

**ORIGINAL ARTICLE**

# South Korea's "3-D" Problem: De-risking and Diversifying in Response to China's Economic Coercion

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**Abstract**

*China has used coercive economic measures against South Korea since 2017 to retaliate for the installation of the THAAD anti-ballistic missile system, but little is known about the Korean strategy for responding to these measures. Informed by interviews with foreign policymakers, business leaders, and scholars of international relations in Korea, this essay reinterprets the politics of international trade in an age of great-power rivalry from the perspective of middle powers. It does so by using Albert Hirschman's insight that great powers tend to abuse the influence that stems from holding a dominant economic position against their smaller international counterparts, but in so doing create incentives for middle (and small) powers to reduce their exposure to such asymmetric trading relations. We use three cases to illustrate how South Korean firms and policymakers have responded with a strategy that seeks to manage the risks of co-existing with China ("de-risking" and "diversification") rather than completely escaping from the Chinese economic orbit ("decoupling"). In doing so, we illustrate the impact of and limits to coercive statecraft and the strategy that Korea has pursued in response to its "3-D" problem.*

**Introduction**

Scholars of foreign policy have long grappled with the question of whether economic and security interests can be achieved simultaneously. Statists argue that security interests should always trump those related to trade in foreign policy, while the liberal view is that these interests need not come into conflict and that each should be pursued on their merits.<sup>1</sup>

In recent years, as several Western and Western-leaning states have been embroiled in disputes with China (which for many is their largest trading partner), three strategies have been proposed as responses to the security/economics

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1. Vinod K. Aggarwal and Kristi Govella, eds., *Linking trade and security: Evolving institutions and strategies in Asia, Europe, and the United States* (New York: Springer, 2013).

2. Reuters, “Trump again raises idea of decoupling economy from China”, 16 September 2020, <https://www.reuters.com/article/usa-trump-china-idUSKBN25Z08U>.

3. See e.g., Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, “*De-risking*” within *MON-ETVAL states and territories* (Brussels: Council of Europe, 2015).

4. Sue Mi Terry, ed., *Between the Eagle and the Dragon: Challenges and opportunities for South Korea in the U.S.–China competition* (Washington: Wilson Center, 2022).

5. See, respectively, Erik Gartzke, “The capitalist peace”, *American Journal of Political Science* 51, no. 1 (2007): 166–91; Celeste Beesley and Scott Cooper, “Micro-foundations of the commercial peace: The effect of net exports on Ukrainian attitudes towards war with Russia”, *Journal of Peace Research*, 2022. <https://journals.sagepub.com/doi/abs/10.1177/00223433221109621>.

6. Jaewoo Choo, “Defending against China’s economic coercion: Strategic options for the ROK–US alliance”. In *Between the Eagle and the Dragon: Challenges and opportunities for South Korea in the U.S.–China competition*, edited by Sue Mi Terry (Washington: Wilson Center, 2022), 61–67.

7. David Hundt, “Free trade agreements and US foreign policy”, *Pacific Focus* 30, no. 2 (2015): 151–72.

8. David Hundt and Sooyoung Kim, “Elite opinion and the ‘Belt and Road’ debate in South Korea”, *Pacific Affairs* 92, no. 1 (2019): 27–48.

9. World Bank, “Exports of goods and services (% of GDP)–Korea, Rep.” *World Bank: Data*, 3 May 2023. <https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS?locations=KR&view=map>.

10. Aya Adachi, Alexander Brown, and Max J. Zenglein, “Fasten your seatbelts: How to manage China’s economic coercion”, *China Monitor*, 25 August 2022.

11. Xiaolin Duan, “Domestic sources of China’s wolf-warrior diplomacy: Individual incentive, institutional changes, and diversionary strategies” *Pacific Review*, 2023. <https://www.tandfonline.com/doi/abs/10.1080/09512748.2023.2205163>.

trade-off. The purest distillation of the statist view has been *decoupling*, which implies a conscious reduction in trade volumes and even severing of commercial ties with actual or prospective adversaries. This strategy has achieved its greatest resonance in the United States (US) foreign policy establishment, especially during the Trump era.<sup>2</sup> *De-risking* and *diversification*, meanwhile, have been proposed by both statist and liberals as more moderate and less confrontational alternatives to decoupling. These strategies, which have their roots in Europe rather than the US, imply a less sudden and comprehensive reduction in trade volumes and arrangements, and instead call for commercial ties with would-be adversaries to be reorganized.<sup>3</sup> Diversification—the search for new markets—might be seen as part-and-parcel of everyday international trade, but de-risking is more explicitly political, in that adversaries themselves are deemed to be sources of risk.

A litmus test for these proposed strategies has been the long-running attempts by middle (and small) powers in East Asia and the Pacific, such as South Korea (ROK), to maintain a balance in their interests, whereby the United States (US) has been a major security guarantor while China has been a dominant economic partner.<sup>4</sup> Since the establishment of diplomatic relations in the early 1990s, bilateral economic relations between China and South Korea have expanded exponentially. In an arrangement akin to a “capitalist” or “commercial” peace,<sup>5</sup> three decades of economic enmeshment have brought the two countries together, although there still are key differences in their political systems, in their views of North Korea, and in their opinions about the value of the US security presence in East Asia and the Pacific. Nonetheless, mutual economic benefit has disguised these differences,<sup>6</sup> and the signing of a bilateral free trade agreement (FTA) in 2014 solidified China’s position as Korea’s largest two-way trade and investment partner.<sup>7</sup> In 2018, South Korea even joined China’s Belt and Road Initiative despite the misgivings of its American ally, in part due to what were perceived as the overwhelming economic benefits to be gained from closer integration with China.<sup>8</sup>

While the scale of bilateral trade continued to grow, the overall pattern morphed into one less favorable to the Korean side: indeed, South Korea’s trade dependency on China is one of the highest in the world, at more than US\$150 billion in both 2020 and 2021.<sup>9</sup> This disadvantageous development coincided, and was partly the result of, the various forms of economic retaliation that China has initiated against South Korea. What has made these economic measures particularly unsettling is their informal nature, often under the guise of “soft bans”, boycotts, the seeding of popular discontent, and the arbitrary imposition of regulatory measures, rather than outright violations of preferential trading relations,<sup>10</sup> which are assumed to apply when countries have signed an FTA. These actions can be mainly attributed to the fallout of the Terminal High Altitude Area Defense (THAAD) affair in 2016/17, whereby China expressed its displeasure with the decision of the South Korean government to install a US-designed missile defense system, on the grounds that it would nullify not only an attack from North Korea but in the process degrade China’s offensive capacities.

