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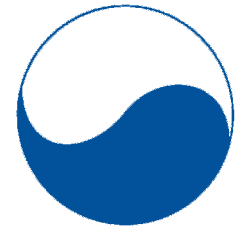

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CONTENTS

ECONOMIC RELATIONS BETWEEN KOREA AND CHINA

by Lee Chang-kyu

Introduction

The reestablishment in 1992 of formal diplomatic relations between Korea and China—relations between the two countries had ceased during the Cold War—has led to a surprisingly rapid growth of bilateral economic exchanges. In 2001, China became Korea's second-largest export destination, overtaking Japan; and China was the second-largest destination for Korea's foreign direct investment (FDI) outflows. Two years later, in 2003, China overtook the United States as Korea's primary export destination, and China also became the primary destination for Korea's FDI outflows.

The economically complementary structures of the two countries, as well as their geographic proximity and cultural familiarity, contributed greatly to the rapid increase in economic exchanges. China's rapid economic growth also provided an impetus for accelerating the bilateral economic exchanges. Owing to these factors, the two countries have developed an economically significant interdependence. In particular, having China as a major trading partner is very important for Korea's small, open economy. Thus, it is important to understand the sources of the expansion in economic exchanges between the two countries.

Trade

Before the establishment of official diplomatic relations, trade between Korea and China took the form of entrepôt trade, and the bilateral trade volume between the two countries was not significant. However, since official diplomatic relations were established, trade relations between the two countries have changed dramatically. Trade volumes have increased explosively, except for a temporary lag in 1998 when the Korean economy faced serious difficulties in the aftermath of the Asian financial crisis. Since then, the two countries have maintained relations of significant economic interdependence.

In the 1992–2003 period, exports of Korean goods to China increased at an annual rate of 26.5 percent, while Korea's imports of Chinese goods increased at an annual rate of 17.5 percent. As ***Table 1*** indicates, the share of exports to China out of Korea's total ex-

Table 1: **Korea's Trade with China, 1992–2003**

Year	Total exports ($,000)	Exports to China ($,000)	Share of exports (%)	Total imports ($,000)	Imports from China ($,000)	Share of import (%)
1992	76,631,515	2,653,639	3.46	81,775,257	3,724,941	4.56
1993	82,235,866	5,150,992	6.26	83,800,142	3,928,741	4.69
1994	96,013,237	6,202,986	6.46	102,348,175	5,462,849	5.34
1995	125,057,988	9,143,588	7.31	135,118,933	7,401,196	5.48
1996	129,715,137	11,377,068	8.77	150,339,100	8,538,568	5.68
1997	136,164,204	13,572,463	9.96	144,616,374	10,116,861	7.00
1998	132,313,143	11,943,990	9.02	93,281,754	6,483,958	6.95
1999	143,685,459	13,684,599	9.52	119,752,282	8,866,667	7.40
2000	172,267,510	18,454,540	10.71	160,481,018	12,798,728	7.98
2001	150,439,144	18,190,190	12.09	141,097,821	13,302,675	9.43
2002	162,470,528	23,753,586	14.62	152,126,153	17,399,779	11.44
2003	193,817,443	35,109,715	18.11	178,826,657	21,909,127	12.25

Source: Korea International Trade Association, KOTIS database, www.kita.org/.

ports rose from 3.46 percent in 1992 to 18.11 percent by 2003; the share of imports from China rose from 4.56 percent of Korea's total imports to 12.25 percent by 2003.

The recent brisk exports from Korea to China are due, at least partially, to the fact that the Chinese economy, because of China's entry into the World Trade Organization (WTO), is growing quite rapidly. With this growth has come demand for electrical equipment such as Korea's semiconductors and communications equipment. Korea's main export goods to China included industrial intermediate goods such as electrical machinery (HS 85), nuclear reactors and boilers (HS 84), plastics (HS39), petrochemical products (HS29), and iron and steel (HS72). This trade pattern reflects the economically complementary structures of the two countries. During the 1997–2002 period, as ***Table 2*** shows, parts and intermediate goods made up between 69.4 percent and 76.1 percent of Korea's exports of manufactured goods to China.

Korea's imports from China are currently undergoing a structural transformation. China has been undergoing rapid industrialization and has begun to manufacture a rising volume of electronic and electrical components to be exported abroad. Thus, it is natural that Korea and China are entering an increasingly competitive environment with regard to certain commodities such as electrical machinery and optical instruments.

