Korea-China FTA: strategies and benefits

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Two Korea-China summits were held in the first half of 2010, during which promoting a Korea-China Free Trade Agreement arose as an important agenda. The Korea-China FTA is an issue discussed between the two countries for nearly 6 years. Related talks started in September of 2004 at the ASEAN (Association of Southeast Asian Nations) +3 Finance Ministers’ Meeting, where a joint private research was agreed upon. From 2005, the Korea Institute for International Economic Policy (KIEP) and China’s Development Research Center (DRC) conducted a joint research and issued reports. At the Asia-Pacific Economic Cooperation (APEC) summit in November of 2006, the two countries agreed to launch an official joint study on the Korea-China FTA. According to this agreement, the study began in March of 2007 with five meetings until June of 2008. However, the 6th meeting, scheduled to be the final one, was not held for almost 2 years. The related discussion was
virtually interrupted due to the global economic crisis which started in the latter half of 2008.

The two summits held on April 30th and May 28th of 2010 broke this deadlock. Korea and China will now meet at the negotiating table to discuss an FTA. For Korea, this FTA negotiation entails its biggest trading partner. As for China, Korea is its third largest trading partner and a potent manufacturing superpower of East Asia. This is the most critical negotiating table that Korea and China will come across since the establishment of Korea-China diplomatic ties in 1992.

* Motives for promoting an FTA

However, Korea and China are maintaining completely different stances in both attitude and strategy, when the other FTAs each of them has concluded are looked into. Korea follows a textbook style whereas China is strategic. Korea has been trained through what can be seen as conventional warfare through its previous FTA negotiations with advanced large-scale economies such as the U.S. and EU. China, meanwhile, is apt in unconventional warfare.

An FTA signifies opening up the markets of two countries through bilateral agreements beyond the regulations of the WTO system. Its purpose is to maximize economic profit through opening. Trading costs are cut with lower tariffs and industries are strengthened as the scope of competition becomes wider. Korea is a representative exemplar, having already promoted FTAs under this textbook meaning.

Korea has pursued negotiations with Chile, Singapore, ASEAN, the EFTA (European Free Trade Association), Canada, the United States, Japan, India, EU, Mexico, GCC (Gulf Cooperation Council), Australia, New Zealand, Peru, Colombia, and Turkey. Among them, FTAs with Chile, Singapore, ASEAN, the EFTA, the United States, India, and EU have come into effect or been settled. Korea also faces negotiations with China. The
world’s four economic superpowers — EU, the United States, Japan, and China — are all included in the countries that Korea has promoted an FTA with. Some large-scale economies such as ASEAN and India are also on the list. This shows that Korea has been pushing for FTAs with large countries where it expects the biggest economic effect according to the textbook rule. Moreover, Korea engaged in tough negotiations with countries such as the United States and EU with previously high levels of market opening that requested the same of the counterpart country. Through that process, Korea has inclined towards concluding a consistently high-level and comprehensive FTA. Its negotiating ability has also been trained to global levels.

China is a different story. China has concluded FTAs or CEPAs (Closer Economic Partnership Agreement) with ASEAN, Hong Kong, Macao, Pakistan, Chile, New Zealand, Singapore, Peru, and Costa Rica. It is also undergoing negotiations with GCC, Australia, Iceland, Norway, SACU (Southern African Customs Union), and Taiwan. It is difficult to find coherence in the countries that have concluded an FTA with China. There are no main trading partners where the effects of opening up markets would be maximized by reducing trading costs or advanced economic superpowers among those countries. Excluding Hong Kong since it maintains a special relationship with China, the ASEAN - with whom China concluded its first FTA - is about the only main trading partner of China. This owes to the fact that China emphasizes an FTA’s strategic significance as much as its economic meaning. In order to

No matter how it may first have been initiated, the Korea-China FTA is a negotiation in which China needs to focus on the economic effects the most.
successfully lead negotiations with China despite its differing FTA negotiating style, Korea first needs to understand the strategic character of China’s FTA.