The emergence of coercive statecraft in Chinese foreign policy—or what is sometimes referred to as “wolf warrior diplomacy”<sup>11</sup>—throws into doubt the assumptions of both the statist and the liberal interpretations of the politics of international trade. If liberals were too optimistic in assuming that high levels of economic interdependence make coercive actions unthinkable, they have also underestimated the ability and desire of states to weaponize trade through informal channels. The statist analysis of the politics of trade, meanwhile, has overestimated the ability for policymakers to dictate terms to the private sector,

12. Editorial Board, "The gaping 'national security' hole in the world trade regime" *East Asia Forum*, 2 October 2023. <https://doi.org/10.59425/eabc.1696248924>.

13. Albert O. Hirschman, *National power and the structure of foreign trade* (Berkeley: University of California Press, 1945).

14. Albert O. Hirschman, "Beyond asymmetry: Critical notes on myself as a young man and on some other old friends", *International Organization* 32, no. 1 (1978), 47.

15. Interview 4, 2022.

16. Robert Gilpin, *U.S. power and the multinational corporation: The political economy of foreign direct investment* (New York: Basic Books, 1975), 39–41.

17. Gilpin, *U.S. power and the multinational corporation*, 198.

18. Pavel Yakovlev and Brandon Spleen, "Make concentrated trade not war?" *Review of Development Economics* 26, no. 2 (2022): 661–686.

including in decisions about where to build production facilities. According to one recent analysis there is "a gaping 'national security' hole" in global trade that allows and even encourages states to prioritize the security aspects of foreign policy,<sup>12</sup> but most countries recognize that doing so is detrimental to international trade and best avoided. The challenge for policymakers is not so much to avoid trading with potential adversaries but to minimize the risks of doing so, as advocates of de-risking might suggest.

To better understand how the ROK has tried to navigate the politics of trade in relation to China, this article draws on interviews conducted with business leaders, academics, and policymakers in South Korea in late 2022 and early 2023. The article analyses the countermeasures that Korea has adopted, with varying degrees of success, to combat China's coercive measures. Albert Hirschman's diagnosis of the politics of international trade during WWII, and especially what he saw as the abuse of asymmetric economic power by states such as Nazi Germany, informs the study.<sup>13</sup> Hirschman argues that smaller states (including those we would now classify as middle powers) have some capacity to withstand the worst effects of coercive statecraft: They may not avoid this tactic, but coercion "contain[s] the 'seeds of its own destruction'"<sup>14</sup> and is thus ultimately self-defeating and unsustainable.

According to a former diplomat, China's imposition of trade measures has had a "long-term negative impact"<sup>15</sup> on the Korean public, government, and business sector. Nonetheless, policymakers and business leaders have been somewhat at odds on the best path forward for managing Korea's relations with China. The strategy that they have adopted better fits the definition of de-risking and diversification rather than decoupling, and it has allowed the ROK to partially reorganize its international trade relations such that its exposure to Chinese coercion has been reduced in recent years. The article illustrates Korea's practice of de-risking and diversification through 1) the forced exit and relocation of Lotte's retail chain in China, 2) the search for new markets beyond China for cultural industries, and 3) the partial reorganization of the semiconductor sector, via the solidification of existing production networks in China as well as reshoring and the formation of new strategic alliances.

### Shattering the capitalist peace in Northeast Asia: the rise of informal sanctions

As noted above, statist and liberals differ in how they see the best arrangement of the economic and political aspects of foreign policy (trade and security, respectively). For statist such as Robert Gilpin,<sup>16</sup> international politics is a contest between national economies, so economics is subordinate to other concerns, especially security. In the 1970s, however, Gilpin was concerned that the United States was "exporting or trading away its comparative advantages", namely "technology, technical know-how, and management",<sup>17</sup> a development that he believed was antithetical to the national interest. A shortcoming of the statist approach is its assumption of a singular national interest, shared by the state, citizens, and the private sector alike. But since firms are positioned differently within the economy and have different abilities to exploit opportunities for trade, the coercive measures imposed by other states do not fall uniformly on a targeted state or the firms based within it.<sup>18</sup> This fact makes it more difficult to coalesce economic actors around a given definition of the national interest.

Contrastingly, the liberal prognosis is far less concerned about the implications of the type of economic enmeshment, including the multitude of overlapping but uneven opportunities that Gilpin noted. Liberals proposed the notion that trade between nations is desirable, presupposing that economic interdependence

19. Daniel W. Drezner, Henry Farrell, and Abraham L. Newman, eds., *The uses and abuses of weaponized interdependence* (New York: Brookings Institution Press, 2021).

20. Michael E. Brown, Sean M. Lynn-Jones, and Steven E. Miller, eds., *Debating the democratic peace* (Boston: MIT Press, 1996); Bruce Russett and John R. Oneal, *Triangulating peace: Democracy, interdependence, and international organizations* (New York: W.W. Norton & Company, 2001).

21. Sebastian Rosato, “The flawed logic of democratic peace theory”, *American Political Science Review* 97, no. 4 (2003): 585–602.

22. Gartzke, “The capitalist peace”, 167.

23. Gartzke, “The capitalist peace”, 173; see also Patrick Gill-Tiney, “A liberal peace? The growth of liberal norms and the decline of interstate violence”, *Journal of Conflict Resolution* 66, no. 3 (2022): 413–442.

