

The Changing Economic Relations between China and Korea: Patterns, Trends and Policy Implications*

Françoise Nicolas**

The economic rise of China and its integration into the globalization process is undoubtedly one of the most important developments of the past decades. The objective of the paper is to examine the changing nature and structure of the Korea-China trade and investment linkages, and to highlight the implications for the definition of Korea's economic policies vis-à-vis China, as well as vis-à-vis the rest of East Asia.

The paper starts by describing China's new role in the regional supply chain and the resulting change in the trade and FDI flows between China and Korea. It highlights the high degree of complementarity between the two economies and the nature of their respective participation in regional production networks. The next section examines the impact of the China-Korea trade and investment linkages on Korea's regional economic policy. It suggests that the criticism against floating rates is less relevant for trade among countries like Korea and China which share extensive production networks and are integrated in a triangular trade pattern with the Western markets. Regarding trade, the development of tight regional production networks suggests that the case for traditional free trade areas is rather weak, while trade facilitation is certainly desirable. In the wake of the current crisis, the shift in bilateral economic relations away from complementarity and towards rising rivalry may, however, substantially affect the game being played by the two countries.

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** French Institute of International Relations, Paris, 27 rue de la Procession, 75740, Paris Cedex 15, France, Tel: 33-(0)1-40-61-60-13, E-mail: nicolas@ifri.org

1. INTRODUCTION

The economic rise of China and its integration into the globalization process is undoubtedly one of the most important developments of the past decades. The resulting change in the global balance of economic activities has far-reaching implications for the world as a whole and for neighboring emerging economies in particular, with Korea as a case in point. Since the two countries established diplomatic relations in 1992, trade and investment linkages have substantially developed and the two economies have become increasingly interdependent. However, the tight economic linkages are primarily private sector-led rather than the result of government-driven initiatives.

The objective of the paper is to examine the nature and structure of the Korea-China trade and investment linkages, and to highlight the implications for the definition of Korea's economic policies vis-à-vis China, as well as vis-à-vis the rest of East Asia. The prospects for further government-led regional economic integration will be examined from this perspective. In addition, the paper looks at how the changes induced by the current global financial crisis may impact Korea-China relations and the stakes of further cooperation.

The paper starts by providing a comprehensive description of China's new role in the regional supply chain and the resulting change in the trade and FDI flows between China and Korea. The next section examines the impact of the China-Korea trade and investment linkages described earlier on Korea's economic policies with an emphasis being placed in particular on trade and exchange rate policies.

2. KOREA-CHINA ECONOMIC RELATIONS: RISING INTERDEPENDENCE

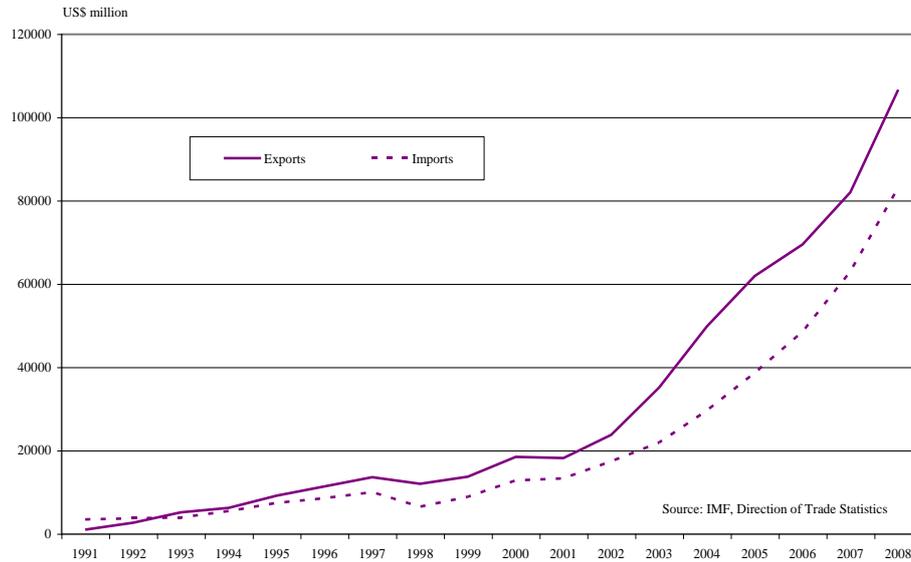
2.1. Dynamic Bilateral Trade

Following the implementation of its open-door policy in the late 1970s, China is getting increasingly integrated in the world trade networks and it is now the world's fourth largest trading nation. The country's exports and imports have surged since the early 1990s, with the US, Japan and the EU (in that order) as major destinations, and with Japan, the EU and emerging East Asia as major suppliers of imports.

