Korea-China economic cooperation

• What Korea is looking for in Korea-China economic cooperation

• Decrease in Korea’s investment in China after global financial crisis
What Korea is looking for in Korea-China economic cooperation

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Recently, politics and economy have taken different paths in Korea-China relations. On the political front, the two countries have a thorny relationship because of China’s uncooperative stance on the ongoing conflicts between South Korea and North Korea. On the economic front, the two nations are expanding cooperation. I would like to share some anecdotes that illustrate this point.

Anecdote 1

One public official I recently met expressed his concerns over Korea-China trade. He worried that Korea’s trade dependency on China was too high. I asked, “What is the solution to the problem?” He gave no response. He seemed forlorn. Is an opportunity only sweet and a crisis only bitter? In cooperation with China, an opportunity is no different from a crisis. They come together. This is a common dilemma that Korea and many Western countries are experiencing in doing business with China.
Anecdote 2

On February 20 of this year, Republican Jon Huntsman, the United States Ambassador to China, showed up near Tienanmen Square in Beijing at a rally of supporters who want to launch a “Jasmine Revolution” in Wangfujing. It was at a time when people were paying attention to how the recent popular uprisings shaking the Middle East would influence China and North Korea. Huntsman is the son of the founder of Huntsman Chemical. He is expected to resign as ambassador to run for president in 2012. At the scene, one Chinese recognized him and asked, “You want to see China in chaos, don't you?” “No, I don’t,” Huntsman said before hurriedly leaving the scene. If stability were broken in China, Korea-China economic cooperation would be shaken, as would global trade that is beginning to take shape.

Anecdote 3

The South Korean government has been taking a contradictory stance toward China. Diplomatically, Korea emphasizes its relationship with the US and provokes China; economically, it actively engages China in the market. China’s Ministry of Foreign Affairs is no different. From a diplomatic perspective, China responds to Korea with two opposing attitudes: strong repulsion and cooperation. From an economic perspective, the cooperation between the two Asian nations goes well. Other countries have similar relationships with China. Currently, major countries such as the US and Japan have strategies toward China that are similar to those of Korea. However, this is not a stable trend and will not continue forever. The world is focused on how long this unstable transitional period will continue, and what kind of political and economic relations will follow.

Anecdote 4

Since diplomatic ties were established between Korea and China,
Korea-China trade has grown amazingly, by an average annual growth rate of 18.7% from 1993 to 2009. Currently, China is the largest importer from and exporter to Korea. Korea is the fourth largest exporter to China and the second largest importer from China. Korea has been profiting from trade with China since diplomatic ties were established. Korea’s annual trade surplus with China surpassed USD 10 billion for the first time in 2003. Since then, this number has fluctuated. In 2010, it reached USD 45 billion for the first time. There is no major Korean corporation that has not focused on business with China.

Many people still ask me when China will fall. I do not intend to deal with Korean people’s deep-rooted uneasiness toward China. However, considering this sentiment, I would like to discuss three aspects of Korea-China economic cooperation.

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Looking at surging Korea-China trade from the East Asian perspective

Despite the uncomfortable relationship between Seoul and Beijing, Korea-China trade totaled USD 188.4 trillion last year, and will soon reach USD 200 trillion. Japan is also focusing its attention on trade with China. There will be more active discussion on regional economic integration this year, such as free trade agreements among Korea, China, and Japan. This is a result of the Chinese economy becoming more vibrant, and the changing structure and new dynamics of the division of labor among the three countries.

To Korea and Japan, trade with China is becoming ever more important. Korea’s largest export destination has changed from the US (1992-2002) to China (2003-present), while its largest import market has changed from Japan (1992-2006) to China (2007-present).

The pattern of China’s foreign trade has been changing in recent years. China has increased imports of intermediate goods from Korea, Japan, and
China's share of trade in East Asia has fallen continuously since 1996, while Korea and Japan’s shares of trade in the region have continued to grow. Japan’s share of exports in the region peaked in 2009, and Korea’s peaked in 2008. Korea’s share accounts for about 30% of imports and exports in the region, a higher proportion than China or Japan.

