



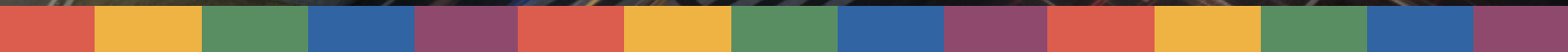
# KOREA'S ECONOMY

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a publication of the Korea Economic Institute and  
the Korea Institute for International Economic Policy



Volume 27







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ISSN 1054-6944



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# KOREA-CHINA ECONOMIC PARTNERSHIP: THE THIRD CHINA RUSH

*By Cheong Young-rok and Lee Chang-kyu*

Recently, Korea has been enjoying a Chinese tourist boom, which was absolutely unexpected until the very recent past. Moreover, Chinese tourists' shopping lists are astounding to Korean businesspeople, who are used to seeing Chinese visitors merely as consumers who buy only cheap goods such as apparel or traditional souvenirs. It is quite striking that Chinese visitors are filling duty-free shops where global brand-name products are sold. Many Chinese queue up to buy brand-name products from handbags to pricey wrist-watches. In contrast, Koreans have started to spend less money even on their business trips to China, since their business-trip budgets do not sufficiently cover their regular travel to China. Inflation and renminbi appreciation could be part of the rising travel costs. At the same time, the recent revival of the China rush is quite pronounced, judging from the increasing number of Korean tourists and increasing amount of investment led, importantly, by large companies that have turned to China in 2010.

The year 2010, which is when the Korean economy recovered from the 2008 global financial crisis, seems to have been the turning point to rerecognize China's importance in many respects. Previously, Koreans saw China as a mere export platform for Korea. Now China has become a major economic partner, vital for Korea's survival. As a result, in just two decades China is the only country to become a partner to Korea that engages in not only the exchange of goods but also other production factors. Thus, it is possible to make a cautious forecast that, ultimately, the economic integration between the two countries will be stronger and deeper than their integration between any other areas in the near future.

Korea is reevaluating China from the ground up. Korea's public sector has begun to see China in a different light based on thorough analysis. Observing China's overwhelming performance, Koreans find themselves in a conundrum about how to find ways to maintain the technology lead of Korean companies over China. Korea has also invested many resources in its academic sector, mobilizing most of the established Korean sinologists in academia. Some of the research outputs are worth mentioning here: The National Research Council for Economics, Humanities, and Social Sciences of Korea has recently published a collected volume of 55 papers.<sup>1</sup> The Korean Association for Contemporary China Studies (KACCS), an interdisciplinary academic association, recently held a seminar dealing with key concerns about China and relevant perspectives. These papers will provide some insights into key Korean concerns about China and the future direction of Korean responses.

The Korean business community is also struggling to find new ways to penetrate the expanding Chinese domestic market effectively. As China's wage level increases,<sup>2</sup> Korea's simple, labor-intensive investments are already being crowded out by local Chinese manufacturers. Korea's leading companies with factories in China are starting to beef up the management-level personnel to strengthen coordination. Most recently, one of Korea's leading conglomerates nominated an established Chinese professor,<sup>3</sup> who settled in Korea a long time ago and secured tenure at a Korean university, as chief representative of its Beijing office in charge of research affairs. Korea's past nationalistic environment and closed attitude toward outsiders make this something that was impossible to imagine in the past.

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1. Among them are 23 economics- and business-related papers provided in the appendix.

2. The Chinese government has also provided data on the minimum wage of the various provinces, which ranges from renminbi (RMB) 1,120 in Shanghai to RMB 700 in landlocked provinces such as Liaoning Province. A few years ago, the exodus of the Korean businesses from Shandong province was criticized by many.

3. The professor was trained in Japan, and he received tenure in a leading university in Seoul.

We argue in this essay that Korea is going through a complete overhaul of its economic partnership with China, an overhaul that is based on the more realistic assessment that China has now become a global economic player and that the Korean business sector is heading toward a deeper integration with China that will require more energy and a more sustained effort and partnership than with any other country. China, with its economic power and influence in the global economy, has transformed itself from a comfortable counterpart into a tough partner. In this paper, we will use the previously mentioned research papers to evaluate the bilateral partnership. We will refer to the statistical analyses contained in the papers and also the subjective conclusions of the authors. We also adopt the indices of foreign direct investment to export ratio and actual (effective) trade dependency ratio to support our argument.

This paper evaluates the two decades of Korea-China economic partnership since diplomatic normalization and the current problems that Korean policymakers, members of the business community, and those in academia are experiencing. The next section will summarize the stages of partnership based on the trade and investment trend between the two countries. Then we analyze the characteristics of the partnerships and show how Korea has adjusted to the changing environment. In the final section, we provide some concluding remarks.