24. Hundt, “Free trade agreements and US foreign policy”, 152.

25. Yul Sohn, *The U.S. and China's FTA networks in Northeast Asia: How should South Korea respond?* (Seoul: East Asia Institute, 2012), 2.

26. Seungjoo Lee, *The evolutionary dynamics of institutional balancing in East Asia* (Seoul: East Asia Institute, 2012), 7.

27. Hundt, “Free trade agreements and US foreign policy”, 157.

28. Hirschman, *National power and the structure of foreign trade*.

29. Hirschman, “Beyond asymmetry”.

30. Henry Farrell and Abraham L. Newman, “Weaponized interdependence: How global economic networks shape state coercion”, *International Security* 44, no. 1 (2019): 42–79.

raises the costs of disruption to that exchange.<sup>19</sup> Following this logic, greater trade acts as an inter-state ballast, building more peaceful relations. Proponents of the democratic peace (DP) celebrated what they saw as the potential for democracies to avoid conflict and to promote peace and mutual prosperity,<sup>20</sup> but their critics noted that even if democracies avoided conflict with each other, it was difficult to establish a direct causal relationship between their political systems and/or practices on the one hand and their propensity for peaceful coexistence on the other.<sup>21</sup>

In this context the capitalist peace (CP) thesis was proposed as a more plausible explanation of peaceful inter-state relations. Great liberal thinkers such as Adam Smith, Montesquieu, and Ludwig von Mises have argued that peace comes from, and relies upon, economic development and trade. If the DP emphasized the role of democracy in promoting peace, its liberal stablemate CP “was guided by the philosophy of market economics”,<sup>22</sup> and especially the enmeshment of their economies and engagement with world affairs: “Financial or monetary integration leads dyads to be less likely to experience conflict” because “threats against another state become costly when threats spark market repercussions”.<sup>23</sup>

This logic that suggests potentially pacifying outcomes for states has led proponents to seek means of achieving further inter-state capitalist market integration, such as via free trade agreements (FTAs), which began to proliferate after the breakdown of multilateral trade negotiations in the mid-to-late 1990s. More correctly known as “preferential” trade agreements, in that they allow the best possible trading conditions, and extend a host of benefits, FTAs do not and cannot guarantee that trade will continue uninterrupted.<sup>24</sup> Nor do they assume or ensure that trade will not be politicized or made contingent on other considerations, such as security. Nonetheless, FTAs are the closest thing countries have to such commercial certainty, in that they make it “hard for the contracting parties to cut off relations... no country has pursued an FTA with a country that in future may become a potential enemy”.<sup>25</sup> States tend to be selective in their choices of FTA partners given the intermeshing of economies with potential or actual competitors may lead to future complexities. According to Seungjoo Lee, great powers do not sign trade agreements “purely on the basis of economic benefits” but rather “to reward military allies and strengthen their security status”,<sup>26</sup> a *quid pro quo* with smaller partners that may offer some benefit. As then-US Trade Representative Bob Zoellick said in 2003: “A free trade agreement is not something that one has a right to”, but instead is “a privilege... that must be earned”.<sup>27</sup>

To better understand the contemporary era, we turn to Albert Hirschman’s analysis of the politics of trade during World War II. According to Hirschman, “seemingly harmless” trade relations between two states can engender asymmetric interdependence, thereby offering great powers another form of political and strategic leverage over smaller, dependent states.<sup>28</sup> Three decades later, Hirschman revisited his original schema and noted that prospective target states have strong incentives to reduce their reliance on would-be dominant powers.<sup>29</sup> Even if these adjustments entailed some material costs, Hirschman suggested, there was a natural tendency on the part of would-be target states to minimize the ill-effects of interdependence.

As the Bush-era example cited above illustrates, the US has at times made international trade contingent on achievement of its political and security goals. A prime instance of “weaponized interdependence” was America’s use of its dominance within the SWIFT inter-bank clearing system to compel international cooperation to deny funds to non-state actors suspected of supporting terrorist organizations during the Bush era.<sup>30</sup> The US is not the only country to have weap-

31. Chia-Chien Chang and Alan H. Yang, “Weaponized interdependence: China’s economic statecraft and social penetration against Taiwan”, *Orbis* 64, no. 2 (2020): 312–333.

32. Dorothy J. Orchard, “China’s use of the boycott as a political weapon”, *Annals of the American Academy of Political and Social Science* 152, no. 1 (1930), 252.

33. Adachi, Brown, and Zenglein, “Fasten your seatbelts”; Darren J. Lim and Victor A. Ferguson, “Informal economic sanctions: The political economy of Chinese coercion during the THAAD dispute”, *Review of International Political Economy* 29, no. 5 (2022): 1525–1548.

34. Drezner, Farrell, and Newman, *The uses and abuses of weaponized interdependence*.

35. Lim and Ferguson, “Informal economic sanctions”.

36. Darren J. Lim, “Economic statecraft and the revenge of the state”, *East Asia Forum Quarterly* 11, no. 4 (2019): 31–32.

37. Adachi, Brown, and Zenglein, “Fasten your seatbelts”.

38. See e.g., Lim and Ferguson, “Informal economic sanctions”; Adachi, Brown, and Zenglein, “Fasten your seatbelts”.

onized trade in defense of its national interests. In China, the ruling Communist Party has made clear its intention of creating an international system conducive to the party’s continued monopoly on power, and coercive economic measures are a means to that end.<sup>31</sup> But a tendency to politicize trade can be found in earlier eras of China’s foreign policy history too. In the 1920s, for instance, China “put to effective use an economic weapon, the boycott... in defense of her[sic] sovereignty”, and these measures had a discernible impact: “Trade has been cut off, shipping dislocated, manufacturing depressed, and the economic life of the boycotted nation severely disturbed”.<sup>32</sup>

This willingness to use its asymmetric trade relations with other states continues to the present. As US–China relations have increasingly come into friction, China’s efforts have been directed especially towards those allied to the US, such as Australia and South Korea, as a means of broadcasting its displeasure to other states. The use of informal economic measures has gained momentum and expanded in scope. Between 2010 and 2022 there were 123 cases of China harnessing economic interdependence to target foreign firms, industries, and other entities, through boycotts, threats, and defensive trade measures, as well as “soft bans” on trade and restrictions on tourist arrivals.<sup>33</sup> These tactics are more subtle than formal sanctions and are increasingly preferred as they minimize possible legal challenges at the World Trade Organization, thereby allowing for plausible deniability. The unofficial nature of these measures allows them also to be more easily wound back and to delay effectively targeted countermeasures from receiving states.<sup>34</sup> These measures are also unilateral without receiving international support.