The structural change in Korea's imports from China can be seen in ***Table 3,*** which shows that the share of imports of raw materials decreased from 67.77 percent to 37.36 percent in the 1995–2003 period, the share of capital goods increased significantly from 8.05 percent to 33.41 percent, and the share of consumption goods increased slightly from 24.15 percent to 29.22 percent.

Korea has recorded trade surpluses with China since 1993 (see Table 1), and this trade imbalance between the two countries has been generally expanding, making the trade imbalance one of the tough bilateral trade issues. In 2002, Korea achieved a record trade surplus with China of about $6.4 billion. In 2003, Korea's trade surplus with China increased further to $13.2 billion. In the same period, Korea's bilateral trade surplus with China accounted for about 88 percent of Korea's total trade surplus of $15 billion. On the other hand, China's competitiveness in fiber processing, textiles, and garments has been improving continuously, and in 2002 China began to enjoy a trade surplus with Korea in sectors such as garments, cotton textiles, silk products, and natural fiber products.

It has long been recognized that the existence of a bilateral trade surplus or a deficit can be a misleading indicator of microeconomic competitiveness and macroeconomic imbalance. Nonetheless, the bilateral trade imbalance has been one of the key issues in trade disputes all around the world. The widening trade imbalance could, therefore, escalate into a full-blown trade dispute between the countries involved. Thus, it is essential to prevent a potential trade dispute between Korea and China in order to sustain the expansionary trend of mutual economic exchanges in the future.

At various bilateral meetings, the Chinese government has continued to demand that its Korean counterpart redress the trade imbalance between the two countries. Meanwhile, the Korean government has insisted that maintaining the expansionary trade relations between the two countries should be given primary emphasis in the near future and that trade balance can be attained as the structural changes of trade relations between the two countries proceed.

Table 2: **Korea's Exports of Manufacturing Goods to China, 1997–2002, in millions of dollars**

	1997	1998	1999	2000	2001	2002
Manufacturing goods exported to China (total)	11,765	10,608	12,203	16,360	16,314	22,304
Share of parts and intermediate goods	8,134	7,483	9,036	12,455	12,095	15,484
Percentage	69.1	70.5	74.0	76.1	74.1	69.4

Source: Trade Research Institute of the Korea International Trade Association, www.kita.net/tri/eng_tri/index_main.jsp.

Table 3: **Classification of Korea's Imports from China**

Imported goods	1995		2000		2002		2003	
	($,000)	(%)	($,000)	(%)	($,000)	(%)	($,000)	(%)
Raw materials	5,015,830	67.77	5,837,474	45.61	6,778,856	38.96	8,184,340	37.36
Capital goods	596,035	8.05	3,682,348	28.77	5,199,808	29.88	7,320,748	33.41
Consumption goods	1,787,466	24.15	3,278,131	25.61	5,419,949	31.15	6,401,477	29.22
Others	1,865	0.03	775	0.01	1,166	0.01	2,562	0.01
Total	7,401,196	100.00	12,798,728	100.00	17,399,779	100.00	21,909,127	100.00

Source: Korea International Trade Association, KOTIS database, www.kita.org/.

In contrast with past meetings, China did not raise the issue of the bilateral trade imbalance between the two countries at the Korea-China summit in July 2003, which may reflect confidence on the part of China that this issue will be resolved in the near future. At that meeting, the leaders of both countries agreed to an expansion and deepening of substantial cooperative relations in areas such as politics, economy, trade, culture, and personal exchanges.

Foreign Direct Investment

In 1992, Korea and China established official diplomatic relations, and they subsequently signed an investment protection treaty. In the 1992–96 period, Korean FDI in China increased remarkably, as ***Table 4*** shows. After 1994, China became the second most attractive destination, after the United States, for overseas investments of Korean companies. Korean FDI outflows in China reached a peak in 1996, but investment fever toward China subsided significantly after 1977 because of the devastating financial crisis in Korea. In 1997–99, the annual amount of actual FDI continued to fall, which probably reflects the fact that a large number of Korean firms suffered from a deficiency of funds caused by the financial crisis. They simply did not possess the financial capability of doing business actively in China.