### **From Investment-Driven Trade to Domestic Market Expansion**

In general, it is accepted that the degree of bilateral economic partnership can be estimated by trade and investment dependency indicators. On the basis of these indicators, we will elaborate the stages of Korea-China economic partnership. In the late 1980s, when Korea was governed by former military men, the government was eager to erase the stigma (or dilute the criticism) of military dictatorship by forming partnerships even with former socialist countries, including the Soviet

Union and China. But China, at the time, could not be an important partner in either trade or investment.

The year 2012 will mark the 20th anniversary of Korea-China diplomatic normalization. In the past two decades, the Korea-China economic partnership has gone through drastic changes. Some describe the development of the Korea-China bilateral relationship as “explosive.”<sup>4</sup> Before 1992, more than 50 percent of Korea’s trade was distributed among the United States, Japan, and the European Union. In 1992, for example, the United States accounted for 23.0 percent of Korea’s total trade, followed by Japan at 19.6 percent, and the EU at 12.8 percent. China’s share was a mere 4.0 percent. In 2010, however, China led in Korea’s trade, accounting for about 21.1 percent, while the United States, Japan, and the EU each made up 10 percent. There exists a caveat, however, because China’s trade is overestimated. The Korea-China trade is highly concentrated--at about 50–70 percent--on reexport from China. Thus, if we take that fact into consideration, China’s net share or actual (effective) trade dependency ratio could be reduced to less than 10 percent, which is the same or lower than Korea’s trade with the United States, Japan, and the EU.<sup>5</sup> Moreover, China-Japan trade amounted to \$296.6 billion in 2010, which is 10.05 percent of China’s total trade, and China-Korea trade totaled \$206.8 billion, which was 7.0 percent of China’s trade. Regarding imports into China, Japan makes up 12.81 percent as the country, while Korea is a close second at 10.03 percent. Because the China-Japan bilateral diplomatic normalization was established much earlier, in 1972, Korea’s economic partnership with China is seen as extraordinary and “explosive.”

*Figure 1* shows clearly the four different stages of bilateral economic cooperation: exploring partnership before normalization (in approximately 1992); the first trial China rush before the breakout of Asian financial crisis of 1997 (1992–1997); the second China rush, this time a full-fledged rush, that accompanied China’s World Trade Organization (WTO) accession

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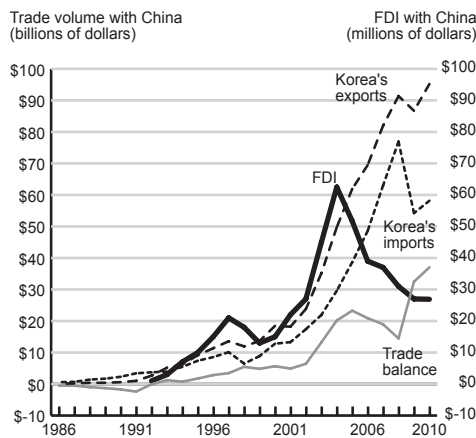
4. See, for example, Suh Jin-Young, “Meaning of Strategic Cooperative Relationship between Korea and China” (paper prepared for colloquium at Seoul National University, 2011).

5. This was deduced from data provided by Korea International Trade Association, KITA.net, [http://stat.kita.net/top/state/n\\_submain\\_stat\\_kita.jsp?menuId=04&subUrl=n\\_default-test\\_kita.jsp?lang\\_gbn=kor^statid=cts&top\\_menu\\_id=db11](http://stat.kita.net/top/state/n_submain_stat_kita.jsp?menuId=04&subUrl=n_default-test_kita.jsp?lang_gbn=kor^statid=cts&top_menu_id=db11).



(1999–2008); and the recent third China rush with the recovery from the global financial crisis (beginning in 2009). If we condense the stages, the Korea-China bilateral economic partnership could be divided into two distinct stages: the first stage before the outbreak of the Asian financial crisis when Korea's China investment sought to establish mere trade platforms, followed by the second stage of expansionary economic partnership that encompassed the real, monetary, and the labor sectors. The end of the first stage coincides with the time of the end of the WTO acceptance negotiation between China and the United States, which signaled the global investment rush into China.

**Figure 1: Trends in Korea-China Trade, 1986–2010**



Sources: Korea International Trade Association, KITA.net, [http://stat.kita.net/top/state/n\\_submain\\_stat\\_kita.jsp?menuId=04&subUrl=n\\_default-test\\_kita.jsp?lang\\_gbn=kor^statid=cts&top\\_menu\\_id=db11](http://stat.kita.net/top/state/n_submain_stat_kita.jsp?menuId=04&subUrl=n_default-test_kita.jsp?lang_gbn=kor^statid=cts&top_menu_id=db11); "Overseas Investment Statistics," Korea Exim Bank, Overseas Economic Research Institute, [http://keri.koreaexim.go.kr/05\\_invest/01\\_statistics/investTotal.jsp](http://keri.koreaexim.go.kr/05_invest/01_statistics/investTotal.jsp).