### The “3-D” problem and Korea’s response to coercive statecraft

The origin of the recent bout of Chinese coercive statecraft directed at the ROK lay in the decision in 2016 by the Park Geun-hye government that it would install the US-designed THAAD system in Korea. According to Korean analysts such as Professor Chung Jae-ho of Seoul National University (and later ambassador to Beijing), the anti-ballistic missile system was Seoul’s attempt to shore up its defenses in the case of North Korean nuclear attack. However, Beijing had long opposed the deployment of THAAD on the Korean peninsula, claiming it could enable the US and its allies to surveil the Chinese mainland and thereby undermine China’s nuclear deterrent.

Seoul was unswayed by Chinese threats and installed THAAD in 2017. Beijing targeted various sectors of the Korean economy, including retailing, EV batteries, motor vehicles, tourism, and cultural exports. These measures included blacklisting, new and intrusive health and safety checks, and the fomenting of popular boycotts against Korean goods and services.<sup>35</sup> These measures caused significant economic losses for South Korean companies connected to the Chinese economy. For instance, carmakers Hyundai and Kia saw their sales in China declined by more than 30 percent in 2017, with Hyundai’s sales falling 64 percent in the second quarter alone.<sup>36</sup>

Much of the analysis of the trade dispute is conducted from the perspective of the instigator, in that it focuses on China’s motivations for enacting the measures, such as the THAAD dispute or the crossing of one or more “red lines” (e.g., commenting on China’s human rights record).<sup>37</sup> Similarly, the literature has often emphasized that China’s measures are carefully calibrated, such that they inflict maximal pain and disruption to the target while minimizing the effects on the instigator.<sup>38</sup> A Korean academic interviewed for this study referred to China as “reluctant sanctioner” in that it imposed penalties not on vital sectors

39. Interview 7, 2022.

40. Industry Technology Research Center (Saneop Gisul Research Center), THAAD *bae-chi-wa HanJung gwangye akhwa-e ddareun sane-opbyeol yeonghyang* (Impact by industrial sector stemming from the THAAD deployment and the deterioration in Korea–China relations) (Seoul: KDB), 2017; see also Lim and Ferguson, “Informal economic sanctions”; Dursun Peksen and Timothy M. Peterson, “Sanctions and alternate markets: How trade and alliances affect the onset of economic coercion”, *Political Research Quarterly* 69, no. 1 (2016): 4–16.

41. Patrick Biernacki and Dan Waldorf, “Snowball sampling: Problems and techniques of chain referral sampling”, *Sociological Methods and Research* 10, no. 2 (1981): 141–163.

42. Yeong-mun Kim, “Jung-guk-eseo wanjeon cheolsuhan Lotte Mart story (The story of Lotte Mart, which totally withdrew from China)”, *Forbes Korea*, 23 May 2018; see also Lim, “Economic statecraft and the revenge of the state”.

43. Interview 2, 2022.

but rather less important ones such as entertainment and retail, both of which had high exposure to the Chinese market.<sup>39</sup> This tendency was also evident in a study conducted by the Electronics and Telecommunications Research Institute, a Korean think-tank, which in 2017 assessed the comparative vulnerability of different industrial sectors to a new wave of Chinese measures.<sup>40</sup>

While these findings about the motivations for China’s coercive measures are valuable, they do not necessarily tell us much about the responses and reactions of the ROK as the target, including for instance which of the “3-D” strategies (decoupling, de-risking, and diversification) it might find most suitable. This article, by contrast, puts the Korean perspective at the center of its account of the trade dispute. By doing so we illustrate the agency that middle powers (and small states) have in the politics of international trade.

An important source of data was a series of in-depth, open-ended interviews with people who had direct knowledge of the practice of China’s trade measures, especially in a Korean context. These informants included policymakers, policy and industry analysts, corporate executives, and academics. Due to the sensitivity of the topic, anonymity was granted to all participants and their positions are described only in vague rather than precise terms. Permission to conduct the interviews was granted by the Human Ethics Advisory Group at the authors’ home institution (HAE-22-102).

Most of the interviews lasted for about 60 minutes. In most cases, interviews were held at venues suggested by the participants, such as cafes, restaurants, and workplaces, while others were conducted via Zoom. Participants were recruited using chain-referral (“snowball”) sampling,<sup>41</sup> drawing on the authors’ research networks. Informed consent was obtained prior to the interviews, which were recorded only when the participants agreed. The interviews focused on why the trade dispute had evolved, how it affected Korean interests, its impact on ties with China, and the optimal path forward for Korea.

### Diversification and relocation: Lotte’s expulsion

The Korean retail chain Lotte was directly implicated in the THAAD affair after agreeing to sell the land needed to host the missile batteries. Within weeks of agreeing to sell the land to the South Korean government, 23 of Lotte’s stores in China had been forced to close, due to what Chinese authorities labelled fire safety violations. By August, 87 of 112 Lotte Marts in China had been shut down and 74 had endured regulatory suspensions. By the end of 2017, Lotte’s annual sales in China had declined by almost 77 percent from the previous year, including a fall of 95 percent in the second quarter. Coupled with rising anti-Korean sentiment in China, the Lotte Group withdrew from the Chinese market in 2018 with a loss of 1.2 trillion won, while its other businesses that remained continued to experience similar regulatory challenges.<sup>42</sup>

In one sense, Lotte was the biggest loser from the THAAD debacle. By being expelled from China (an act of decoupling by Chinese authorities), it was a well-publicized victim of the trade dispute. Nonetheless, a Korea-based scholar who specializes in international trade noted in an interview that there is “another side to the story,”<sup>43</sup> which underlines Korean agency in the dispute. That is, there were three inter-related reasons why the Korean government did not spend its diplomatic capital on trying to contest China’s decision to “decouple” and instead reverted to a strategy of diversification and de-risking.