China ranks particularly high among emerging Asia's trading partners, but while it imports a lot from the rest of the region, from industrial and emerging economies alike, it does not export much to neighboring emerging Asian economies. Over the period 1990-2006, the share of East Asia as a destination for Chinese exports has decreased from 67 to 38.9% and the Newly Industrializing Economies (NIEs) are the major losers. At the same time East Asia's share as a source of imports has risen from 55.4 to 58.1% of total Chinese imports. As a result, China runs a trade deficit with the region as a whole and in particular vis-à-vis Korea.

With the exception of Hong Kong, Korea has undoubtedly benefited more from the opening up of the Chinese economy than any other East Asian economy. China's trade with Korea has soared since the two countries resumed diplomatic relations in the early 1990s but the real takeoff in bilateral trade took place in early 2000s as can be seen on figure 1.

The bilateral trade between China and Korea amounted to close to 190 billion US\$ in 2008 (compared to 17 billion in 1995). Korean exports to China rose to close to 107 billion US\$ in 2008, while Korean imports from China reached 83 US\$ billions. Korea is nowadays the second source of imports for China, behind Japan but ahead of the US. From the Korean perspective, China now ranks first among the country's export markets, ahead of the US (table 1). Korea is the East Asian country with the largest

Figure 1 Korea's Trade with China, 1991-2008**Table 1 Korean Exports by Destination, 1992-2008 (% share)**

1992		2000		2008	
USA	23,6	USA	21,8	China	21,7
Japan	15,1	Japan	11,9	USA	11,0
Hong Kong	7,7	China	10,7	Japan	6,7
Singapore	4,2	Hong Kong	6,2	Hong Kong	4,7
Germany	3,8	Taiwan	4,7	Singapore	3,9
China	3,5	Singapore	3,3	Taiwan	2,7
Top6	57,9		58,6		50,6

Source: KITA.

pro-China export bias (Haddad, 2007). This tight connection with fast-rising China has undoubtedly helped Korea's recovery after the 1997-1998

financial crisis and has certainly contributed to the country's persistently strong growth record over the past few years.¹⁾ The flip-side of this increasingly tight economic relationship is first that Korea is now more dependent on the fate of the Chinese economy and second that the risk of frictions is higher than in the past. In particular, China's chronic trade deficit with Korea has fuelled complaints in the former country, leading to the imposition of anti-dumping measures and causing festering in the relations between the two countries.²⁾

2.2. Korean FDI in China

Another important form of interaction between the two economies is foreign direct investment. FDI into China tends to be dominated by Asian investors,³⁾ and Korea plays an increasing role in this respect. No fewer than 20 000 Korean companies were reported to be operating in China in 2008. If Hong Kong is excluded, Korea now ranks as the second individual investor in China, on the heels of Japan, but far ahead of the US, as shown in table 2.

Similarly, from Korea's perspective, China looms large as an investment destination. It now ranks first, ahead of more traditional destinations such as the US in particular (figure 2).⁴⁾ Korean firms are attracted both by China's low labor costs and by the favorable treatment granted in designated export-processing zones. Korean investments in China are still primarily efficiency-seeking rather than market-seeking.⁵⁾

¹⁾ According to some estimates, exports to China accounted for about 40% of Korea's export growth over the past few years.

²⁾ Out of the 151 AD actions initiated by China since January 1995, 27 targeted Korea (compared to 28 for Japan and 22 for the US). Similarly, out of the 108 anti-dumping actions initiated by Korea, 23 targeted China (14 Japan, and 13 the US).

³⁾ The importance of (mainly Asian) FDI inflows to China may be inflated to some extent by "round tripping", that is Chinese companies moving funds out of China to Hong Kong or other tax heavens and returning to China as FDI to take advantage of preferential tax treatment (Chia Siow Yue, 2004). On the other hand, however, FDI originating in the Virgin Islands can be expected to be to a large extent of Taiwanese origin.

⁴⁾ China overtook the US as Korea's preferred destination for outward investment in 2003.

⁵⁾ In this respect they differ from FDI from the US and the EU which tend to target the large Chinese market.