Given the global trend of regional integration, economic integration among Korea, China, and Japan is highly likely to be realized in the near future. The Chinese government is spurring the qualitative growth of its economy while pursuing active FTA policies and increasing product quality. This is a sign that both cooperation and competition between Korea and China will increase over time.

Paying attention to China’s consumption-led economy

The Chinese government began to shift its economic growth strategy from export-led growth to one led by domestic demand and export. China announced a plan for balanced growth by distribution under the slogan “inclusive growth” in its 12th Five-Year Plan, which was released last October. The core of this plan includes expansion of domestic demand, stable economic development, and adjusted income distribution. “Inclusive growth” means that people share sustainable economic growth and the subsequent economic outcomes; “stable development” means that China is setting its target for economic development based not only on numbers, but also on quality.
To increase consumption, it is imperative to change the industrial structure. For this reason, it is expected that China will focus on the promotion of tertiary industries and private corporations with high employment effects. To expand domestic consumption, more jobs must be created and workers must earn more income. To these ends, tertiary industries should be expanded. Tertiary industries comprise a small proportion of China’s industries, so they have relatively high potential to create new jobs. The Chinese government is transforming its economic growth methods in order to adjust to the slowdown of the global economy in the aftermath of the global financial crisis, and to changing external and internal situations.

This transformation will not be fast. Experts predict that it will take more than ten years for China to shift to a consumption-driven market. Most importantly, the transformation must be followed by the reform of the resource distribution mechanism, which will take much time.

Korea should take China’s change of growth strategy as an opportunity to build and develop the Korea-China relationship. If China pursues balanced growth of its economy, private consumption will increase, and imports will subsequently expand. Accordingly, competition with

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<th>Korea, China and Japan’s trade dependence</th>
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<tr>
<td></td>
<td>2005</td>
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<tr>
<td>Korea</td>
<td>64.5</td>
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<td>China</td>
<td>60.4</td>
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<td>Japan</td>
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Source: Re-quotation from EIU, Korean Ministry of Strategy and Finance
companies from foreign countries with industrial structures similar to that of Korea, such as Japan and Taiwan, will be even fiercer. Taking this into consideration, Korea should promote a Korea-China free trade agreement in order to enter the Chinese domestic market on favorable terms.

**Anticipation of a Korea-China FTA**

Recently, there has been much discussion of Korea’s negotiations for a free trade agreement with China, Korea’s largest export market. If the FTA between Korea and China is concluded, it will have an unprecedented impact on Korea. Korea’s economy is smaller than those of China and Japan, and Korea is more dependent on trade than those countries. China is Korea’s largest trading partner and a major destination for Korean investment. Korea stands to benefit the most from the economic integration of Korea, China, and Japan. Economic integration will be a driving force behind increased growth potential and the restructuring of the economy.

According to joint private research conducted in 2007 by Korea, China, and Japan, if these three Asian countries conclude FTA's, Japan is expected to see a 0.2% increase in GDP, China will see a 0.6% increase, and Korea will see a 2.6% increase (Korean Ministry of Strategy and Finance). Korea’s exports to China can be divided into exports for processing and exports for domestic consumption. About 70% of Korea’s exports to China are intermediate goods for China’s re-export; the remaining 30% are for the Chinese domestic market. Raw materials and capital goods account for 93.4% of Korea’s total exports to China. Korean companies located in China process these: 25% of this is sold in the domestic market, and the remaining 75% is re-exported to other countries.

Forty percent of Korea’s imports from China (USD 31.5 billion) are used for re-export, and the remaining 60% (USD 45.4 billion) are sold in the Korean market. When imports for sale in the domestic markets are calculated, excluding imports for re-export, Korea’s imports from China are
larger than China’s imports from Korea by USD 18 billion. Korea’s imports from China are divided into raw materials and capital goods (82.4%), and consumer goods (17.6%); raw materials and capital goods are again divided into imports for domestic consumption (50%) and imports for export (50%).

Korea exports raw materials and capital goods for processing to China, and vice versa. In its trade with China, Korea enjoys a trade surplus from exports of raw materials and capital goods, while it suffers a trade deficit from exports of consumer goods for the domestic market.