First, the government recognised that the group’s underlying economic position in China was quite poor. Lotte’s flagship department store in Beijing had

been losing considerable money well before the THAAD dispute, depleting the group's finances. An official in the Korean distribution industry, quoted in an "insider account" of the Lotte incident that was published by *Forbes Korea*, said that: "Eleven years ago [2007], when Lotte Mart first set foot in China, was the time when Alibaba [an influential Chinese e-commerce company] was already opening numerous online shopping malls each year" and yet "[i]t's shocking that Lotte didn't realize that in China [these] online stores were going to eat up all the offline distributor markets",<sup>44</sup> such as the ones that Lotte was only then setting up. Lotte was thus "flying in the face of recent business history"<sup>45</sup> in trying to set up a profitable foreign-owned retail network in China. Given that retail markets in countries such as Vietnam and Indonesia were less well developed than China's, and in the absence of the state-sponsored animus directed towards the company during the THAAD crisis, there was a cogent business case for the relocation of Lotte's operations to Southeast Asia. Consequently, the Korean government saw little reason to contest the company's expulsion from China, and instead tacitly supported its relocation to less politically contentious markets such as Indonesia. For the government to insist that Lotte remain operating in China would have been tantamount to supporting a bad business decision.

Second, firms are expected to be globally competitive in Korea's model of "developmental capitalism",<sup>46</sup> which implies a certain degree of reinvention and relocation. Admittedly, this process is expected to be driven by market (economic) as opposed to non-market (political) forces, and Lotte was a victim of the toxic politics of the THAAD dispute. But in a sense its experience has been akin to the countless Korean small-and-medium-sized enterprises (SMEs) that have gone bankrupt since the mid-2000s due to their inability to remain competitive in the Chinese market. According to a scholar who studies Korean SMEs and their China strategy, most of these companies have failed to integrate into global supply chains and the production processes of the world's leading corporations, and instead became vulnerable because they were relying solely on Chinese firms.<sup>47</sup>

Just as the government has been unwilling to help these smaller corporations salvage their operations in China, so too was it reluctant to protect Lotte's interests in that country, even though it was driven from the market because of a combination of market and non-market forces. According to a former policy advisor and trade negotiator, there was a growing consensus within the government that "reshoring" from China – either to South Korea or elsewhere – was a logical response to changing economic conditions.<sup>48</sup> This process was well underway before the THAAD crisis, with Vietnam being a preferred destination, because Korean SMEs were facing rising costs in China and thus lower profitability. The "technological edge" of these firms had disappeared, meaning that they were unable to survive in China. Given this phenomenon was widespread in the Korean SME sector, there was no justification for a rescue – or what might be perceived as such – for the much wealthier Lotte Group.

A third rationale for the government not supporting Lotte was that it had performed poorly compared to its fellow *chaebol* conglomerates. There is a longstanding pattern and practice of mutual support within Korea's "developmental alliance",<sup>49</sup> especially during the phase when the state fostered strategic industrial sectors such as steel, shipbuilding, and automobiles in the 1970s, but in more recent decades the government has expected the conglomerates to be globally oriented enterprises that operate at scale and that do not need much direct public support. Lotte, along with conglomerates such as the SK Group and Samsung, cultivated close relations with the government of varying degrees

44. Quoted in Kim, "Jung-guk-eseo wanjeon cheolsuhan Lotte Mart story".

45. Interview 2, 2022.

46. See e.g., David Hundt, *Korea's developmental alliance: State, capital, and the politics of rapid development* (London: Routledge, 2009).

47. Interview 3, 2022.

48. Interview 8, 2022.

49. Hundt, *Korea's developmental alliance*.

50. Albert, Eleanor, "South Korea's Chaebol Challenge", Council on Foreign Relations, 4 May 2018. <https://www.cfr.org/backgrounder/south-koreas-chaebol-challenge>.

51. Ministry of Culture, Sports, and Tourism, *2020-nyeon kijun contents saneop josa (2020 content industry survey)* (Seoul: Ministry of Culture, Sports, and Tourism, Republic of Korea, 2022).

52. Interview 3, 2022; see also Mi-ju Park, "LG Saeng-geon 'The Face Shop'-do Jungkuk maejang da bbaeda (LG Household & Health Care withdraws all its stores from China, including 'The Face Shop')", *Asia Kyeongje*, 15 October 2018. <https://www.asiae.co.kr/article/2018101215130450603>.

53. Interview 2, 2022.

54. Interview 3, 2022.

55. Dal Yong Jin and Tae-jin Yoon, "The Korean Wave: Retrospect and prospect – Introduction", *International Journal of Communication* 11 (2017): 2241–2249.

56. Bill Ide, "Chinese media call for boycott of South Korean goods", *VOA News*, 2 March 2017. <https://www.voanews.com/a/chinese-media-call-for-boycott-of-south-korean-goods/3746701.html>.

of intimacy, but as global enterprises, the *chaebols* were expected to manage and if necessary, diversify the risks associated with their business affairs. In strategic sectors such as semiconductors (discussed later in the article), the government might support and even encourage the *chaebols* to liquidate their overseas investments and move "bricks and mortar" facilities to less risky environs, including South Korea,<sup>50</sup> but no such case could be made in less strategic sectors such as Lotte's retail chain.