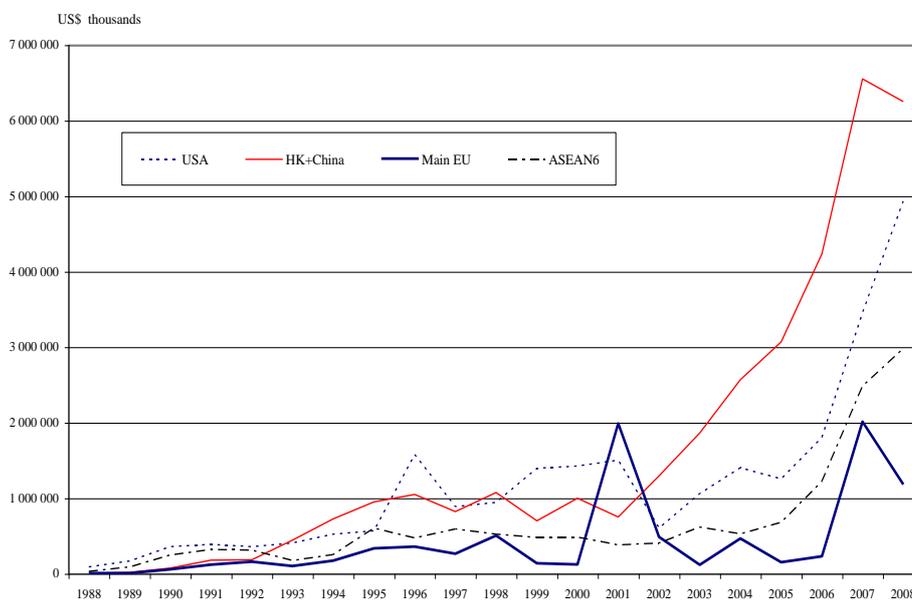
Table 2 FDI into China by Source Country, 1983-2007

(Unit: %)

	1983-1991	1992-2003	2004-2007
Hong Kong	58.7	45.1	32.8
Taiwan	0.0	7.6	3.5
Singapore	1.2	5.0	3.7
Japan	13.4	7.8	7.8
Korea	0.0	3.6	7.3
Sub-total	73.1	69.1	58.2
United States	11.1	8.8	4.8
Virgin Islands	0.0	5.7	16.8

Note: Data for realized FDI.

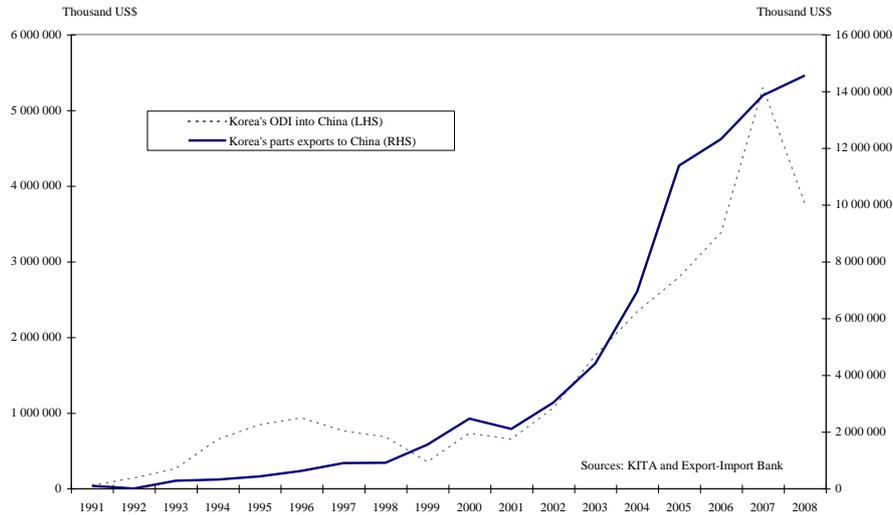
Source: China Statistical Yearbook, various issues.

Figure 2 Korea's Outward Direct Investment, 1988-2008, by Destination

In the case of China, the trade-FDI nexus is particularly tight for two major reasons. First, foreign-invested enterprises (FIEs) tend to be more export-oriented than Chinese firms. It is usually reported that FIEs account for about 60% of China's exports. As a result, FDI inflows tend to be positively correlated with Chinese exports. Secondly, FIEs also tend to be much more dependent on imported inputs so that FDI inflows are also positively correlated with China's imports from neighboring economies. As shown in a number of analyses, the share of domestic value-added is much lower in the production of wholly foreign-owned firms operating in China (and to a lesser extent in that of joint venture firms) than in the production of domestic firms, be they state-owned firms collectively-owned firms or private firms. According to the latest estimates by Koopman, Wang, and Wei (2008), the share of domestic value-added is 27.8% in the former case, and between 70 and 82% for the latter.

The complementarity between trade and investment is confirmed in the Sino-Korean relation. As explained by Park (2007), "Regardless of the type of investment, Korean investments in China have created intra-firm trade. Labor-intensive companies that expanded into China to export finished goods to the United States, to third party nations, or back to Korea, tend to rely on their parent companies or other Korean firms for intermediate goods. Since the target of third country trade is the same as the export market for Korean goods, this type of trade replaces traditional exports, and may even lead to increases in imports as these finished goods are imported back into Korea. However, the export of parts and components to China is resulting in export expansion. Generally exports of parts and intermediate goods by parent companies are expected to be greater than increases in imports of finished goods from China."

These characteristics have obvious implications for the composition and nature of trade flows as will be seen below.