We will review the Korea-China relationship, relying on a two-stage analysis. In the first stage, Korea traded directly and indirectly with China even before diplomatic normalization. Until 1992, however, Korea incurred a trade deficit, which can be well understood when we take into consideration that there existed uncertainty about China's ability to pay. Obviously,

there is more import activity than export. The year 1992 was also the year when Korea incurred a trade deficit with China, which can be understood when we remember that diplomatic normalization took place in the latter half of 1992 (on August 24). The deficit signifies the diplomatic normalization.

Another very important phenomenon regarding the Korean economic partnership with China is the intensity of Korea's investment into China. Before the 1990s, Korea had been neither active and nor familiar with overseas investment. But with time Korean investors seemed to find their foreign investments in China manageable or even easier than domestic investments, presumably owing to China's less-developed stage and the existence of a great number of people of Korean-Chinese descent who are fluent in Korean, which facilitated Korean investment. The initial size of the Korean investment started from around \$100 million in 1992, growing to more than \$1 billion in the mid-1990s, and peaking at \$6.2 billion in 2004.

According to data from China's Ministry of Commerce,<sup>6</sup> Korea has invested a total of \$47.3 billion. According to data from the Export-Import Bank of Korea, Korea's investment in China never surpassed \$31.6 billion. Judging from the total world investment into China, which stands at \$1.05 trillion, the Korean share represents a mere 5 percent, according to both the Chinese and Korean sources. China's hosting of foreign direct investment (FDI) continues to increase, but Korea's contribution peaked in 2004, and since then has shown a decreasing trend in both absolute amount and share (Figure 2). According to the Korea Exim Bank, however, in 2010 the amount of investment from Korea increased from \$2.08 billion to \$3.16 billion, which explains well the changing attitudes of leading Korean conglomerates and, as a result, the active investment expansion by key Korean conglomerates.

The Korea-China partnership is highly related to investment-driven trade, which ultimately is reexported to countries and regions such as the United States, the EU, and others based on market segregation. If we link trade and investment, we come up with some interest-

6. FDI statistics can be found in *China Statistical Abstract 2011* (Beijing: China Statistics Press, 2011) and "Overseas Investment Statistics," Korea Exim Bank, Overseas Economic Research Institute, [http://keri.koreaexim.go.kr/05\\_invest/01\\_statistics/investTotal.jsp](http://keri.koreaexim.go.kr/05_invest/01_statistics/investTotal.jsp).

ing indices. One is a ratio of trade to FDI, calculated from total exports divided by total arrival of FDI. In 2010, for example, China's Ministry of Commerce reported that China had accumulated total FDI of \$1.05 trillion while exporting \$1.576 trillion. As a result, the global trade-to-FDI ratio is 1.5. If we single out Korea, the ratio is approximately 1.45 (\$68.8 billion in trade and \$47.3 billion in FDI). This confirms that Korea's FDI into China shows the same characteristics as other countries' FDI into China.<sup>7</sup>

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*“Chinese leaders studied the relevant Korean cases for implications, particularly focusing on ways they could privatize former state-owned enterprises by giving more property rights to these companies to the Chinese. Korea was also seen as a key source of an all-in-one solution in the process of economic development for developing countries.”*

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It is also interesting to see the actual trade dependency ratio calculated by net trade relationship with Chinese companies. The ratio can be calculated with Korean trade deducted by reexport and buying back portions, which in return shows us the importance of local markets in trade. As we see in **Table 1**, survey data show us the importance of the local Chinese market compared

with buyback by Korea or reexport to a third market. In 1995, the sales share in the local market was less than 30 percent, but by 2005 it was greater than 50 percent, which differs from the average person's notion that it still remained at about 30 percent. It could be interpreted that local sales include local sales to export companies through local letter-of-credit sales.

Also in the initial stage of diplomatic normalization, Korea enjoyed a development premium with China. Chinese government officials frequently visited the Korean embassy in Beijing to solicit development policy ideas, including about an export-oriented development model. This lasted at least until the outbreak of the Asian financial crisis of 1997, after which it ceased. The turning point was in 1997. As Korea became a key victim of the Asian financial crisis, it lost face as did the Korean economic development model. Thus, from 1997 onward, China on many occasions was a major lifeline for the Korean economy. China's major concern was how to implement an industrialization policy to maintain national pillar industries. Korea was admired as an exemplary model that had implemented the nationalistic development model that maintained its national pride while developing the Korean economy. POSCO, an integrated steel mill, and Hyundai Automobiles have been cited by Chinese leaders on many different occasions.

**Table 1: Trends in Sales Destinations of Korean FDI in China, 1995–2006**

Characteristics	Analysts						
	KITA	Lee	KITA	Jee	EXIM	EXIM	KOTRA
	1995	2002	2003	2004	2004	2005	2006
Sample size	n.a.	166	1180	298	463	598	540
Local market	27.7	29.3	40.6	38.1	49.4	51.0	47.6
Buyback	23.5	20.2	15.8	26.7	14.5	12.6	30.4
Reexport	48.9	50.5	43.6	35.2	36.2	36.3	22.0

Sources: Jee Mansoo, “Korean Investment into China [in Korean],” *Politeia*, 2007.