### **Diversification and the search for new markets: Korea's cultural industries**

Lotte was not the only Korean victim of the trade dispute: the cultural industries (broadly defined) were also hard-hit when judged by the longevity and impact of the measures enacted against them. Korean cultural exports were valued at US\$ 9.8 billion in 2020, and their growth can be traced to the meteoric popularity of *Hallyu* (Korean pop culture) since the late 1990s. Since that time, Korean cinema, television dramas, music, and fashion brands are highly popular in various parts of the world, especially Asia. The gaming industry, meanwhile, is the largest segment of the cultural exports sector by value, at 68 percent of total revenues in 2020.<sup>51</sup> For Chinese consumers of Korean cultural exports, in sectors such as food, cosmetics, entertainment, and tourism, they have had a strong affinity. Yet, as a Korean scholar who specialises in trade economics argued, the strong appeal of Korean culture in China made the industry vulnerable to informal trade measures in the context of the THAAD debate.<sup>52</sup>

According to a government advisor and academic based in Seoul, China's practice of coercive diplomacy most commonly targets sectors that are small, will not incur any economic pain on China itself, and are comparatively short-lived in duration.<sup>53</sup> In general, such measures tend to be lifted after about one year, but for the Korean cultural industries the measures have remained in place since their enactment in 2017.

The Chinese government had been concerned about the rampant popularity of Korean culture in China even before THAAD. First, the appeal of Korean pop culture was unwelcome at a time when the neo-nationalist Xi Jinping government was promoting the innate superiority of Chinese culture. Some Chinese commentators looked askance at Korean culture and argued that it was derivative of Chinese culture, so it was problematic in this view for Korean cultural exports to be so heavily consumed in China. Second and relatedly, the government and other nationalist forces argued that if Chinese consumers were to enjoy popular culture, they should be buying from Chinese firms rather than foreign ones.<sup>54</sup> These industries can generate substantial profits, and the government therefore preferred that the gains go to local firms rather than Korean ones. Finally, the Chinese government realised that popular culture is a source and conduit of "soft power" and that Korea's cultural industries have contributed to the creation of a positive "national brand".<sup>55</sup> Just as Korea's national brand had benefited from the appeal of its popular culture, so did the Chinese government hope that raising the profile of China's popular culture would burnish its image in the world.

For these reasons, China decoupled itself from the ROK through informal, unacknowledged, but significant restrictions on Korean cultural exports. The most overt formulation of the restrictions was a call through the state media for a "Korean Performing Arts Activities Ban", via appeals to Chinese citizens to stop watching Korean films and television series or frequenting Korean restaurants.<sup>56</sup> But the covert and more tangible formulation was a series of informal economic

57. Soo-yeon Kim, “No. of Chinese tourists to S. Korea dips 30 pct over THAAD row”, *Yonhap News Agency*, 2 July 2020. <https://en.yna.co.kr/view/AEN20200702003700320>; Lim, “Economic statecraft and the revenge of the state”.

58. Tamar Herman, “In a post-THAAD world, K-Pop focuses on new markets aside from China” *Forbes*, 28 February 2018. <https://www.forbes.com/sites/tamarherman/2018/02/28/in-a-post-thaad-world-k-pop-focuses-on-new-markets-aside-from-china/?sh=3a36d5f26d81>.

59. Kimberley Kao, “South Korea’s SM Entertainment plans to set up its Southeast Asia headquarters in Singapore”, *CNBC*, 30 November 2022. <https://www.cnbc.com/2022/12/01/south-korea-sm-entertainment-to-set-up-southeast-asia-hq-in-singapore.html>.

60. Ministry of Culture, Sports, and Tourism, *2020-nyeon kijun contents saneop josa*.

61. Statista, “Semiconductor industry revenue worldwide from 2012 to 2023” *Statista*, 2023. <https://www.statista.com/statistics/272872/global-semiconductor-industry-revenue-forecast/>.

62. Cited in Christian Davies, “Tech cold war: South Korea pivots from China to US”, *Financial Times*, 1 August 2023. <https://www.ft.com/content/c164c880-a832-422f-8fb4-29b2185d4982>.

63. Ben Murphy, *Chokepoints: China’s self-identified strategic technology import dependencies* (Washington: Center for Security and Emerging Technology, 2022); see also Masha Borak, “China boosts semiconductor production in 2020, but imports keep apace, frustrating self-sufficiency goals”, *South China Morning Post*, 19 January 2021. <https://www.scmp.com/tech/policy/article/3118327/china-boosts-semiconductor-production-2020-imports-keep-apace>.

64. Wonho Yeon, “U.S.–China strategic competition and economic security strategy of Korea.” In *Between the Eagle and the Dragon: Challenges and opportunities for South Korea in the U.S.–China competition*, edited by Sue Mi Terry (Washington: Wilson Center, 2022b), 51–60.

65. Cited in Davies, “Tech cold war”.

measures: the capacity of Korean musicians to perform in China was curtailed, Chinese broadcasters were prevented from contracting new Korean television programs, and Korean actors were not allowed to take part in Chinese productions. Furthermore, China’s National Tourism Administration ordered companies to cancel tours scheduled for South Korea with the threat of revoking their licenses. The number of Chinese visitors to South Korea dropped by 41 percent in two years, from just over 8 million in 2016 to 4.8 million in 2018, which reduced tourism revenue by US\$15.6 billion.<sup>57</sup>

There are parallels that can be drawn between Lotte’s retail chain and the cultural industries sector. In both cases, Korean firms found and developed new markets that have compensated for the foregone revenues from China. The Korean government may have had some sympathy for the cultural industries sector because their products were competitive in a host of international markets, including China, but the same could not be said for Lotte’s retail operations. The cultural industries were a sector on the rise in the Korean economy, but retailing was in decline.

Despite the relative merits of the cultural industries’ case, the government has not been able to have the measures removed. Instead, its response has been to offer public support to the sector and encourage its diversification and development of markets other than China. Some Korean musicians, for instance, have prioritised their Japanese fans by releasing new songs in the Japanese language and holding more concerts in the country.<sup>58</sup> Korean arts talent firm SM Entertainment, meanwhile, announced plans to set up in Singapore as part of a push into Southeast Asia, another significant market for Korean cultural products. And with visits from China restricted, South Korea has created new visa categories, such as *Hallyu* visas to attract fans of popular culture (especially from Asia) and digital nomad visas.<sup>59</sup> These measures may not fully compensate for the losses sustained from China’s decision to decouple, but they are a proactive effort to support a valued sector of the Korean economy.