Figure 3 Korea's Parts Exports to and ODI into China (1991-2008)

2.3. Composition of Trade: the Rise of Intra-industry Trade in Electronics Products

It is now a well-documented fact that the rise in East Asia intra-regional trade since the early 1990s has been largely driven by rapidly growing trade in parts, components and intermediate products that is a reflection of greater vertical specialization and the dispersion of production processes across borders. The bulk of China's imports from neighboring East Asia is indeed made of parts, components, and raw materials and this holds particularly true for Korea.

The composition of bilateral trade has substantially changed over the past fifteen years. First, while Korea used to export textile products to China in the 1990s, it now primarily exports electronic products, as well as refined petroleum products and a few chemical products. During the 1997-2002 period, parts and intermediate goods accounted for 69 to 76% of Korea's exports of manufactured goods to China (Lee, 2003). Today, Korea's exports tend to be dominated by parts and components and by capital goods:

the former accounted for 36% of the total in 2006 (up from less than 5% in 1992) and the latter for 16.7% (up from 7.3%). In parallel, the share of semi-finished dropped from 84% in 1992 to 43.3% in 2006 (Song, 2008).

When considered in greater details, Korean exports to China are increasingly concentrated in electronics products. Among those, of particular note are intermediate goods, comprising active components (SITC 776), as well as parts for electronic data processing and office equipment (759), and parts for telecom related devices (764). These three categories of intermediate goods accounted for 15% of Korea's total exports in 2000 and 19% in 2008. In addition, electrical machinery and apparatus (778) and television receivers (761) also loom large among major export products (table 3).

Table 3 Top 10 Korean Export Products to China (3-digit SITC)

1992	2000	2008
676	776	871
673	334	764
571	511	334
611	611	776
653	764	511
674	513	778
266	657	513
511	571	759
641	653	761
334	759	772

Note: SITC codes 871 (Optical instruments and apparatus, n.e.s.), 764 (parts for telecom related devices), 334 (Petroleum oils and oils obtained from bituminous minerals, other than crude), 776 (transistors, integrated circuits, etc.), 511 (Hydrocarbons, n.e.s. and their halogenated sulphonated, nitrated or nitrosated derivative), 778 (Electrical machinery and apparatus, n.e.s.), 513 (Carboxylic acids and derivatives thereof), 759 (parts suitable for electronic data processing and office equipment), 761 (television receivers), 772 (switches, relays, fuses, etc.).

Source: KITA.

Table 4 Top Ten Korean Import Products from China (SITC 3-digit)

1992	2000	2008
044	776	673
653	321	776
654	044	778
333	764	764
661	759	676
321	752	321
651	671	752
652	841	772
081	778	684
334	034	759

Source: KITA.

Although China is no longer a net importer of electronics products, it is still a net importer of electronics components. China primarily sources its components from its neighboring countries, in particular from Korea with regards to telecom equipment parts⁶⁾ (Gangnes and van Asche, 2008).

Korean main import products from China have also changed substantially, shifting away from clothing and primary products in the 1990s to electronic products such as computers, semi-conductors or telecommunication appliances. The share of primary goods (primarily agricultural products: maize (044), fish (034)) decreased sharply from 37.1% in 1992 to 6.3% in 2006. The share of final goods increased from 12.6% to 36.2%, but parts and components and capital goods are the import goods with the most rapid growth. (Song, 2008, p. 77). While they were dominated by light industry goods in the 1990s, Korean imports from China are now heavily concentrated in IT industry and electronic goods, but of a different kind than those exported by Korea (table 4).

⁶⁾ In contrast, ASEAN countries tend to export active components and Japan passive components.

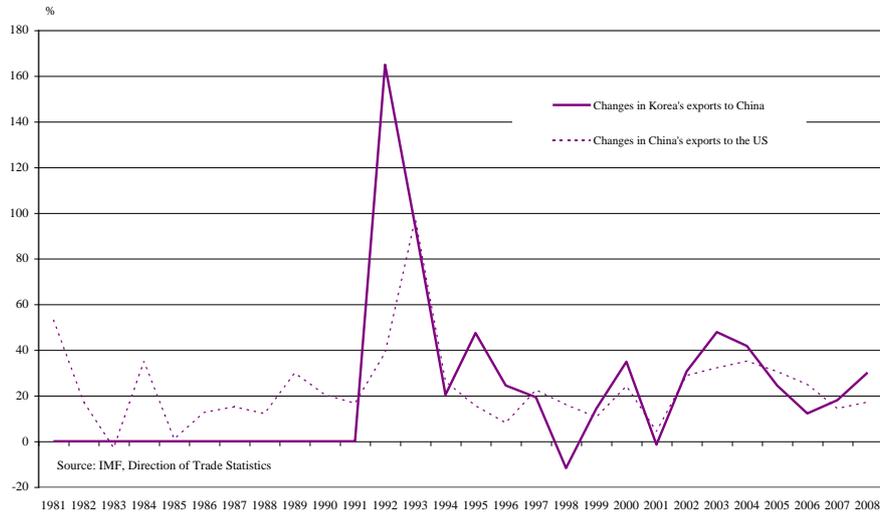
The presence of electronic products and parts (776, 764, 778, 772, and 759) as export as well as import products points to a rise in intra-industry trade between the two economies. When diplomatic relations were established between the two nations in 1992, intra-industry trade accounted for 12.9% of total trade, but rose to 64% in 2006, reflecting a significant structural change in the trade between the two nations. Another important feature is that within intra-industry trade, vertical intra-industry trade increased more rapidly than horizontal intra-industry trade. The percentage of VIIT in 1992 only amounted to 9.3%, but rose to 21.5% in 1995 and over 40% in 2004. In contrast, HIIT rose from 3.6% in 1992 to 13.9% in 2001, but fell after 2003 to 9.6% in 2006 (Park, 2007). The predominance of VIIT over HIIT is characteristic of production-sharing prevailing in East Asia.

