

PERSPECTIVE

Tensions Rise on the Korean Peninsula

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The world is watching the Korean peninsula. The situation between North and South Korea has been tense for a long time, but it has been escalating amid increasingly bold rhetoric and threats from the leaders of North Korea and the United States.

When North Korea's leader, Kim Jong-un, threatened a missile attack on the island of Guam (a US territory) and launched a missile over Japan, the situation became even more highly charged. North Korea has been developing a nuclear program for more than 30 years, and despite warnings from the United States and others, it has actually accelerated.

Kim and Trump have been engaging in a Twitter war, with creative name-calling on both sides. And in a show of force, eight US aircraft recently skirted North Korea's coastline, which was the furthest north of the demilitarized zone between North and South Korea that American warplanes had flown since North Korea started testing ballistic missiles and nuclear weapons in the 1990s.

The sanctions against North Korea the United Nations (UN) Security Council unanimously passed at the beginning of August 2017 were a big step forward in terms of resolving the situation through diplomatic means. However, there is much "leakage" in the global financial system that could still enable the North Koreans to transfer money around the world, possibly using Bitcoin and other cryptocurrencies to evade sanctions.

Governments have found it increasingly difficult to implement sanctions on North Korea because of its proximity to China and China's reluctance (at least so far) to implement drastic embargoes. But I think China is key in terms of helping to resolve the situation.

Trade between China and North Korea has been substantial, but China has so far been unwilling to show much displeasure with North Korea's actions. As part of the UN sanctions, China recently announced it would impose an immediate ban on textile imports from North Korea and would limit oil exports starting in 2018.

The Chinese also announced sales of liquefied natural gas and condensate oil to North Korea would be banned outright. This was after Beijing cut off purchases from North Korea of coal, iron ore and seafood as well as other goods. Since China accounts for about 90% of North Korea's trade, these sanctions could eventually have an impact.

Some media reports indicate the Chinese could be reluctant to cut off trade completely for fears a North Korean government collapse could trigger a mass migration into China. Sanctions don't just impact governments, they hurt ordinary citizens. If all the oil exports from China to North Korea stopped, some observers speculate Russia might take over that role.

Observations on North Korea

In a commentary in the *Wall Street Journal* in August 2017, former US Secretary of State Henry Kissinger mentioned that although North Korea had not developed an operational intercontinental ballistic missile (ICBM) arsenal, its short- and intermediate-range missiles were already a threat to countries like Vietnam, South Korea and Japan. Those countries could therefore be incentivized to develop their own nuclear weapons, which would mark an ominous turn for Asia and the world. Of most concern to China would be the development of an armed force in Japan capable of offensive action.

Information about North Korea is generally sketchy, but over the years a number of North Korean defectors have arrived in South Korea and have talked about the situation there. While I haven't personally been to North Korea, a doctor I know was recently in Pyongyang and shared some of his observations. A surgical expert, he was asked to perform some very specialized operations and also give instructions to North Korean doctors. The doctors he met there impressed him and seemed to be living well. He said they were quite knowledgeable and had access to foreign journals and internet sites that gave them information about medicine globally.

The Chinese are able to travel to North Korea on tours, and a Chinese friend of mine relayed his experiences there, too. He's a very perceptive person, and despite efforts to impress him and his group, he saw through that and confirmed most of North Korea was in fact very poor.

Tourists to North Korea—even Chinese tourists—are held with a tight leash and always arranged in a group with a set itinerary. Each place my friend visited looked impressive, but as soon as the group left, the lights went off. One day he told the tour guide that he was tired and wanted to stay in the hotel, but the guide pleaded with him to come on the tour and he finally relented. He figured that perhaps to save electricity, the hotel's power was turned off after the entire tour left. In the countryside, he noted farming was all manual and quite primitive. Men and women built roads breaking stones by hand to create aggregate.

Journalists from other countries have from time to time been offered a glimpse into life in North Korea, confirming the tightly controlled government tours of Pyongyang. Those visiting recently have reportedly been met with various affirmations (including visible signage) that North Korea was not going to back down on its nuclear ambitions. Children could be seen playing with toy rockets and sculptures of atoms. And, there apparently is all kinds of bomb imagery. Even a bakery had an upright rocket cake on display for foreign visitors to see. The bottom line is that it seems the North Koreans don't want to give up their nuclear capability, even if it is to their peril.