### De-risking, countervailing power, and strategic alliances: semiconductors

Since 2014 semiconductors have been the single-biggest source of export income to the ROK, with the sector’s exports being valued at just short of US\$ 100 billion in 2020.<sup>60</sup> East Asia is a global hub for the multiphase creation of semiconductors and South Korea accounts for 18–20 percent of the US\$670+ billion industry, second only to Taiwan.<sup>61</sup> Like their Taiwanese counterparts, Korean firms such as Samsung and SK Group are involved in some of the most valuable, upstream segments of the industry. China, meanwhile, is involved in the assembly, packaging, and testing of the technology, which are less skilled- and capital-intensive processes, and thus downstream of and reliant upon the segments dominated by Korean firms. In 2022, for instance, “more than half of South Korea’s chip shipments went to China”,<sup>62</sup> with most of these being components rather than innovative goods.

As with other “chokepoint technologies”,<sup>63</sup> China’s reliance on Korean firms for the components needed for its own production of semiconductors has made Korean chipmakers immune from the type of coercive measures that have enacted in other sectors. Similarly, tech firms in Japan have been exempt from the type of retaliatory measures that have been enacted against other sectors in response to what China sees as a hostile stance.<sup>64</sup> According to Chris Miller (Tufts University), “China needs the chips, and it has repeatedly proven willing to buy foreign-made chips if its domestic firms are meaningfully behind, as they are with Dram [dynamic random access memory chips] today.”<sup>65</sup>

66. Interview 6, 2022.

67. Interview 18, 2022; see also Shahid Yusuf and Danny Leipziger, *Global supply chains in the post-Covid multipolar world: Korea's options* (Seoul: Korea Institute for International Economic Policy, 2022).

68. Interview 1, 2022; see also Ministry of Foreign Affairs, *Strategy for a free, peaceful, and prosperous Indo-Pacific region* (Seoul: Ministry of Foreign Affairs, Republic of Korea, 2022).

69. Al Jazeera, "South Korea unveils tax breaks for domestic investments in chips" *Al Jazeera*, 3 January 2023. <https://www.aljazeera.com/amp/economy/2023/1/3/south-korea-unveils-tax-breaks-for-domestic-investments-in-chips>.

70. Interview 6, 2022.

71. Interview 14, 2023.

72. Interview 3, 2022.

73. Interview 14, 2023.

74. Interview 2, 2022.

75. Interview 6, 2022.

76. Wonho Yeon, "FAB4 nonui-wa uri-ui dae-eung (The FAB4 logic and the response of South Korea)", *Jeongse-wa Jeongchaek (Trends and Policy)* 42 (2022a).

These structural advantages aside, Korean firms have exercised their own agency to reduce the likelihood that they would be targets of retaliatory measures. These firms are substantial investors in China: SK Hynix has production facilities in Wuxi, Chongqing, and Dalian, while Samsung Electronics produces semiconductors in Xi'an and Suzhou and has R&D centers in Xi'an, Suzhou, and Hangzhou. A business leader and observer of the semiconductor industry agreed that any Chinese retaliation against Korean chipmakers would have sizeable "adverse impacts on local production and employment" but added that the *chaebols* had invested both economic and political capital in China "for many decades." These companies, he reported, had developed close ties to Chinese corporate and political elites. In some cities and provinces, Korean firms were the single largest employers, so there was much mutual benefit to these arrangements.<sup>66</sup>

Despite the accumulation of these substantial synergies, some Korean policymakers and politicians, as well as their foreign counterparts, have proposed that crucial technologies be "on-shored", "friend-shored, or "re-shored" –that is, de-risked and/or decoupled through relocation to friendlier, safer locales.<sup>67</sup> According to a Seoul-based policymaker, this goal was consistent with President Yoon Seok-yeol's vision of Korea as a "global pivot state" in the Indo-Pacific, in that it would be aligned with US regional strategy and its recent trajectory of decoupling from China.<sup>68</sup> In keeping with this vision, in early 2023 the administration announced that chipmakers would be eligible for subsidies of US\$ 2.85 billion by 2024 if they moved to the ROK as part of an initiative that had previously been offered to sectors such as electronics.<sup>69</sup> However, such incentives are unnecessary if not irrelevant in the case of semiconductors: as a business leader noted, Korean firms such as SK Hynix only produce their most innovative technologies, such as DRAM chips below 10 nanometers, at their plants in South Korea.<sup>70</sup>

Business leaders argued that policymakers were "fascinated" by concepts such as "de-risking", "supply chain resilience", and "decoupling", but an executive whose company's biggest customers are in China said that "[i]t's not just a matter of flicking a switch".<sup>71</sup> Decisions on where to locate a firm's production and who to partner with are carefully considered, and asking firms to suddenly reorganize their operations on political grounds exacts a material cost.<sup>72</sup>

As one informant claimed, "the concept of 'decoupling' only makes sense if you're willing to shut the door on a big market", whereas seeking "diversified markets" –that is, spreading and thereby reducing business risks– "is something that firms do as a matter of course".<sup>73</sup> According to an academic and advisor to President Yoon, some of the comparatively high rates of inflation that many countries have experienced since about 2021 can be attributed to the reorganization of supply chains. COVID-era shortages and the war in Ukraine have adversely affected inflation too, but to a certain degree, its historically high rate reflects the costs entailed in relocating some operations to less politically sensitive settings.<sup>74</sup> An informant with knowledge of the semiconductor industry said that reshoring to some supposedly safer and friendlier regions, such as Eastern Europe, would considerably increase operational costs for Korean firms, in part because China is "geographically and culturally" closer to Korea and thus a preferred base for operations despite the ratcheting up of tensions during and after the THAAD crisis.<sup>75</sup>

In 2022 the reshoring/decoupling debate was amplified further with the passage of the Biden administration's CHIPS and Science Act. Firms in fields such as semiconductors became eligible for billions of dollars in tax benefits if they agreed to build new facilities in the US, while those who continued to work

77. Antonio Varas, Raj Varadarajan, Ramiro Palma, Jimmy Goodrich, and Falan Yinug, *Strengthening the global semiconductor supply chain in an uncertain era* (Boston: Boston Consulting Group & Semiconductor Industry Association, 2021).