2.4. Korea and China, Partners rather than Competitors

Although China's export profile appears to be increasingly similar to Korea's according to traditional similarity indices, this new state of play must be assessed in association with the previous observations about the rise in intra-regional intra-industry trade. As emphasized by Weiss and Shanwen (2003), China's gains of market share in the US market are misleading because they are due to exports of assembled parts and components originally produced in neighboring East Asian economies, with Korea as a case in point.

The close correlation between the fluctuations in Chinese exports to the US and in Korean exports to China (see figure 4) points to the existence of an indirect trading relation and supports the hypothesis that China is being used as an export-processing zone by a number of Korean producers. At the aggregate level, Chinese exports and Korean exports appear to be quite closely correlated, suggesting that they may be subject to common shocks but also that their productive structures are complementary.⁷⁾ The complementarity

⁷⁾ As a result of this complementarity, the rise in exports to China may more than offset the market share losses in third markets. See Ahearne *et al.* (2003) or Eichengreen *et al.* (2004) for further evidence on this point. While the former fail to find a statistically significant

Figure 4 Changes in China's and Korea's Exports

assumption is further supported by the observed rise in the complementarity index among Northeast Asian economies, in particular between Korea's exports and China's imports (Sang-yirl Nam, 2004).

This complementary relationship is particularly true in the electronics sector where China's production and exports of information technology hardware (primarily computer equipment) are based on imports of high value-added parts and components originating from emerging Asia (Korea, but also Taiwan, Singapore, Malaysia or even the Philippines).⁸⁾

In order to determine, whether China is really encroaching on Korea's export markets, it is necessary to remove the effects of rising intra-industry trade from the trade balance performances. To that end, another similarity index needs to be calculated on the basis of net exports rather than on the

impact of Chinese exports on East Asian exports, thus concluding that there is no evidence that increases in China's exports reduce the exports of other emerging economies, the latter show, through the use of a gravity model, that the rise in China's exports — and imports — positively affects the exports of its high-income neighbors but negatively affects the exports of less developed countries in the region.

⁸⁾ Electronic components account for more than 40% of Malaysia's and the Philippine's total exports to China, while it accounts for 32% of Singapore's exports to China.

basis of gross exports. This approach allows comparison of economies' trade composition based on sectors in which they are exporting 'value added'. Such calculations by the Department of Foreign Affairs and Trade of the Australian Government lead to results which differ widely from those obtained making use of the gross exports. In fact China's net export profile is found to diverge from that of Korea (as well as of Taiwan) since the early 1990s, probably reflecting the latter's shift out of labor-intensive industries such as clothing and footwear in which China is still heavily specialized. In this respect, the situation of Korea is clearly distinct from that of other countries in the region. Further evidence confirms this state of affairs: the gains in China's market shares in electronics production can be shown to occur primarily at the expense of Japan and most NIEs, with the exception of South Korea (Gangnes and van Asche, 2008). As a result Korea's net exports of mobile phones, digital and video cameras, computers and computer parts continue to expand strongly in the face of China's expansion in similar industries.

The rise in Chinese electronic exports to the US and to a lesser extent to the EU should also not be interpreted as crowding out East Asian exports but simply as a redirection of such exports. As far as Korea is concerned, the drop in its exports of consumer electronic products to the US can be shown to be offset by a rise in its exports of electronic components to China. As explained by Gangnes and van Assche (2008), Korea is found to be a particularly active upgrader in the electronics industry with a rapidly rising technology index in contrast to that of Taiwan, Japan, and Hong Kong. Korea still exhibits a much higher sophistication level than that of China.