As the Korean economy began to recover from the financial crisis, Korean FDI into China (on an arrival basis) began to show a resurgence in 2000, increas-

Table 4: **The Flow of Korea's Foreign Direct Investment into China, 1988–2003**

	Flow of contracted FDI		Flow of actual FDI	
	Number of projects	Amount ($,000)	Number of projects	Amount ($,000)
1988	2	3,400	1	10
1989	12	9,770	7	6,360
1990	39	55,624	24	16,174
1991	112	84,722	69	42,469
1992	269	223,113	170	141,127
1993	631	622,701	381	263,682
1994	1,065	824,858	841	633,084
1995	885	1,282,300	751	841,122
1996	925	1,953,625	733	901,210
1997	751	914,318	630	725,683
1998	317	895,841	263	677,950
1999	552	482,264	457	348,691
2000	905	931,699	766	612,958
2001	1,123	981,971	1,028	576,845
2002	1,512	2,015,808	1,331	891,601
2003	1,757	2,557,501	1,623	1,304,997
Accumulated balance	10,857	13,839,515	9,075	7,983,963

Source: Export-Import Bank of Korea, www.koreaexim.go.kr/web/eng/index.jsp.

ing at a rate of 75.8 percent in comparison with the previous year. In 2003, China began to overtake the United States as Korea's preferred destination for FDI outflows on an annual basis. In 2003, the number of Korean FDI projects in China accounted for 59.7 percent of the total number of Korean foreign investments in the same period; and the amount of Korean FDI in China accounted for 37.1 percent of Korea's total FDI on an arrival basis. At the end of 2003, the total cumulative number of Korean FDI projects in China was 9,075, and the cumulative balance was $7.98 billion on an arrival basis. The total number of projects in China accounted for 46.0 percent of the total number of Korean foreign investments, and the cumulative balance accounts for 18.0 percent on an arrival basis.

Several features of Korea's FDI into China are worth mentioning. First, Korean FDI to China has been biased toward the manufacturing sector (***Table 5***). As of November 2003, 87.3 percent of Korea's FDI in China was invested in the manufacturing sector. Within the manufacturing sector, the top four subsectors were electronics and telecommunications equipment, textiles and apparel, petroleum and chemical products, and machinery and equipment. This observation supports, at least indirectly, the view that Korean FDI in China is the main channel for bilateral trade between Korea and China.[1]

Second, as ***Table 6*** and ***Table 7*** show, a majority of the Korean investors in China are small and medium-size enterprises (SMEs). After the financial crisis of the late 1990s, it was Korean SMEs rather than larger firms that played the dominant role in terms of FDI to China; this is in sharp contrast with U.S. and European Union investments in China. In 2000–03, the average annual growth rate of FDI in China by Korean SMEs was about 66.7 percent. The fact that most Korean investors in China are SMEs also shows in the relatively low average amount of capital invested by Korean firms. Also, the average amount of FDI that Korean SMEs invested in China decreased significantly in 1999–2000, when it was less than $300,000 (see ***Table 8***).

Two factors can explain why SMEs can be successful at FDI in China. One is the geographic proximity

Table 5: **Composition by Selected Industries of Korea's FDI to China, 1994–2003, percentage**

Selected industries	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
Manufacturing sector	91.8	84.5	77.5	64.3	85.7	81.2	84.4	83.9	82.7	87.3
Wholesale and retail	0.6	1.5	4.9	2.4	0.5	0.3	4.2	1.9	2.7	6.1
Real estate	1.7	6.6	2.9	6.2	4.8	10.7	4.6	4.1	4.8	4.0
Other	5.9	7.5	14.7	27.2	9.0	7.8	6.8	10.1	4.8	2.4

Source: Export-Import Bank of Korea, www.koreaexim.go.kr/web/eng/index.jsp.
a January–November.

Table 6: **Growth Rate of Korea's FDI to China, Classified by Size of Firms, 1994–2003, percentage**

Size of firms	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
Large firms	376.8	43.5	15.1	–3.2	7.0	–57.7	66.6	–38.3	50.8	7.6
SMEs	51.0	20.2	–4.1	–47.2	–49.0	11.4	98.5	61.5	57.6	52.9

Source: Export-Import Bank of Korea, www.koreaexim.go.kr/web/eng/index.jsp.
a January–November.

1. Kim, Si-joong, "Implications of China's Accession to the WTO for Korean Economy," in *China's Integration with the World Economy: Repercussions of China's Accession to the WTO,* ed. Lee, Kyung-tae et al. (Seoul: Korea Institute for International Economic Policy (KIEP), 2002), 370–1.

Table 7: **Number of Korean FDI Projects in China, Classified by Size of Firms, 1994–2003, percentage**

Size of firms		1994	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
Large firms	No.	92	91	73	50	20	11	14	16	29	35
	%	10.9	12.1	10.0	7.9	7.6	2.4	1.8	1.6	2.2	2.5
SMEs	No.	749	660	660	580	243	446	752	1,012	1,302	1,342
	%	89.1	87.9	80.0	92.1	92.4	97.6	98.2	98.4	97.8	97.5

Source: Export-Import Bank of Korea, www.koreaexim.go.kr/web/eng/index.jsp.
a January–November.

