

# RISKS TO WATCH

# SOUTH KOREA

North and South Korea exchanged artillery fire on Nov. 23, triggered when Pyongyang's military launched 170 rounds in and around a South Korean island near disputed sea border. The incident, which killed two civilians and two Marines, marked a sharp escalation of tension between the rivals, punctuating a series of conciliatory moves in recent months that appeared headed for renewal of dialogue, after ties sank to their lowest point in years when a South Korean navy ship was torpedoed in March, killing 46 sailors. North Korea is entering what could be a lengthy period of leadership transition fraught with uncertainty, after Kim Jong-il's youngest son surfaced in September as heir apparent, which could push the risks to South Korean asset prices upwards.

## CONFLICT WITH THE NORTH

North Korea did what had been almost the unthinkable: struck at a South Korean civilian area. The attack dramatically raised the risk level for the Korean peninsula and across north Asia, which accounts for one-sixth of the global economy. The incident was a reminder that the North could lob thousands of artillery rounds into more populated and developed areas of the South, including the dense capital region of Seoul, home to about half of the country's population, and fire missiles at cities in the South and in Japan, causing crippling economic damage.

Analysts still believe war is unlikely. North Korea's obsolete conventional armed forces and equipment mean quick and near certain defeat if it wages full-scale war, and Pyongyang is well aware of its limitations. Even though it has exploded nuclear devices, North Korea has not shown it has a working nuclear bomb. Experts say they do not believe the North has the ability to miniaturise an atomic weapon to place on a missile.

South Korean President Lee Myung-bak has ordered a review of the military's rules of engagement to strengthen response to any attack by North Korea, especially against civilian areas. It will also consider reinforcing military assets and troops on the islands that lie close to the disputed sea border with the North, the scene of fatal naval clashes in previous years.

### What to watch:

- Further aggression by the North. Artillery shots were heard from a South Korean island three days after the attack, a reminder to the few residents who have chosen to remain there that rounds can start raining down on them any time.
- Another major provocation by the North, such as a repeat of the March sinking of the Cheonan corvette, would be negative for South Korea's won, stocks and bonds. Markets had become relatively immune to sabre-rattling by Pyongyang but in the current climate of heightened risks they are more susceptible to geopolitical tensions.

## REUNIFICATION

Besides war, the second major risk scenario for markets would be the implosion of the North Korean regime, leading to sudden reunification. Most estimates say it could cost Seoul more than \$1 trillion to absorb its impoverished neighbour. As well as the enormous fiscal costs, South Korea would have to deal with the possible influx of millions of refugees and the social upheaval that this would cause in the South. Tensions with China could spike as Beijing tries to protect its interests, and influence the future of North Korea which it has used as a buffer against pro-Western states.



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## RISK DATA BOX

<b>Sovereign foreign currency:</b>	
S&P	A (stable)
Moody's	A1 (stable)
<b>World Governance Indicators:</b>	
Voice & Accountability	68.2
Political Stability	52.4
Govt Effectiveness	83.3
Regulatory Quality	75.2
Rule of Law	82.5
Control of Corruption	71.4
<b>Eurasia Group</b>	
GPRI score	72
<b>IHS Global Insight</b>	
Country risk	2.09
Sovereign	A+ (stable)

North Korean leader Kim Jong-il shows his ballot during the 12th Supreme People's Assembly in Pyongyang, April 9, 2009 in this frame grab taken from footage released by KRT  
REUTERS/KRT via Reuters TV

South Korean President Lee Myung-bak has proposed a new tax to help fund the eventual bill for reunification, but the suggestion met a lukewarm response.

### What to watch:

- The appointment of Kim Jong-un, youngest son of the leader, to key positions confirms that he is the chosen successor. Rising with him are Kim Jong-il's sister and her husband, creating a powerful triumvirate ready to take over the family dynasty that has ruled North Korea since its founding after World War Two. But given the parlous economic condition of the country, the ruling elites have an ever-shrinking share of the spoils to divide between them, and there is always the chance that other powerful blocs, particularly within the military, try to make a power grab.
- Clues about the stability of the North Korean regime. The North's decision to revalue its currency in late 2009 sparked rare internal protests, and Kim Jong-il's efforts to push through new measures to reassert control over the sanction-hit economy may further destabilise his regime.
- Clues about Kim Jong-il's health. He is widely believed to have suffered a stroke in 2008. If he were to die or become incapacitated before Kim Jong-un has a firm grip on power, the chances of upheaval and regime collapse would be much greater.