Lastly, China's gains in market share require a further qualification: the bulk of Chinese exports are due to firms relocating from neighboring economies losing market share. In other words, in addition to being import-intensive, China's exports are mainly driven by Foreign Invested Enterprises (FIEs), most of which originates from Asia.⁹⁾ Indeed, Asian firms rank high

⁹⁾ This remark concurs with C-H Kwan's observation that we need to distinguish between "made in China" and "made by Chinese" or "what China produces" and "what Chinese

among the export-oriented foreign firms, while Western MNCs tend to seek to target the domestic market. This means that while a number of East Asian economies lose direct export competitiveness, their firms preserve and extend their competitive advantage and actually benefit the home country by promoting exports of intermediate products and related design and marketing activities and remitting dividends. This is certainly the case for Korean firms, whose drop in US market shares results to a large extent from the fragmentation of production and from their relocation in China. As a result, these firms now export from their Chinese production bases rather than from their home country's production bases.¹⁰⁾

3. POLICY IMPLICATIONS AND PROSPECTS FOR CHANGE

Given the specific nature of the *de facto* integration observed between China and Korea, an interesting issue is to examine the policy implications as well as the impact on the prospects for *de jure* cooperation between the two economies.

3.1. Implications for Korea's Economic Policies

It follows from the previous remarks that the rise of China can be deemed for the time being to be more a boon than a bane for most emerging Asian economies, with Korea as a case in point. As the fastest and the most steadily growing economy in the region (and even in the world), China has been an important export market and a major contributor to sustained growth in Korea. However, this has been possible because Korea managed to take the appropriate steps to reap the full benefits of its integration with China.

produce" (Kwan, 2004). For a sobering assessment of the China's miracle, see Gilboy, 2004.

¹⁰⁾ By way of illustration, Samsung now produces about 30% of its PCs in China.

3.1.1. Korea's development strategy

Despite the economic rise of China, neighboring East Asian economies necessarily maintain comparative advantages in some areas but the problem is that the resulting specialization may not square with their objectives and lead to what may be perceived as a “downgrading” of their industrial base. In Korea, a widely shared concern is that there may be no supporting activities to fill the gap opened by activities leaving the country. The real challenge is thus to encourage the necessary adjustments that will help avoid such a development. The other aspect of the challenge is the speed at which adjustment is imposed. One cannot deny that the rise of China imposes a much quicker transition than would have been the case otherwise. The real challenge for a country like Korea is to manage to find niche markets and to be flexible enough to face swift changes in comparative advantages imposed by the rapid intensification of competition from China. A particularly strong pressure can be expected in labor-intensive sectors such as textiles and clothing, footwear, toys and plastic products. As explained earlier, Korea has succeeded so far in shifting from low-technology activities to higher technology and more sophisticated activities, in particular in the electronics sector.

Enhancing competitiveness is key, as a way of reaching more sophisticated and higher value added sectors of activities, and of maximizing the opportunities offered by the regional fragmentation of production processes. Production sharing arrangements may already be in place, but they can certainly be further deepened and/or restructured.

3.1.2. The case for a China-Korea FTA?

For the time being, the need for a FTA arrangement between China and Korea does not appear to be extremely pressing. A major reason is that most of bilateral trade is already conducted duty free as a result of processing arrangements and/or as a result of the Information Technology Products Agreement (ITA).¹¹⁾ As explained earlier, a substantial share of Korean

¹¹⁾ The ITA was concluded by 29 participants at the Singapore Ministerial Conference in

exports to China and of Chinese exports to Korea is made up of electronic products which fall under the ITA which provides for participants to completely eliminate duties on IT products covered by the Agreement.¹²⁾ By contrast, consumer products on which China imposes relatively high levels of tariff rates account for a negligible share.

Also, very little Korean FDI in China results from tariff-jumping considerations for instance.

For these various reasons, the elimination of tariffs between the two countries is unlikely to have a substantial impact on their bilateral trade, making the case for a China-Korea FTA relatively weak under the currently prevailing division of labor between the two countries.

3.1.3. Implications for exchange rate policy choice

More importantly perhaps, the distinct nature of the relationship between China and Korea has also a direct impact on the choice of an exchange rate policy. Traditionally, when trade intensification leads to inter-industry specialization it is thought to exacerbate cyclical asymmetries thus enhancing the case for flexible exchange rates as a means of adjustment.¹³⁾ In contrast, when the rise in trade gives rise to intra-industry specialization it fosters business cycle synchronization and thus makes the case against flexible exchange rates (or for fixed exchange rates) more compelling.

Although China and Korea are likely to be affected by symmetrical shocks, with a drop in external demand hitting simultaneously Chinese exports of final goods and East Asian exports of parts and components, the case for a fixed exchange rate is not particularly strong because Sino-Korean trade is

December 1996. The number of participants has grown to 70, representing about 97% of world trade in information technology products.