78. Eun-kyeong Park, “Yoon Young-kwan Myeongyae Kyosu ‘anMi-gyeongJung jeollyak an meokhyeo... Yangja-taekil sanghwang naemol-lyeottda’ (Emeritus Professor Yoon Young-kwan: ‘A strategy of relying on the US for security and China for the economy is not working’... We’re in a position where we must choose one or the other)”, *Kyunghyang Sinmun*, 5 October 2023. <https://m.khan.co.kr/politics/defense-diplomacy/article/202310052126005>.

79. Cited in Davies, “Tech cold war”.

in China risked being penalized or punished.<sup>76</sup> The proposed “Chip Alliance” between the US, Taiwan, South Korea, and Japan would be an extended form of friend-shoring and decoupling, in that some production could move to the US from Taiwan, South Korea, and Japan. There were claims that this use of “market-driven incentive programs to achieve a more diversified geographical footprint”<sup>77</sup> and strategic cooperation in relation to key technologies could be extended to other sectors and result in a greater degree of economic coordination between South Korea and the US in response to the emergent strategic rivalry between China and the US.

China did not and could not ignore the decoupling debate, especially at a time when some Korean policymakers and academics, such as former Foreign Minister and Professor of International Relations, Yoon Young-kwan, have called on the ROK to consider its “ideological positioning” amid the emergence of a “new cold war”.<sup>78</sup> In May 2023, Korea’s finance minister, Choo Kyung-ho, said: “We have never announced a plan to decouple from China, and we have no intention of doing so”, but China’s ambassador, Xing Haiming, said publicly the following month: “I can assure you, those who bet on China’s defeat will definitely regret it”.<sup>79</sup> While the ROK might not describe its strategy as decoupling, it certainly had strong elements of de-risking, and from China’s perspective the distinction may not have been all that useful.

### **Conclusion: from de-risking and diversification to decoupling?**

This article has recounted the trade dispute between China and South Korea from a middle-power perspective, to illustrate how the target rather than the instigator of a series of coercive measures perceives of such a dispute. Much analysis has treated the dispute as a symptom of China’s displeasure with what it sees as encirclement by the United States and its regional allies such as the ROK, but this article has shown how retelling the story from the perspective of the target rather than the instigator provides new insights into how middle powers respond to the “3-D” problem during trade disputes. In highlighting Korean agency, we do not imply that middle powers will always or even sometimes get their way or somehow outwit their larger and more powerful counterparts in a trade dispute, but rather that they have some capacity to defend their interests and mitigate the worst effects of the measures taken against them.

The account supplied here casts new light on not only how and why Lotte became directly embroiled in the dispute, but also the price that the government was willing to pay for the THAAD system. If Lotte had been running a successful and lucrative enterprise in China, then the government might have done more to defend it. But Korean officials instead calculated that Lotte’s expulsion from China was part of the cost that must be paid for the security assurances that THAAD would bring, and that the Lotte Group could be partly compensated if it were encouraged to pursue new opportunities in a less volatile political setting.

The cultural industries, by contrast, were a Korean success story and one that the government had used to promote its “national brand”: popular culture, in the form of films, mini-series, online games, and cosmetics, has had significant appeal in much of East Asia (including China) and beyond. Nonetheless, the Korean government could not prevent the sector being targeted during the trade dispute. As noted, the Chinese government wanted to promote local cultural industries at the expense of their Korean counterparts. Given that many of the trade measures were informal and thus deniable, the Korean government could do little to help the *Hallyu* sector. The success of the sector in other markets meant

that it could prosper even without access to China. In this sense these measures had a significant but non-fatal economic impact on Korea, and the government's response was to publicly support the industry while encouraging it to seek new markets for its outstanding products.

The semiconductor industry, finally, showed how and why middle powers (and even small states) sometimes have countervailing economic power that makes them almost immune from coercion. The deep interconnectedness of Korean and Chinese chipmakers created a state of mutual dependence and benefit that the Beijing government maintained despite its animus towards the ROK during the THAAD dispute. The Korean government wanted to reduce that interdependence through reshoring (de-risking), although chipmakers were reluctant to comply. In the context of rising anti-China sentiment in many countries, and with the passage of the CHIPS Act in 2022, the US and its allies such as South Korea have begun to rethink how and where they should develop advanced technologies like semiconductors and artificial intelligence, but this process of decoupling is unlikely to proceed smoothly if private firms are not aligned with the government's position.

This article has found support for Hirschman's diagnosis of the politics of international trade by confirming that targeted states such as South Korea seek to reduce their exposure to coercion, but it has also shown how this can occur through a strategy of de-risking and diversification. The evidence from the Korean case suggests that the shift away from complex interdependence has only been partial to date, with diversification being more easily achieved than de-risking. The concepts of decoupling and de-risking might well be more dramatic, tangible, and thus appealing to political leaders, but the Korean economy is still enmeshed with that of China to a comparatively high degree. Given that a substantial share of bilateral trade occurs in complex sectors that rely on technology rather than commodities, these inter-firm partnerships are not likely to be easily, uniformly, or quickly unwound. The cases reviewed in this article show how the decoupling that China has instigated has exacted an economic and political cost to Korea. But if the ROK responds in kind by signing on to a "tech war" in partnership with the US and other allies, any benefits of doing so may be soon outweighed by the costs, in the form of a further and unpredictable deterioration in its relations with China.

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