* “Strategic” character of China’s FTA

All countries have a strategy in promoting an FTA. Korea’s is to maximize the economic effects of FTA through “simultaneous FTAs with large advanced economic powers.” In short, its strategy is to create maximum economic benefits through a high-level FTA with big markets.

However, China, rather than seeking economic effects by cutting trading costs between the two countries, places greater emphasis on other various accompanying effects that can be acquired through an FTA. In this sense, it is much more “strategic” than Korea. Namely, China is seeking to secure its dominance in consolidating the East Asian region (ASEAN), to strengthen relations with countries with energy/resources/food (Chile, Australia, Norway, Iceland, New Zealand, GCC, SACU), to consider the complex geopolitics keeping the U.S. and Taiwan in mind (Pakistan, Costa Rica), and to stabilize the economic power of Greater China (Hong Kong, Macao, Singapore, Taiwan).

Meanwhile, of China’s top 10 exporting countries, only those classified as Greater China — Hong Kong (CEPA), Singapore, and Taiwan (Economic Cooperation Framework Agreement or ECFA) — have concluded or are discussing an FTA or similar economic cooperation agreements. This is far from maximizing economic profits through the opening of markets. In short, it is utterly different from Korea which concluded or discussed FTAs with all its main trading partners such as China, the United States, EU, and Japan.

* Strategic character of China’s FTA leads to flexible negotiations

The strategic character of China’s FTA can be seen not only through
its selection of countries but also in the style of its FTA negotiations. China’s style of negotiations shows variety in the duration, scope, and framework for each country, as it places more emphasis on the strategic goals rather than economic effects. This phenomenon occurs since it is more inclined to reach a conclusion of any sort that matches the characteristic of its counterpart, rather than negotiating with the purpose of reaching a certain level of market opening.

The period it takes for China to reach an agreement also differs depending on the other party. It underwent 17 negotiations during three years for an FTA with ASEAN and 15 negotiations for three years with New Zealand. However, it concluded an FTA after four negotiations with Chile during one year, and six negotiations with Costa Rica also within one year. The China-Taiwan ECFA was concluded in six months.

The scope of negotiations also differs according to the counterpart. The FTA with Pakistan was focused on product commerce excluding the service sector. However, FTAs with advanced nations like New Zealand included comprehensive issues such as goods, service, investment, intellectual property rights, environment, labor, transparency, and conflict settlement.

### China's FTA deals (as of June 2010)

<table>
<thead>
<tr>
<th>Counterparts</th>
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<tr>
<td>Concluded</td>
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<tr>
<td>ASEAN, Hong Kong(CEPA), Macao(CEPA), Pakistan, Chile, New Zealand, Singapore, Peru, and Costa Rica</td>
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<tr>
<td>Negotiating</td>
</tr>
<tr>
<td>GCC, Australia, Iceland, Norway, SACU and Taiwan(ECFA)</td>
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<tr>
<td>Joint research on FTA</td>
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<tr>
<td>India and Korea</td>
</tr>
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</table>

Source: The Ministry of Commerce, China
China also uses various tools such as successive negotiations, the Early Harvest Program (EHP), continuous supplemental negotiations, and others. With ASEAN, it engaged in a successive negotiation where they discussed goods, service, and investment separately. For Pakistan, a separate preferential trade agreement was translated into an FTA. They used a negotiating framework that included the EHP with ASEAN, Pakistan, and Taiwan. China also underwent 7 supplemental negotiations for the CEPA it signed with Hong Kong, continuously expanding the scope of the service market opening.

* Korea-China FTA, exchange of strategies and profits

China has been proactive in its attitude towards the Korea-China FTA. In that case, what strategic meaning is China granting on its FTA with Korea? Some analyses include it being a response to the already-settled Korea-U.S. FTA amidst complex U.S.-China relations, a means to secure leadership within the East Asian region, and the political stability of the Korean peninsula. These claims are feasible considering the fact that China’s proactive attitude was made known through the top leading elites, rather than the Ministry of Commerce in charge of FTA negotiations.