Note: KITA = Korea International Trade Association; Lee = Lee Chang-soo, “Research on FDI and Trade Relationships [in Korean]” (Seoul: KIEP, 2002); Jee = Jee Mansoo, “Korean Investment into China”; EXIM = Korea Export-Import Bank; KOTRA = Korea Trade-Investment Promotion Agency.

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7. See *China Statistical Abstract 2011*.

In addition, the Chinese government was very interested in the privatization process of well-known public companies like the aforementioned POSCO, which was observed and envied by Chinese leaders since the early stage of China's economic reform and open-door policy. Chinese leaders studied the relevant Korean cases for implications, particularly focusing on ways they could privatize former state-owned enterprises by giving more property rights to these companies to the Chinese. Korea was also seen as a key source of an all-in-one solution in the process of economic development for developing countries.

The year 2008 was also a time when the Korean economy was losing confidence in the dollar economy and, ultimately, in the U.S. economy. During the recovery from financial crisis, China played a critical role in generating hard currency foreign exchange from developed countries like the United States, Japan, and the EU. A simple calculation tells us how important China was during the 1997–2010 period. From 1992 onward, the Korea-China trade volume increased from a mere \$6.379 billion to \$153.35 billion in 2010.<sup>8</sup> During this time, Korea achieved a trade surplus totaling \$217.6 billion, and the volume of its trade grew 24 times larger from 1992 to 2010. More specifically, beginning in 1997, China became a key source of the Korean trade surplus which generated foreign exchange. From 1997 to 2010, Korea enjoyed a total trade surplus of \$211.74 billion. This accounts for the high current foreign exchange reserve generation in Korea. As of the end of 2010, Korea's foreign exchange reserves stood at \$291.6 billion.<sup>9</sup>

Another important relation between the two countries has been cross exchanges of a great number of permanent residents. In addition to conventional exchanges of trade and investment, Korea and China exchange both labor and students on a relatively large scale. Owing to 30,000–40,000 in China, approximately 120,000

Koreans reside in China with permanent residential status, according to the 2010 Chinese population census. The Korea Chamber of Commerce in China estimated the number of Korean Chinese at 700,000, which far exceeds the official Chinese figure. At the end of December 2010, 608,881 Chinese were residing in Korea, including 409,079 Korean Chinese, out of total foreign resident population of 1,261,415. The Chinese share of the total is 48.27 percent; and among Chinese, Korean Chinese make up 67.18 percent. They are employed in many of Korea's small- and medium-size enterprises, restaurants, and private homes as housekeepers and babysitters. In fact, some Korean Chinese have succeeded in realizing their "Korean dream" and now run their own businesses focusing on labor-intensive industries such as restaurants. In addition, about 58,000 Chinese students are studying in Korea, while approximately 64,000 Korean students are studying in China. In 2010 a staggering 1.88 million Chinese visited Korea while 4.08 million Koreans visited China.<sup>10</sup>

At the time of the outbreak of global financial crisis of 2008, Korea once again relied on China for securing foreign exchange and sought China as a source for a foreign exchange swap in the case of future crisis. This currency swap arrangement was symbolic of China's ability to rescue the Korean economy if Korea suffered a serious foreign exchange shortage, which is yet to happen, however. China has become a key country in Asia, one that plays a vital role in supporting currency risk. Korea was the first country to conclude a currency swap agreement with China; its size was 180 billion renminbi (RMB). This took place on 12 December 2008. The agreement was significant because it helped speed the internationalization of the yuan; RMB 180 billion was almost equivalent to \$25 billion. It was followed by Hong Kong (RMB 200 billion), Malaysia (RMB 80 billion), Belarus (RMB 20 billion), Indonesia (RMB 100 billion), Argentina

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8. The National Bureau of Statistics of China collects data up to over \$200 billion.

9. Korea International Trade Association, KITA.net, [http://stat.kita.net/top/state/n\\_submain\\_stat\\_kita.jsp?menuId=01&subUrl=n\\_default-test\\_kita.jsp?lang\\_gbn=kor^statid=kts&top\\_menu\\_id=db11](http://stat.kita.net/top/state/n_submain_stat_kita.jsp?menuId=01&subUrl=n_default-test_kita.jsp?lang_gbn=kor^statid=kts&top_menu_id=db11).

10. Korea Immigration Service data.

11. *Jingji Cankao Bao* [Economic reference news; in Chinese], 3 April 2009, and "Foreign Exchange Reserves," Wikipedia, [http://en.wikipedia.org/wiki/Foreign\\_exchange\\_reserves](http://en.wikipedia.org/wiki/Foreign_exchange_reserves).