Table 8: **Average Amount of Korean Firms' FDI to China, Classified by Size of Firms, 1994–2003, in thousands of dollars**

Size of firms	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
Large firms	3,735.6	5,420.9	7,777.1	10,990.4	29,401.5	22,590.4	29,576.9	15,977.1	13,293.4	10,868.4
SMEs	386.4	527.0	505.3	303.7	370.0	224.7	264.5	317.4	388.7	528.6

Source: Export-Import Bank of Korea, www.koreaexim.go.kr/web/eng/index.jsp.
a January–November.

of Korea and China. Proximity makes it relatively easy for SMEs in Korea to become involved in overseas business in China. The other factor is the significant complementarity of industrial structures between Korea and China. Both these factors permit Korean SMEs to engage actively in business in China despite their disadvantages in terms of collection of information, ability to fund projects, and technological levels.

A third general observation about Korean FDI in China is that Korean investments tend to be clustered in several coastal regions in China because these places provide a more favorable business environment (including infrastructure) for Korean companies. Shandong province is the most popular place; it accounts for more than 30 percent of Korean projects and about 25 percent of total Korean investment in China. The abundance of skilled labor, investment-promoting policies from the provincial government, and ethnic connections in this area are crucial for attracting Korean FDI. Shandong is followed by Tianjin, Jiangsu, Liaoning, and Shanghai in terms of amount of investment. Thus, the locations of Korean investments contrast with the locations for FDI that are popular with overseas Chinese, who mainly concentrate their investments in Guangdong, Fujian, and the Yangtze River delta area around Shanghai.

International Segmentation of Production

One of the important features of Korean FDI into China is that Korean firms are largely engaged in processing trade and participating in the international segmentation of production. Korea's FDI into China contributes to increasing Korean exports to China because Korean affiliates in China import large amounts of intermediate goods and components from Korea. They then reship large amounts of their finished goods to third countries such as the United States and Japan.

Thus, the share of procurement of intermediate goods from the home country and the share of exports from among all finished goods could be clear indicators of the processing trade activities of Korean firms in China. According to a survey study of Korean affiliates in China,[2] the share of imports from Korea in the procurement of intermediate goods is about 44 percent, and a large part of these imports correspond to

2. Lee, C. S. and Lee C. K., "Korea's FDI into China: Determinants of the Provincial Distribution," working paper 02-16 (Seoul: KIEP, 2002), 12.

the supply of components from parent firms to their affiliates for final assembly. It can, therefore, be characterized as intrafirm trade. ***Table 9*** indicates that for this survey the share of intrafirm procurement was about 40 percent.

The share of export sales is also very high, amounting to some 70 percent. In particular, exports to the third countries (*B´–C´*) constitute a large share—50.5 percent. In addition, Table 9 shows that large Korean firms and Korean SMEs in China apparently differ in terms of where they sell their final goods. It is clear that the Korean SMEs, in particular, relocate some segments of their production in China so that China plays a crucial role of a production base for some Korean SMEs. The Korean SMEs seem to transfer the downstream, labor-intensive stages of production to China. This specialization in assembly operations has been frequently observed in the textile industry and in the electric and electronic equipment industry.

Opportunity or Threat?

Right now, there is widespread apprehension in much of Asia that China, the world's fastest-growing economy, will pose an economic threat to many countries of Asia. A few years ago, the economic threat of China did not seem to be a serious issue in Korea. Recently, an increasing number of Korean companies are relocating their production bases to China. Since 2001, small firms outpaced large companies in overseas investments to China. Furthermore, some conglomerates in Korea are enthusiastically reinforcing their activities in China. In 2003, Samsung announced plans to transfer most of its personal computer production from Korea to Suzhou by 2005. Posco announced plans to build a $20 million steel plate plant in Kunshan by 2005 to supply the Shanghai car industry with its automotive steel plates. LG, another high-profile Korean multinational, plans to boost research and development (R&D) activities in China and turn China into one of its core export bases.