Understanding and making good use of China’s such strategic character could help Korea win concessions from China during the FTA negotiations. However, it is not going to be easy to realize this. Above all, Korea has the largest economic scale among countries that have concluded an FTA with China. For China, Korea is its third largest trading partner following the United States and Japan. Moreover, the two countries have formed a close structure of division of labor with over 20,000 Korean companies investing in China. Meanwhile, the core industries of Korea, including electronics, semiconductors, steel, shipbuilding, and petrochemistry, are core industries that China is focusing on for the future.

As such, no matter how it may first have been initiated, the Korea-
China FTA is a negotiation in which China needs to emphasize economic effects the most. This tendency will become even more evident once the issues become clear with the start of the negotiations and also when the Ministry of Commerce of China, carrying out negotiations with China’s industrial sector, starts demanding more. As such, extra effort is required in order to translate the strategic significance that China places on the Korea-China FTA into economic profit for Korea. It is especially important for Korea to propose and agree on a negotiating platform that is favorable for Korea during the high-level talks prior to the negotiations.
Korea's auto industry expecting benefits from the Korea-China FTA

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* GM Daewoo will enjoy relatively greater benefits

The impact of the Korea-China Free Trade Agreement on the Korean automotive industry will likely vary for individual automakers. HMC/Kia, which has already localized manufacturing facilities in China, would have a limited positive impact from the agreement, whereas GM Daewoo, a Korean affiliate of General Motors, expects more sizeable benefits of cost reduction and export growth due to tariff elimination.

Currently, HMC/Kia’s annual production capacity in China exceeds one million vehicles per year, and its plan to put additional 400,000 units will limit export growth opportunities from the agreement. Similarly, Renault-Samsung, a Korean affiliate of Renault-Nissan, would have a limited positive impact from the agreement as Renault-Nissan increases its local production capacity to meet rising auto demand in China.

GM Daewoo has been enjoying robust growth in exports to China thanks
to rising exports of “knock down products (knock down method: a trade method used to export vehicles in forms of parts kit, then re-assemble into complete vehicles in local facilities to avoid tariffs),” and its auto parts exports have also shown rapid growth. Recently, Chinese automakers’ interests in Korean auto parts are growing and if tariffs are eliminated, it would further accelerate exports of Korean parts to China. However, GM Daewoo’s knock down exports may decline if it decides to leverage its Chinese affiliates as its small vehicle development and manufacturing base.

**More significant positive impacts of the FTA could come from the elimination of non-tariff barriers**

### Complete vehicles trade among Korea-China-Japan (in USD 100,000)

<table>
<thead>
<tr>
<th>Year</th>
<th>Korea</th>
<th>Japan</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>2,345</td>
<td>13,138</td>
<td>64.8</td>
</tr>
<tr>
<td>2009</td>
<td>3,953</td>
<td>34,850</td>
<td>119.3</td>
</tr>
</tbody>
</table>

### Auto parts trade among Korea-China-Japan (in USD 100,000)

<table>
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<tr>
<th>Year</th>
<th>Korea</th>
<th>Japan</th>
<th>China</th>
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</thead>
<tbody>
<tr>
<td>2004</td>
<td>7,191</td>
<td>23,714</td>
<td>4,608</td>
</tr>
<tr>
<td>2009</td>
<td>8,929</td>
<td>59,297</td>
<td>10,624</td>
</tr>
</tbody>
</table>
* Concerns of the auto parts industry

On the other hand, some Korean auto parts makers are concerned about the negative impacts from the Korea-China FTA and are against it. The tire industry, for instance, sees limited upside in exports from the agreement as Korea’s big three makers already have sufficient localized manufacturing facilities in China. It expects increased imports of low priced tires from China. Currently, the Chinese tire market is saturated with both Chinese and foreign tire makers. Korean tire makers are especially concerned about foreign tire makers with manufacturing facilities in China and assert that the Korea government must not only consider Chinese tire makers but also such foreign tire makers in China during the FTA negotiations.