Currently, Korea’s trade with China is growing exponentially, with a trade volume of almost USD 500 million a day. The products traded between the two countries have greatly improved in quality, with a higher proportion of state-of-the-art products, such as semiconductors, LCD’s, and mobile phones.

China’s import tariff rate for Korean products is 9.7%. This rate is significantly higher than those of the US and the EU. The proportion of Korea’s exports to China that fall under general trade, for which tariffs must be paid, increased from 29.1% in 2007 to 33.7% in 2009. If a free trade agreement is concluded between Korea and China, reduced tariffs will result in increased profits.
The decrease in South Korea’s investment in China after the global financial crisis

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In December 2009, when foreign companies were reducing investment in China amidst the global financial crisis, Taiwan’s MediaTek, which was providing China with original technology for knock-off mobile phones, decided to invest USD 17 million in China. The ambition of the company was to establish sales and R&D bases in Beijing in order to break into the 3G mobile phone and intelligent mobile phone markets. This is just one of many cases in which Taiwanese and Hong Kong companies have rushed to enter the Chinese market.

What about South Korean investment in China? Since taking a downward turn four years ago, there has been no sign of recovery. South Korea’s investment in China peaked in 2007, but it shrank by almost half in 2009. Investment increased slightly in 2010, but remained much lower than it had been in the past. This decrease in South Korea’s investment in China can be attributed to the global financial crisis, but a question remains: why
has South Korea’s investment decreased so significantly in China? Investments in China accounted for 39.1% of South Korea’s total outward foreign direct investment (FDI) in 2005. This number dropped to 10.6% in 2009, and then rose to 13.7% in 2010, a figure much lower than the previous high.

The downward trend in South Korea’s investment in China

There are two reasons for the drop in South Korea’s outward FDI in China. The first reason, as one might easily guess, is the contracting economy in the wake of the global financial crisis, and the subsequent decrease in investment. Declining investment in China has been a worldwide trend since the financial crisis. Therefore, South Korea’s shrinking investment in China is also inevitable. This is a problem that can be resolved with time.

The second and more important reason is the change in investment cycles. Generally speaking, after investment increases for a certain period, it naturally slows down or takes a downturn.
There were two “investment booms” in South Korean investment in China. The first boom came in the early to mid-1990s. South Korean investment in China skyrocketed after China’s expansion of open policies (so-called “omni-directional openness”) in 1991, and the establishment of diplomatic ties between South Korea and China in 1992. South Korea’s FDI in China nearly doubled from USD 360 million in 1992 to USD 640 million in 1994. China’s share of South Korea’s outbound FDI also surged. However, the first China investment boom took a downturn in 1996. Given that the majority of South Korean investment in China at that time was comprised of investments by small and medium corporations in China’s processing and manufacturing, the decreased investment in China after 1996 suggests that China was greatly influenced by the Asian financial crisis, and that China’s investment value as a processing and manufacturing base had reached its limit.

The second investment boom came in the early to mid-2000s. The major causes of the boom were the opening of the Chinese market and the liberalization of investments following China’s accession to the WTO in 2001, and the earnest opening of the service industry from 2005. South Korea’s investment in China was only USD 650 million in 2001, but it increased to USD 2.81 billion in 2005, and to USD 5.26 billion in 2007. In 2001, investment in China accounted for 12.3% of South Korea’s total outward FDI, but this number surged to 39.1% in 2005. The following are some characteristics of the second boom: investment was led by big
enterprises; purposes and methods of investment changed—investments increased not only in processing and manufacturing, but also in domestic markets.

The second investment boom took a downturn in 2005. While the amount of South Korean investment in China peaked in 2007, the proportion of South Korea’s outward FDI invested in China decreased to 23.7%. The falling investment in China after 2008 was predictable based on investment cycles. Perhaps the global financial crisis triggered a more rapid decrease in investment.

The second investment boom triggered by China’s globalization is currently reaching its limit. Now is the time for South Korea to ponder its future investments in China.