(RMB 70 billion), and Singapore (RMB 150 billion). As a result, Korea started a new currency cooperation agreement with China, and, at the same time, Korea took 27.7 percent out of the total currency swap, the size of which was RMB 800 billion (equivalent to more than \$120 billion).<sup>11</sup> Judging from the total Korean swap size, we can see that the Chinese share is significant. Korea also has swap agreements with the United States (\$30 billion), Japan (\$20 billion), and China (equivalent to \$25 billion).

Last, Korea's regional development policy has also been substantially influenced. Before diplomatic normalization with China, Korea's eastern and southern regions received more attention because they played important roles in relations with Japan and the United States. From 1992 on, Korea's western coastal area began to receive more attention as it is the key area that trades with China, and demand in China is expected to expand in the future.

## **Emergence of China as a Global Economic Player**

### *China's Economic Transformation*

When we read China's economic indicators, they often give misleading signals. In terms of quantity, as of 2010, China has already become the second-largest economy in the world although its per capita income of \$4,382 still remains at less than half of the world average of \$9,226 and is only one-fifth of Korea's 2010 per capita income of \$20,591. This gives a somewhat misleading impression to both average Koreans and most of businesspeople.<sup>12</sup> In terms of domestic equality, China is still suffering from income inequality and regional disparities, a fact often pointed out by both academics and journalists.

China, however, has completed its dramatic economic transformation in only a generation's time. On China's economic development path, the years 1998 and 2008 had special implications. In 1998, China's gross do-

mestic product (GDP) reached \$1 trillion for the first time. In the same year, China's negotiations with the United States over its entry into the WTO were also finalized. The year 2008 also signified to the global economy that China was now a global economic player based on the size of its GDP, which was close to \$4.53 trillion, and its unusually large foreign exchange reserves of \$2 trillion. China had fully emerged as a country of potential last resort in times of global economic crises. China had transformed itself from a transition economy to a global manufacturer and a consumer market. Furthermore, China, equipped with the yuan which is rapidly internationalizing to become a vehicle currency, is pursuing free trade agreement (FTA) diplomacy on a global scale.

First, after its successful implementation of its economic reform and open-door policy, China became a major manufacturing site for the world. Without question, this was a result of the massive investment inflow from other countries in the world, led by the top 500 multinational corporations, a trend that became more pronounced after China's WTO accession in 2001. To a large degree, China has been the key beneficiary of the WTO. When the WTO was first launched in 1995, China was not a founding member. However, once China became a formal member in 2001, China turned into a key recipient of international FDI flows. Chinese government data show that China hosted a total FDI of \$700.5 billion from 2001 to 2010, which accounts for 66.8 percent of total FDI of \$1.0484 trillion entering China since the inauguration of its 1978 economic reform and open-door policy.<sup>13</sup> Since China's accession to the WTO, China has hosted an average of \$70 billion dollars annually, which is enormous in comparison with other developing countries. When Korea was a developing country, for example, it hosted, at most, less than \$20 billion annually. China's total trade was \$2.9523 trillion, presumably based on huge accumulation of FDI, before 2010. China became the world's biggest exporting country beginning in 2008, after catching up with Germany.

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12. The chief executive officer of Samsung confessed that his notion of the China market was totally off the mark until a few days before he was assigned to Beijing; see "Second Opening of Business in China," *Chosun Daily*, 17 May 2011, p. B5.

13. *China Statistical Abstract 2011*.

14. China's ambassador to Korea, Zhang Xinsen, has emphasized this on many occasions; see *Chosun Daily*, 17 May 2011.



Second, China is redrafting its development model and accelerating its FTA diplomacy in order to maintain its status as a global manufacturer. If all of China were engaging in export production for the global market, it would be extremely difficult for most developing countries to find a niche market. On the one hand, China is promoting an FTA with Korea,<sup>14</sup> and on the other hand, it is trying its best to expand its domestic market. As we see from **Table 2**, China has already concluded FTAs with nine economic areas, is currently negotiating with five areas, and is conducting research with three areas. Among countries involved in China's FTA diplomacy, the Northeast Asian region that encompasses both Japan and Korea is the largest and most critical area.

Third, China's economic transformation could also be seen in the area of consumerism in China. Chinese tourists are sweeping the world. China incurred a tourist income deficit in 2010. According to the State Administration of Foreign Exchange, China earns \$45.8 billion from tourists, but Chinese tourists spend \$54.9 billion,<sup>15</sup> resulting in a deficit of \$9.1 billion. China is a multifaceted economy with strong global competitiveness based on a cheaper cost structure as well as a huge consumption market.