A sharp increase in parts imports is another concern of Korean parts makers. Recent trade statistics indicate that parts imports of Korea from China have increased substantially while its parts exports to China have been relatively stagnant. There is a possibility that parts imports of Korea from China will further accelerate if the FTA eliminates import tariffs on Chinese parts. Amid rising cost reduction pressures, Korean automakers may consider raising their portion of Chinese parts usage.

* Non-tariff barriers may have a larger impact

More significant positive impacts of the FTA could come from elimination of non-tariff barriers, since a substantial number of regulations in China are designed to protect its own automotive industry. Such barriers include complicated certification systems that require excessive amounts of hours, costs, documentation, and field visitations, which could even cause technology leaks. Delayed decision-making or unnecessary costs due to over-regulation in foreign investment is another issue that the FTA must address.

The Korean delegation must be fully aware of China’s unique business
environment. They should understand the roles of Chinese partners for
Korean companies’ successful operations in China and make reasonable
proposals to the Chinese delegation before requesting excessive
concessions. A failure of the agreement due to excessive or impractical
requests would deteriorate the reputation of Korea in the Chinese market,
which may create a more difficult business environment for Korean
companies.

The reinforcement of intellectual property rights protection is another
important agenda that the FTA parties must discuss. Several copied
replacement parts are already being distributed in the Chinese market and
have caused severe damage to the image and revenues of the original parts
makers. The current patent application process needs to be amended to
protect advanced technologies developed by Korean auto makers.

The Korean delegation also needs to be well informed of China’s
changing labor environment and the Chinese government’s more aggressive
policy on nurturing its automotive industry when negotiating.  

China posted crude steel production of 570 million tons in 2009, a 13.4% increase year on year, amid unprecedented global economic crisis. This equates to nearly 50% of global crude steel output, and reaffirms that China is by far the No. 1 steel producer and the largest steel market in the world. In that sense, the Korea-China FTA will have a significant impact on Korean steelmakers and provide opportunities for Korea to acquire more competitive stance in entering into the Chinese market than other countries.

Korea has implemented trade liberalization in steel since 2004 by eliminating tariffs under the WTO tariff concession on most steel products (HS7206-29, 7301-08, 7312-13, 17). Thus, Korea should actively leverage the talks to induce China to repeal its tariffs on imported steel and its government’s steel subsidies as well. If Korea wins the concession in this regard, Korean domestic steel makers may expect more export opportunities
instead of being concerned about the negative impacts the free trade pact might bring.

* The largest mutual steel trading partners - Korea and China

Korean domestic steelmakers have built a solid business relationship with their Chinese partners in the past two decades. The initial relationship was shaped when Korea dispatched the steel delegation to the Chinese Ministry of Metallurgy in 1990 to establish the Korea-China Steel Cooperation Committee. Since then, the committee continued to solidify co-operational relationships at private level-15 dialogues held until 1998 when the Chinese government closed the Ministry of Metallurgy and shifted its functions to the China Iron and Steel Association. Through the close relationship, however, Seoul and Beijing agreed in 2001 to restart the dialogue with both the governments and steel companies attending in order to put a substantial amount of efforts, in particular, in free trade in steel.

Due to these efforts, Korea and China have become each other’s largest export/import markets; as of 2009, Korea exported 5.06 million tons of steel to China, equivalent to USD 4,352 million, and imported around 10 million tons of steel products from China. Also, China is the No. 1 investment destination for Korean steelmakers putting USD 3 billion of direct investment (as of 2009). If China has the will to improve its regulations related to foreign direct investment in steel, it is expected to bring about a
hike in investment from Korean steel makers, via the Korea-China FTA.