## KEY DATES

- **December 1, 2010**  
Chinese State Councillor Dai Bingguo expected to visit North Korea
- **December 2, 2010**  
Japan's Defence Ministry symposium on security after Cheonan sinking
- **February 16, 2011**  
North Korea celebrate's the birthday of its leader Kim Jong-il
- **2012**  
National elections in South Korea

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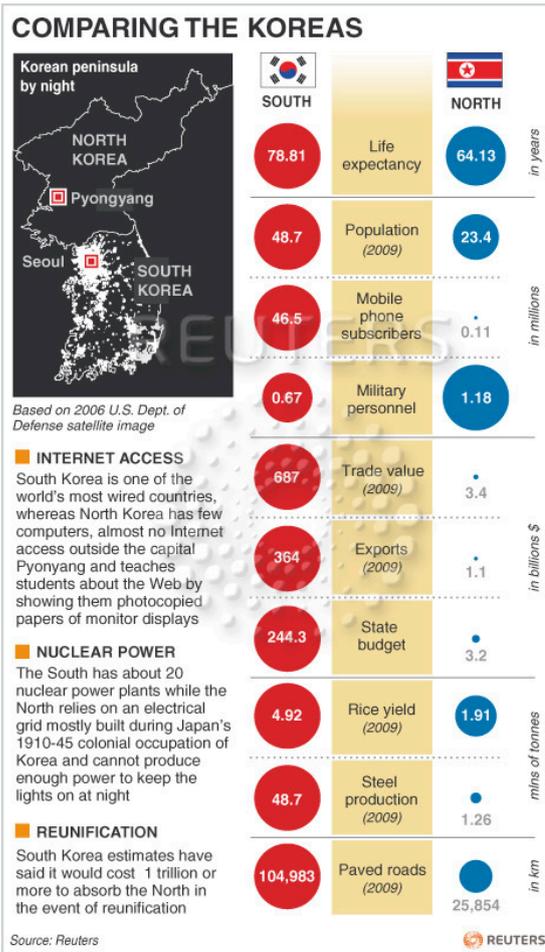
**GOVERNMENT EFFECTIVENESS AND REFORM**

South Korea is regarded as having a high-quality bureaucracy but policymaking and progress on economic reforms are often stymied by fractious politics. It is not uncommon for sessions of parliament to be disrupted and blocked for days or weeks at a time, hampering the implementation of policies. President Lee's Grand National Party (GNP) has control of parliament, but his legislative agenda was held up for months this year in a row over plans to move some ministries to a new administrative capital.

As Lee looks to secure his legacy as a reformer, he has made clear in recent weeks that his focus is on middle- and working-class welfare as much as improving business conditions. A ruling GNP legislator who is a confidant of Lee has proposed abandoning plans for tax cuts in order to secure the resources needed for welfare projects, fuelling a potentially divisive debate inside the party.

**What to watch:**

- Budget deadline. Work has been slow to review and approve the government budget by the Dec. 2 constitutional deadline, adding to the likelihood that parliament will again miss it. The possibility of beginning a new fiscal year on Jan. 1 without a budget is slim, however, as parliament customarily strikes a deal before midnight on New Year's day.
- Will progress be finally made on a free trade deal with the United States? Top U.S. and South Korean trade officials met in late October, only the start of what would be a gruelling process to iron out differences and concerns among U.S. automakers, more than three years after the deal was signed.



**RISK DATA**

**JLT Group**

Strikes, riots & civil unrest	4
Terrorism	3
War & civil war	3
Economic risk	4
Currency risk	2
Sovereign risk	4
Expropriation	2
Contract repudiation risk	4
Legal & regulatory risk	3

**Coface**

Country rating	A2
Business climate	A2

**Transparency International**

Corruption Perceptions Index Score	5.5
Rank (of 180)	39

**World Bank Doing Business**

Rank (of 183)	19
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**WEF Global Competitiveness**

Score	4.93
Rank (of 133)	22

**Reporters Sans Frontières**

World Press Freedom Index Score	13.33
Rank (of 175)	42