China has produced a large number of millionaires and billionaires. In China, there exist two different publications on the newly established rich: the online Hurun Report and *New Fortunes* magazine. Through

these publications, China's nouveaux riches have shocked the world with their assets. According to *New Fortunes*, the total assets of the top 500 richest Chinese amount to 8.7 percent of China's total GDP.<sup>16</sup> Formal government publications also confirm that 7–8 percent of China's population in the major cities, which stands at about 100 million, have achieved a per capita income over \$10,000. Bear in mind that Deng Xiaoping's economic reform and open-door policy had originally set the target per capita income of \$10,000 to be achieved by 2050. **Table 3** clearly shows the distribution of those cities in China. Eleven cities in 2010 already have a per capita income greater than \$10,000: Shenzhen, Guangzhou, Suzhou, Wuxi, Shanghai, Beijing, Dalian, Weihai, Foshan, Ningbo, and Zhuhai, all of which are coastal cities. Compared with the national average per capita income level of less than \$4,382, the high incomes in these coastal cities are shocking enough to shatter the common notion that China is still a developing country. Moreover, these "club cities" with \$10,000 per capita income are expected to expand every year along with the accelerated economic development in China.

Fourth, China has stood up to play the role of the country of last resort in times of major global economic crises since the outbreak of subprime crisis in 2008. China already is equipped with two elements that are required of a global rescuer. If China exercises its buying power in the world market, it can be a lifeline for developed countries. China played this role, for

**Table 2: China's Progress in Concluding Free Trade Agreements**

Concluded	Mainland and Hong Kong Closer Economic Partnership Arrangement, Association of Southeast Asian Nations, Pakistan, Chile, New Zealand, Singapore, Peru, Asia-Pacific Economic Cooperation, Costa Rica, Taiwan
Under negotiation	Australia, Iceland, Norway, South Africa Customs Union, Switzerland
Research in progress	India, Korea, Korea-Japan-China

Source: "China FTA Network," Ministry of Commerce, People's Republic of China, <http://fta.mofcom.gov.cn/index.shtml>.

15. State Administration of Foreign Exchange, Beijing, [www.safe.gov.cn/model\\_safe/tjsj/tjsj\\_detail.jsp?ID=110500000000000000,44&id=5](http://www.safe.gov.cn/model_safe/tjsj/tjsj_detail.jsp?ID=110500000000000000,44&id=5).

16. Their assets were measured in stock.

17. China's highways have already reached 65,100 linear kilometers, which is 81.4 percent of the extent of U.S. highways. And the first high-speed railroad line, connecting Beijing and Shanghai, is expected to be completed in July 2011. Wuhan to Guangzhou and Shanghai to Nanjing are already in operation.

example, with its timely announcement of additional budget spending, or early spending of RMB 4 trillion. Also, China's announcement of the 12th Five-Year Plan is significant because it emphasizes expansion of the domestic economy, which definitely generates new opportunities for ailing developed economies. In this process, domestic market integration is emphasized in many respects.

The new Five-Year Plan also emphasizes domestic demand expansion. One of the tools to do this is unifying the Chinese market by constructing highways,<sup>17</sup> then constructing high-speed railroads. China's high-speed railway construction project will also be a good opportunity for developed countries. Furthermore, China is taking outbound investment as a key tool to ease inflationary pressure and appreciation pressure. This, though, is not a simple task. Rescuing the global economy was dependent on Asia because Asian countries had accumulated huge U.S. dollar reserves during the past several decades, possibly breaking down

and weakening the Bretton Woods system. All Asian countries sought to accumulate more U.S. dollars and secure more of the U.S. market. As of 2010, international foreign exchange composition was distributed among many countries—led by China, Japan, Taiwan, and Korea—and amounted to \$4,888 billion.

At the Group of 20 meeting held Seoul in November 2010, the United States and China were seen as the key actors, and this led to the common use of the term “G-2 meeting” instead of “G-20 meeting.” Appreciation of the renminbi was the key item on the agenda. A Chinese citizen, Zhu Min, was nominated as chief adviser to the managing director of the International Monetary Fund, which was unimaginable 10 years ago. China's currency was gradually becoming one of the key currencies in the world, somewhat through both intention and circumstance. The Chinese government nominated 67,000 Chinese companies to settle their trades in renminbi beginning at the end of 2010,<sup>18</sup> when there were already moves toward renminbi in-

**Table 3: Regional Distribution of Cities with Per Capita Income Greater Than \$10,000, 2009**

Region	Name of city	Population (10 thousand)	Economic size (billions of dollars)	Per capita income (dollars)
<b>Huabei (northern coastal China)</b>	Beijing	1,755.0	187.8	10,070
	Dalian	618.0	64.9	10,507
	Weihai	281.6	28.9	10,254
<b>Huadong (middle coastal China)</b>	Shanghai	1,912.3	219.0	11,451
	Suzhou	943.1	115.2	12,211
	Wuxi	622.2	73.8	11,854
	Ningbo	571.0	61.9	10,833
<b>Huanan (southern coastal China)</b>	Guangzhou	1,031.8	134.3	13,015
	Shenzhen	892.1	121.1	13,574
	Foshan	598.2	70.6	11,810
	Zhuhai	150.7	15.3	10,165
<b>Total</b>		9,376.0 (7.0%)	1,092.8 (22.3%)	3,678 <sup>a</sup>

Source: “China Economic Brief” [in Korean], Korea Trade-Investment Promotion Agency (KOTRA), March 2010.  
<sup>a</sup> Per capita income (national average).