¹²⁾ The ITA is solely a tariff cutting mechanism. While the Declaration provides for the review of non-tariff barriers (NTBs), there are no binding commitments concerning NTBs. There are three basic principles that one must abide by to become an ITA participant: 1) all products listed in the Declaration must be covered, 2) all must be reduced to a zero tariff level, and 3) all other duties and charges (ODCs) must be bound at zero. There are no exceptions to product coverage, however for sensitive items, it is possible to have an extended implementation period (from the WTO website).

¹³⁾ Unless, of course, alternative adjustment instruments are available.

dominated by vertical intra-industry trade and not by horizontal intra-industry trade.

First, an important point of note is the change in the sensitivity of trade flows to exchange rate fluctuations as a result of the existence of production-sharing between countries such as China and Korea. Empirical evidence by Obashi (2009) confirms that intra-East Asian trade in parts and components is far less sensitive to exchange rate fluctuations than trade in finished products¹⁴⁾ suggesting that exchange rate stabilization is less of an issue (and priority) in this part of the world.

Secondly, the specific position of China within the East Asian integrated circuit and the magnitude of processing in China's total trade impose different constraints on the conduct of its exchange rate policy, compared to other countries in the region such as Korea. While pegging to the dollar (or manipulating the currency in order to avoid an appreciation) may still be appropriate for most East Asian economies which seek to preserve their competitiveness,¹⁵⁾ it is more debatable for China. Given the importance of processing in China's trade, a unilateral appreciation of the renminbi vis-à-vis the US dollar (as well as vis-à-vis the currencies of component supplying countries) is unlikely to have a large impact on China's exports to the US because the loss in competitiveness of Chinese exports will be partially offset by the decline in inputs costs resulting from the renminbi appreciation against East Asian component suppliers (Rahman and Thorbecke, 2007). Of course, this holds true only if the Chinese currency appreciates both vis-à-vis the currencies of its export market as well as of its component suppliers. Should the renminbi appreciate only vis-à-vis the dollar but move in line with the currencies of the component supplying countries, the standard impact of an appreciation should be expected. This configuration suggests first that Chinese exports may be more sensitive to changes in the won/dollar exchange rate for instance than to changes in the renminbi/dollar exchange rate, and second that it is not always in the interest of China to have the

¹⁴⁾ This has probably to do with the substantial intra-firm nature of such trade.

¹⁵⁾ This is referred to as the "fear of floating" or rather the "fear of appreciation" (Pontines and Rajan, 2008).

renminbi moving in line with the currencies of component supplying countries. Of course the situation may be different if ordinary exports were dominant; in the latter case a renminbi appreciation is found to cause a large decline in ordinary exports.¹⁶⁾

The pivotal role now played by China in the region suggests that the need to manage the dollar exchange rate is probably stronger for East Asian economies than for China. In this context some flexibility in the dollar/renminbi exchange rate may turn out to be less problematic than often claimed and the rationale for intra-regional exchange rate stabilization remains weak.

3.2. Prospects for Change

In the medium-term, competition from China may get increasingly fierce as China climbs the technological ladder and shifts away from mere assembly activities towards higher value-added activities, thereby reducing its imports of intermediate products. At the same time, however, China is likely to become an increasingly important market for consumer products. More than a threat, the rise of China and the competitive pressure it exerts on neighboring economies constitutes a major challenge, imposing necessary (and possibly costly) adjustments.

Chinese authorities are increasingly seeking to reduce the country's allegedly excessive dependence on imported inputs and to upgrade its industrial structure. Some movement up the value chain is already under way in China and more upgrading can be expected in the coming years. Renewed declarations by the Chinese authorities to change gear and engage in a more resolute strategy of technological development point in this direction. The 2005 11th Five Year Plan called for a shift of the development strategy away from its over-concentration on resource and energy-consuming industry, and towards a more knowledge-intensive and

¹⁶⁾ Such differentiated impacts are obtained by Marquez and Schindler (2006), and Thorbecke and Smith (2008).

environmentally-friendly growth path (Naughton, 2007). This may be seen as an attempt to put an end to the “growth at all costs” strategy and to give some substance to the Government’s new economic mantra emphasizing the achievement of a harmonious society and a better balanced economy. The objective of a number of China’s recent regulations or policy provisions is to prioritize technological development together with environment friendly activities, while export-oriented foreign investments are, if not discouraged, not as actively encouraged as was the case in the past. By way of illustration of such a shift the new regulations of inward investment tend to promote quality of investment rather than sheer quantity.¹⁷⁾ At the same time, Chinese authorities are also trying to develop the Chinese market in an attempt to rebalance growth and to make it less dependent on external demand a more on domestic consumption.

By affecting the conditions in which the two countries interact, this policy change will affect the structure of the game being played by the two countries and impact Korea’s economic strategy in the three areas described earlier.