Recently, therefore, industrial hollowing out has become an increasingly serious issue in Korea, and concerns are rising over a potential future hollowing out of manufacturing industries in Korea. A questionnaire survey conducted in May 2002 by the Korea Chamber of Commerce and Industry (KCCI) showed that about two-thirds of 213 Seoul-based manufacturing companies polled by KCCI planned on overseas plant relocations in less than three years. China was chosen as the most favored destination for the overseas investment of Korean firms.[3]

Table 9: **Procurement and Sales Structure of Korea's Affiliates in China, percentage**

	Procurement of intermediate goods				Sales of final goods			
	A	***C***	***B – C***	***F***	***A´***	***C´***	***B´ – C´***	***F´***
Total	42.4	43.9	13.7	39.7	29.3	20.2	50.5	24.9
Large firms	48.6	43.7	7.7	40.5	69.7	10.3	20.0	16.2
SMEs	41.6	43.9	14.5	39.6	23.8	21.5	54.7	26.1

Where:
A = local procurements
B = imported procurements
C = imports from home country
B–C = imports from third countries
F = intrafirm procurements
A´ = local sales
B´ = export sales
C´ = exports to home country
B´–C´ = exports to third countries
F´ = intrafirm sales

Note: $B = C + (B - C)$; $B´ = C´ + (B´ - C´)$; $A + B = A´ + B´ = 100$.
Source: Lee, C. S. and Lee C. K., "Korea's FDI into China: Determinants of the Provincial Distribution," working paper 02-16 (Seoul: KIEP, 2002), 12.

3. "44% [sic] of Korean firms planning to relocate plants abroad their overseas bases," press relaease no. 45 (Seoul: KCCI, 27 May 2002), http://english.korcham.net/main.asp.

Hollowing out can be defined roughly as an overseas exodus of domestic manufacturers in order to restore their international competitiveness. Concerns about hollowing out will be unwarranted if more sophisticated industries replace departing industries. However, if the massive departure of domestic manufacturers occurs at a rapid pace, some negative effects cannot be avoided—soaring unemployment and increasing economic instability of certain regions or sectors. Sectors with fragile competitiveness are especially vulnerable. China's recent emergence as an economic powerhouse has stunned some neighboring countries in Asia as well as the entire world. In some senses, therefore, potential economic threats to Korea that have become apparent by the rise of China, such as losing international competitiveness and the hollowing out of some domestic industries, should be carefully investigated.

For the time being, however, it seems reasonable to assess China more as an opportunity for than as a threat to South Korea. First, as is discussed above, one of the beneficial effects of FDI is the promotion of exports. FDI can promote the exports of a home country through intrafirm trade between a parent company and its overseas affiliates. To induce net positive effects from FDI, the derived exports of intermediate goods to the host country should be strong enough to compensate for the negative effects on the parent country's exports of final goods. Korean investment in China has grown along with trade. A survey study[4] finds that Korean FDI in China affects Korea's trade balance positively. According to this survey, Korean FDI in China is estimated to create a trade surplus of $3.46 billion, which accounted for 54.5 percent of Korea's actual trade surplus with China in 2002.

In addition, the rise of China offers an excellent chance for Korea to be a key supplier of China's booming economy for such items as memory chips, computers, LCD monitors, and mobile phones. Even the petrochemical industry, in which Korea had a massive overcapacity in the past, benefits from the burgeoning market in mainland China. In 2003, nearly 40 percent of Korea's steel exports were shipped to China as a result of surging demand for steel in mainland China. Furthermore, considerable time will be required for China to single-handedly meet its local demand for high-valued-added steels like automotive steel plates.

In the medium and longer term, certain Korean companies will be under additional and severe pressure from their counterparts in China. Yet, at least for now, any threat is far outweighed by opportunity created by the booming Chinese economy. In the meantime, South Korea has no choice but to push manufacturing in more high-value-added goods. South Korean companies should keep a step ahead in order to survive and should focus more on high-value, multilayer structures that use cutting-edge technologies.

One serious problem confronting the Korean economy needs to be pointed out. Currently, increasing concerns have arisen over Korea's poor R&D environment: the tendency for young graduates to avoid working in the science and engineering sectors, the falling morale of the R&D workforce, and the government's failure to improve outdated policies for attracting qualified R&D workforces. If this tendency is not reversed in a short time, Korea's international competitiveness could quickly wane. In that case, China, as an economic powerhouse, would quickly become a serious threat to Korea rather than the great opportunity it is now.

Dr. Lee is a Research Fellow, Northeast Asia Division, Korea Institute for International Economic Policy.

4. "Survey on Korean Affiliates in China" (in Korean), (Seoul: Korea International Trade Association [KITA], 2003).

KEI
Korea Economic Institute
Korea Economic Institute
1201 F Street, N.W., Suite 910
Washington, D.C. 20004