* Steel Safeguard regulation in FTA is essential for Korean market*

China still maintains its 5% import tariffs on all imported steel products, although it is the largest steel exporting country. The Korean government must propose an immediate repeal of the import tariffs on steel in the free trade talks with China. Also, the Chinese government must suspend both direct and indirect governmental assistance to its state-owned steel enterprises. As long as these favors continue in China, Chinese steel products, with competitive prices backed by government-led capital expenditures and mergers of steel makers to improve economies of scale, will significantly flow into the Korean market and hurt Korean domestic steelmakers. This is fundamentally against the original spirit and goal of the FTA and trade liberalization. Hence, it must be stipulated in the FTA that the steel safeguard regulation shall control a sudden rise in steel imports from China. The steel safeguard in the FTA can efficiently prevent any expected or unexpected trade conflicts between the two nations in steel trade by seeking mutually satisfactory resolution, thereby building up long-term and friendly relationship along the path.
Korea's electronics industry expecting increase in exports to local factories

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China and Korea are the world’s first and fourth electronics manufacturers, accounting for 24.9% and 5.7% of the global production volume, respectively. In the electronics sector, China is Korea’s largest trading country, and the largest trade surplus contributor. In trades with China, Korea has maintained its export and import growth of 17.4% and 16.9%, respectively, resulting in its trade surplus growth of 18% in the past five years. In 2009, Korea recorded a trade surplus of around $18 billion from the electronics trades with China.

China imposes 0-30% import tariffs on major imported electronic devices and appliances such as refrigerators, laundry machines, televisions, and air conditioners. Although the tariffs on the electronic devices are relatively higher than products in other sectors, the electronic products are the major items that contribute substantially to the trade surplus.
* Increase in exports of domestic electronic products will be insignificant

The positive impact from the Korea-China FTA, including the elimination of the import tariffs, will bring limited benefits to the export of Korean electronic products manufacturers as the positives will be offset by stiffening competitions in China’s electronic device market that are led by mid- and low-end products. Telecommunication products, for instance, are already tariff-exempted from the ITA (Information Technology Agreement) between the countries; hence the incremental export of those products would be minimal.

Instead, when Korea’s TV stations go digital in 2012, more mid-to lower-end digital television sales will increase in Korea followed by import increase from China. Chinese manufactures have relative advantages in these product segments in terms of price competitiveness and narrow technology gap, and because Korean manufacturers provide less competitive prices in the segments, Chinese players could find opportunities to expand its exports to Korea. Such products include digital TVs, washing machines, audio equipments and components, and general lighting system.

* Export increase of high-tariff electronic parts expected

If the Korea-China FTA is concluded, domestic electronic device manufacturers will increase exports of the core components such as televisions and audio components, items subject to high import tariffs, to their Chinese manufacturing facilities for local production. The major items...
to see rising export growth in the wake of the FTA would include television components (currently 30% import tariff), radio and telecommunication components (15%), audio components (20-35%), and premium refrigerators (10-30%).

In a long-term view, some concern that the Korea-China FTA may drive Korea to lose manufacturing competitiveness in labor-intensive industries (e.g. appliances, lighting, general electronic devices manufacturing), and could see many domestic electronic device manufacturers (e.g. digital televisions, small appliances, computers makers) to reallocate its production facilities to China. Others concern that the Taiwan-China FTA (currently under discussion), if concluded, may enhance price competitiveness of the Taiwanese peers against Korean manufacturers in the Chinese market, thus stiffening competition. They argue that Korea must leverage very actively on the FTA with China as an opportunity to further penetrate and develop the Chinese market.

In conclusion, Korean delegations must address conflicting trade issues from non-tariff barriers such as ambiguous customs procedures or reliability of trade customs before the Chinese delegations, and acquire clear and timely consent from the Chinese party to lower the barriers for mutually better trade environment.