First of all, Korea will need to shift away from an almost exclusive (at least very heavy) reliance on exports of parts and components and towards enhancing exports of consumer goods. Korea’s challenge is to take the appropriate steps to enhance firms’ competitiveness and help them make the best of the potentially huge Chinese market. The next step is managing to design an appropriate strategy that maintains a competitive edge. Beyond specific micro strategies, such as brand name promotion, or niche market strategy, Korean firms also need some public support in the form of a more investment-friendly environment, as well as more comprehensive measures addressing the development of human capital, and the promotion of venture capital. To that end, industrial and innovation policies are needed.

Secondly, as China develops and gets richer, it will be seen increasingly as a viable market. It is worth emphasizing at this stage that accessing the Chinese market does not necessarily imply moving all stages of production

¹⁷⁾ See Nicolas (2008b) for more details on the shift in China’s investment regulations.

into China. Korean firms can perfectly cater to the Chinese market through exports rather than through FDI. The choice between these two strategies should be based on cost conditions. Of course, other barriers may bias the choice in favor of local production, leading to a sub-optimal resource allocation. This is one of the reasons why the implementation of a FTA with China, which would go beyond tariff elimination, would be a welcome step. Removing trade barriers with China would obviously contribute to a better exploitation of the market as well as to a better allocation of resources, helping in particular to maintain more sophisticated activities in Korea rather than relocating them systematically in China in order to circumvent trade barriers. In particular it is not at all obvious that Korean carmakers made an optimal decision by setting up large production facilities in China. While this may be appropriate for low range goods, which can definitely be produced at better-cost conditions in China, such may not be the case for higher-end products, which may be produced more efficiently in Korea. Depending on the type of products, exports will have to be preferred over FDI.

Lastly, with China shifting away from being a mere assembly platform for re-exporting and towards becoming both a market in its own right and a full-fledged competitor on third markets, the exchange rate issue will need to be solved differently than in the past. In these two cases, since bilateral trade flows can be expected to become increasingly sensitive to exchange rate fluctuations, the case for exchange rate cooperation/stabilization is also likely to rise. For instance, as the two countries get increasingly in competition in third markets such as the US, cooperation will become increasingly advisable, otherwise the risk is high that one country engaging in competitive devaluation or manipulation of its currency may lead the other to follow suit and there will be coordination by chance rather than by design and with no structured joint response in case of turbulence. Broadly speaking the emergence of a new division of labor and of different market patterns is likely to enhance the scope for cooperation in different areas.

In an attempt to rebalance its growth, and to reduce its dependence on

external markets in response to the current global economic crisis, China may be seeking to further boost its internal market. These efforts will result in an expansion of the regional market and Korean firms will need to adjust to the new pattern of demand. For instance, China's domestic demand for home electronics and automobiles is increasing at a rapid pace thanks to a variety of government policies, including the "home electronics and automobiles to the countryside"¹⁸⁾ policy. With this in mind, Korean companies need to place more focus on developing and marketing mid- and low-priced customized products with superior basic functions and high quality.

Another important change resulting from the crisis is the potential expansion of a regional market. In this respect, pushing for a China-Korea FTA may be instrumental in helping turn the region into a market rather than a sheer production base. Moreover the case for an FTA may also be more compelling because of the perceived need to reduce the dependence on the US market in the wake of the crisis.

4. CONCLUDING REMARKS

The Korea-China trade and investment structure has been shown to be unusual in many respects. First, Korea's exports to China are primarily designated for re-exporting abroad after processing in China rather than for meeting China's domestic demand. As a result, parts, components and intermediate goods account for the bulk of Korea's exports to China, and Korea-China trade is essentially intra-industry trade. Second, China has emerged as the main destination of Korea's outward direct investment since the early 2000s. Third, a substantial share of Korean exports to China is purchased by Korean-invested firms operating in China. Fourth, exports by

¹⁸⁾ As part of the campaign "to send electronics down to the country side," a 13% rebate is given to rural households on purchases of TVs, cell phones and computers. Also, subsidies for the purchases of cars and home appliances to replace older models have been tested in a number of rural areas before being extended to all rural areas and lastly to major cities.

Korean-invested firms in China are primarily targeted to the US market and tend to crowd out direct Korean exports to the US.

The specific nature of the de facto integration between China and Korea directly impacts the chances for de jure economic cooperation between the two economies. It has been argued that the highly complementary relationship prevailing to date does not provide a strong rationale for formal cooperation neither in the exchange rate nor in the trade area. However, as China gradually seeks to rebalance its growth strategy and in particular to reduce its dependence on processing trade, the two economies may shift away from being largely complementary to being increasingly in competition. Paradoxically this may pave the way for closer government-led economic cooperation.

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