dredging the harbor, further developing it, and investing in power generation. A possible justification for participation in such projects would not only be South Korea’s ability to use the port as a transshipment site—a material quid pro quo—but the fact that North Korean law appears to give unusual power and discretion to the Rason City People’s Committee. Investment in Rason could support the localization of decision-making and greater pragmatism, which is currently beyond the scope of the Kaesong experiment.

Two further predictions are relatively easy to make. There will clearly be no return to the open-ended assistance of the Kim Dae-jung-Roh and Moo-hyun eras. Indeed, an interesting feature of the new Trustpolitik documents is the suggestion that Seoul would channel more assistance to the North via multilateral channels that are less politicized, an idea that deserves support. Second, the uncertain course of North Korean economic policy and the corresponding risks to both governments and firms make it highly unlikely that large-scale investment projects will serve as icebreakers; as KEDO demonstrated, they are simply too costly to risk. At this point, the more ambitious elements of the Trustpolitik project, from the idea of “Green Détente” and the building of a peace park in the DMZ to investment in electricity, transportation and telecommunication are necessarily in the future. More distant still is the effective revival of the Roh Moo-hyun idea of a Northeast Asia Peace and Cooperation Initiative that would embed North-South relations in a broader multilateral context.

What has not received the attention it deserves is the quite different approach to North-South engagement suggested by our review of the history: what might be called Chinese-style engagement. Rather than seeking out joint public projects, the Park administration might think more seriously of a private sector-led strategy. This would require a reversal of the May 24 measures that were instituted following the sinking of the Cheonan, an admittedly difficult decision. But it would have important advantages that more public strategies have lacked. By backing the government out of the equation, it would force South Korean firms and the North Korean government to jointly decide what has to be done to make economic engagement work.

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2 These exports were nominally financed by “loans” to the North, but needless to say have never been paid back.
3 KOTRA has a reasonable track record in eliminating obvious discrepancies in the data, which is based on mirror statistics from North Korea’s partners. But it has underestimated the growth of North Korea’s trade with developing countries and these figures for five-party shares may thus be biased upwards.
### Leading Economic Indicators for Korea

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<td><strong>Consumer Prices (%)</strong>&lt;br&gt;Annual Change at 2010=100 Constant Prices</td>
<td>2.8</td>
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<td>2.8</td>
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<td><strong>Unemployment Rate (%)</strong></td>
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<td>3.2</td>
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Bank of Korea  
National Statistical Office  
Ministry of Knowledge Economy  
OECD