18. In July 2009 it was a mere 365 companies.

19. “Zhou Xiaochuan: Reform the International Monetary System,” People's Bank of China, 23 March 2009, [www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706\\_.html](http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706_.html).

ternationalization. In reality, the renminbi is already freely circulated in many of the ASEAN countries without being exchanged into local currencies. Zhou Xiaochuan, governor of the People's Bank of China, China's central bank, suggested that special drawing rights should replace the U.S. dollar as the vehicle currency,<sup>19</sup> which created negative repercussions in Western countries. Also, China concluded a currency swap of approximately RMB 800 billion with seven countries, including Korea. China is also actively involved in the Chiang Mai Initiative (CMI), which is a multilateral currency swap arrangement among ASEAN's 10 + 3 countries. In the CMI arrangement, China took 32 percent of a total contribution of \$120 billion.

All these are key components of the Chinese economic transformation. In China, the terminology most often cited in the mass media in recent days is, without question, domestic demand promotion. Since 2008, China also deeply recognizes that expansion in external demand has a definite limit after a certain point.

### ***Korean Responses***

With the extraordinary transformation of the Chinese economy, Koreans are responding in diverse ways and changing their preconceptions. Koreans are now on their feet about the quick transformation of Chinese economy. First of all, labor contracts and wage increases combined with industrial restructuring have forced simple, labor-intensive Korean companies to withdraw their investments from China and move them to other places like Vietnam, Pakistan, and Indonesia. Koreans feel that the China's learning curve is too steep. The Chinese economy is multifaceted, with developing and developed areas of the economy existing side by side.

The year 2008 gave China an unexpected opportunity to begin replacing the United States in its role in the monetary sector. China's dynamism is threatening the Korean economy. China's businesses might take over Korean businesses in many areas, including the export market. In 2010, China's GDP growth amounted to the size of the entire Korean GDP; its net GDP increase was about \$900 billion. Also, China has been maintaining a dual economy of a developing region in the areas away from the coasts and a global production factory in the coastal areas that generates a huge population with considerable wealth. In the near future, China might

change the global international order, and possibly it might even replace the United States in the long run. The World Bank recently predicted that the Chinese renminbi would make up one of the three vehicle currencies in the world by 2025.

When the Korean president, Lee Myung-bak, began his term in 2008, Korea's diplomatic relationship with China was cooling down. For the first time, the Chinese embassy called for a meeting of Korean sinologists in the China Cultural Center in Seoul. The meeting's major focus was the tendency of Korea to tilt back toward the United States and disregard China. The occasion itself was unusual because it showed the acute concerns the Chinese had. China seemed to suspect that Korean foreign policy intended to detach itself from China and piggyback instead on U.S. power.

President Lee's visit to the United States highlighted this suspicion. Afterward, the Chinese ambassador to Korea was replaced by someone who had already served at the director-general level. This was unprecedented as the level of the Chinese ambassador to Korea had been rather low in terms of rank. This had been criticized on numerous occasions. The nomination of the former ambassador, Li Bin, for example, was an embarrassment for Koreans because he was recognized as a mere interpreter who was only a section chief. It was rumored that the Chinese government purposely promoted him for a short while in Beijing to the director-general position and stationed him in the Ministry of Foreign Affairs before sending him to Korea.

In 2010, however, the Korean government seemed to be changing its attitude toward China. The public sector now pays more attention to China: Korea's public sector has been reviewing and reevaluating the significance of China to the Korean economy, which can be seen from the list of research projects assigned by government-sponsored research institutes. Out of the 55 research topics, 23 were related to economics and business, focusing on issues like the promotion of domestic demand, retention of Korean competitiveness, regional policy of Korea, logistics cooperation, energy cooperation, China's development model, yuan settlement and internationalization, tourism, China's asset market, and Sino-U.S. trade disputes (see the appendix to this article).

The private sector also seems to be adjusting quickly to the new changes. Korean conglomerates are experiencing important business exposure (see *Table 4*). Many Korean top managers have started to recognize again the importance of a technology lead over Chinese businesses in order to cope with competition from them. Judging from the astounding number of more than five million engineers in China, combined with the strong leadership initiative of China, Korean businesses are gravely concerned about the rapid catching up being accomplished by Chinese businesses. Newspapers and media sources in Korea have reported that Korean businesses are starting to suspect or at least worry about losing their technological lead, judging from the rather short time that it takes for Chinese companies to catch up.

One top manager in charge of China business at Samsung, a leading Korean conglomerate, revealed the strategy of considering China as a second market that is more important than the Korean domestic market.<sup>20</sup> Kang Ho-moon, the newly appointed chief of Samsung's China business, created a new catch phrase "constructing a second Samsung in China." Instead of "made in China," he emphasized "create in China."