Time to consider the significance of investment in China

What does it mean that South Korea’s investment in China is declining? In fact, foreign investment is not always desirable. Rising foreign investment undermines domestic employment and pushes up unemployment rates. Transfer of technology and relocation of production facilities to foreign countries can weaken the domestic industry base. This is why major advanced countries including the US and Japan do their utmost to attract foreign companies, and fear the increasing investment of their companies in other countries.

However, foreign investment is inevitable. Companies go overseas to reduce production costs, develop products to meet local demand, and find ways to break into foreign markets. In some cases, companies enter foreign markets to avoid trade conflicts: a government urges a foreign company to manufacture products in its land if the company wants to sell products in the country. Depending on the type of industry, foreign investment is essential to establishing a business base, including production facilities, in a foreign country. A case in point is the automotive industry because it requires
customized supply chains and systematic customer service. The service industry has no way but to enter foreign markets because the industry creates value through the direct activities of people.

The type of industry and the purpose of its expansion determine whether an industry should increase foreign investment. In other words, South Korean companies should determine whether to invest more in China based on consideration of China’s market potential, China’s role in the global market, changing opportunities for entry into the Chinese market, and most importantly, their reasons for tapping into the Chinese market.

It is worth noting that China had the only fast-growing mega market after the global financial crisis. It is natural that investments go where markets are. The reason the US is still the biggest investment destination despite its declining economic status is that the US is still the world’s largest market. South Korean investment should, therefore, continue to grow.
The ongoing economic integration of Greater China

Hong Kong and Taiwan’s investment patterns in China are a good lesson for South Korea. In 2008, when the global financial crisis began, Hong Kong and Taiwan’s investments in China accounted for 44.4% and 2.1% of total FDI in China, respectively. In 2010, Hong Kong’s investment reached 63.8% of total FDI in China, and Taiwan’s investment reached 6.3%, an increase of 19.4% and 4.2%, respectively, in two years. On the other hand, South Korea’s investment in China decreased by 0.9%, from 3.4% to 2.5%, during the same period. Even though the method for calculating FDI changed during this period (in 2009, China began counting foreign investments from tax havens such as the Virgin Islands as investments from original countries), it is true that Hong Kong and Taiwan’s investments in China have surged tremendously.

Changes in the composition of Hong Kong and Taiwan’s investments in China are quite significant. Over the last two years, 70% of Taiwanese investment in China has been in the expansion of existing investments, not for new investments. Due to the opportunities that arose from the Closer Economic Partnership Arrangement (CEPA) between Hong Kong and China, and the subsequent opening of the Chinese service industry, Hong Kong has invested mainly in the Chinese service sector, including finance, logistics, and construction. In other words, Hong Kong and Taiwan expanded investment in China because the Chinese market played a more important role in the wake of the global financial crisis, and the trade environment improved. While South Korea’s investment in China remains at the status quo following the second quantitative expansion, Hong Kong and Taiwan are entering a phase of expanded investment for the purposes of entering the Chinese domestic market, and integrating the Greater Chinese market, through the CEPA between Hong Kong and China, and the Economic Cooperation Framework Agreement (ECPA) between Taiwan and China.
Increasing and improving investment in China

South Korea’s economy has been growing in close association with that of China for more than 30 years. Now is the time for South Korea to formulate a new investment scheme for cooperation with China, which is emerging as the axis of the world market. South Korea now needs new goals and methods for active investment in China. Investment in simple processing and manufacturing is no longer desirable nor possible. Instead, South Korea should focus its investments in China’s domestic market. South Korea should try to shift its processing trade with China to complex (or network) processing trade, which links the markets of South Korea, China, and third countries. It should also move away from simple manufacturing toward complex manufacturing, which offers a combination of manufacturing and services. Moreover, South Korea needs to expand its business areas to include logistics, science and technology, medical science, education, and other services.

Government efforts are an essential step in broadening investments. To properly pursue investments in China’s domestic market and the complex processing trade, it is imperative to improve the trade environment. Without measures to improve the trade environment, such as CEPA and ECPA, further integration of the Greater Chinese economy is unimaginable. In trade negotiations such as the pursuit of a free trade agreement with China, South Korea must convince China of the importance of investment liberalization, and of opening its service industry.