Wanting a better understanding of the sort of psyche in North Korea, I recently picked Adam Johnson's novel, *The Orphan Master's Son*, which won the Pulitzer Prize for fiction in 2013. Set in North Korea, apparently Johnson's interest in writing the book came from his exploration into the language of propaganda. It paints a captivating portrait of life there. Even though it's fiction, I think the book can offer us a better understanding of what might be going on in North Korea, since so much is related to the indoctrination and the 24/7 propaganda that has created a cult around the Kim dynasty.

Although there have been many reports of famine and energy shortages in North Korea, there has been evidence of economic growth there in recent years. Visitors have noticed improvements, at least in the capital Pyongyang. South Korea's central bank does research on North Korea's economy and has estimated the economy grew by almost 4% in 2016, although that is certainly from a very low base. A substantial part of the growth is estimated to have come from weapons manufacturing.

US-South Korea Relations

The relationship between South Korea and the United States has been very strong in view of their history going back to the Korean War in the early 1950s. Of the 150,000 US troops currently in more than 70 countries around the world, 28,500 are estimated to be in Korea.¹ The US military presence has declined over the years, so the South Korean government has had to increase its forces in order to ensure adequate defense.

South Korea does pay money to the United States to support the American troops based there—more than US\$800 million annually since 2014 alone.² Besides direct cost sharing, Korea spends a significant amount on weapons purchases from the United States. From 2014 to 2016, South Korea purchased more than US\$1 billion worth of US weapons.³ South Korea is also spending billions more for new construction and relocation of older US bases.

Besides the military aspect, the trade relationship between the United States and South Korea also bears watching. The new Trump administration has called for fairer trade between the two countries. US officials have stated that when South Korea's currency appreciates or depreciates too much at a certain point in time, it disturbs the market and therefore hurts American companies.

Currently, South Korea is one of six countries on the US Treasury Department's "monitoring" list for potential currency manipulation. The list also includes China, Japan, Taiwan, Germany and Switzerland. To note, no US trading partners (including these countries) were actually labeled as such in the [most current report](#).⁴

As South Korea has met some of [the criteria](#) the United States uses to consider a country a manipulator (although again, it has not officially labeled South Korea one), the US government began a process to demand special trade negotiations. This trade relationship going forward is worth noting, as the dynamic could change.

After the Korea-USA Free Trade Agreement (FTA) went into force in 2012, the trade surplus with the United States increased sharply to more than US\$20 billion in 2016, double that of 2011.⁵ The United States imports many goods from South Korea, including vehicles, machinery, pharmaceuticals and mineral fuels.

Trump claimed the FTA brought loss of about 100,000 US jobs, although some have disputed that claim. South Korea recently rejected a US proposal to revise the trade deal, citing the need for further study as to the causes and impacts of the trade deficit.

South Korea has already lowered its dependency on the United States quite significantly during the past 10 to 15 years, while China has emerged to become a major trade partner. In order to minimize the Trump administration's protective trade policy, South Korea seems likely to import more US products, especially in regard to oil. South Korea started to import US shale oil starting in November 2016.

Most South Koreans (including some of my colleagues) have been living with the threat from North Korea from the day they were born. So, what is happening now is not surprising to them and as in the past, the threats have not deterred them from going about their business and attempting to improve their lives and the lives of their families.

Of course, a nuclear war represents a potential global disaster, so there really is no way to plan for it, at least from an investment standpoint. We just have to try to keep calm and carry on for the time being.

In upcoming blogs, I'll report on my recent trip to South Korea and the investment opportunities we currently see there as we hope for a peaceful resolution of the current situation.

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[1.](#) The Heritage Foundation, 2017 Index of US Military Strength.

[2.](#) US Congressional Research Service, "US-South Korea Relations," May 23, 2017.

[3.](#) Source: Stockholm International Peace Research Institute.

[4.](#) US Department of the Treasury, "Foreign Exchange Policies of Major Trading Partners of the United States," April 2017.

[5.](#) Office of the United States Trade Representative, United States Census Bureau.