Hyundai Automobiles is also expanding its production capacity with a third production site in Chongqing. Hyundai already has production factories in Beijing producing Hyundai brand cars, and in Yancheng, Jiangsu, located next to Shanghai, a factory produces

cars for its sister company, Kia. Hyundai plans to increase its annual production capacity in China to as many as 1.43 million passenger cars by 2012, the year of the 20th anniversary of Korea-China normalization.

SK also established "SK China" and "open innovation" as catch phrases for 2010 and concentrates its capacity to capitalize on China's domestic demand, emphasizing the environment and new energy recycling industries. The LG group has tried to set up its eighth-generation LCD panel factory in Guangzhou, Guangdong, in southern China. LG seeks to increase its chemical production capacity to achieve production of 1 million tons of acrylonitrile butadiene styrene. LG recorded an average annual sales growth rate of 19 percent for the last five years.

It is often argued that localization is inevitable in penetrating the China market. Asian ways of doing business are unique, especially in overseas investment. Similar to the United States and other areas, ironically in China also, are the existence of a so-called Taiwanese Town, Japanese Town, and Korea Town. However, there are no U.S. Towns, French Towns, or English Towns, except the original international settlements dating back to the colonial periods in Shanghai. This is a sharply contrasting phenomenon that differs greatly according to the origins of those doing business in China. Asian businesses are still self-sufficient, while the United States and the Europeans employ local Chinese agents, delegating to them full authority. Japanese businesses

**Table 4: Business Exposure to China by Major Korean Conglomerates, 2010**

Korean conglomerates	Presence <sup>1</sup> (no. of sites)	Investment	Sales (billions of dollars)	Employment (no. of workers)
Samsung	99	36 companies	40.7	91,000
LG	40	n.a.	33.0	69,000
Hyundai-Kia	2	2 companies	14.1	n.a.
Hanhwa	19	n.a.	1.8	15,000

Source: "Second Opening of Business in China," *Chosun Daily*, 17 May 2011, p. B5.

1. Presence includes representative offices, manufacturing factories, research and development offices, and sales outposts.

20. Samsung has already established its own business network in China with 99 related outposts including 22 sister companies, 36 production corporations, 34 sales corporations, and 7 research centers. Samsung's total investment up to 2010 amounted to \$9 billion, which is either 31.3 percent of Korea's total FDI into China (according to the Korea Exim Bank) or 19.0 percent (according to China's Ministry of Commerce).



also suffer the same weaknesses in terms of localization. While the Japanese are involved in the full details of business management, they cannot avoid arousing anti-Japanese sentiment in the end.

To overcome such phenomena, Asian businesses are also starting to rely on localization. They either delegate the management to local Chinese managers or employ local Chinese staff and give them equal status with expatriates. Japan, which has had much experience with intensive contacts with the Chinese since 1972—much longer than the Koreans—seems to cooperate with Taiwan businesses, which are more friendly toward Japan because of Taiwan's past as a Japanese colony from 1894 to 1945. The Taiwanese are thriving in the China market thanks to their understanding of China. As a result, while many Korean businesses disinvested from China, Japanese businesses have made an S-turn—they disinvested from China and moved instead to Taiwan in order to re-invest in China—since the mid-1990s. Japanese businesses give much more emphasis to Taiwanese businesses in China, and the Taiwanese have become important partners.

Korea still employs Korean Chinese as local business partners, and this is considered ideal. Some Korean businesses are also concerned about the Economic Cooperation Framework Agreement (ECFA) between the mainland and Taiwan because the ECFA can enhance the economic partnership between Japan and mainland China, through Taiwan.

Most recently, China has expressed its desire to conclude an FTA with Korea as soon as possible. To be more precise, the Chinese government has strongly requested an early conclusion of an FTA. How then can Korea cope with China's FTA strategy?

On the possibility of an FTA with China, Korea is receptive because Korea has already concluded FTAs with two pillar areas: the United States and the EU. But the timing is not decided yet. Public opinion seems to be evenly divided on the Korea-China FTA. One side is very positive toward an FTA with China. This group's active stance is based on the "timing argument" that China is developing beyond our imagination. With China's sheer size, negotiation leverage will be disproportionately in favor of China. If an FTA is a necessity for both countries, why not conclude the agreement right away to gain an early-mover advantage?

Another group is more hesitant and cautious toward an FTA with China. The current actual Chinese tariff rate is far lower than the simple tariff average because most Korean exports already enjoy tariff exemptions in China. Also, the Chinese domestic market, much like the Japanese market, has higher nontariff barriers. China's logistics cost structure is lower, and overseas businesses cannot break down the cost barrier. Moreover, China is divided into two very different markets. One is a very cheap market for average Chinese citizens who make up about 90 percent of the total market. The remaining 10 percent is a market for the top global brand names, and only a few rich Chinese can afford these. Neither market is suitable for Korean businesses because Korean products do not belong to either of them. Korean products are too expensive for the average Chinese and too cheap and ordinary for Chinese millionaires or billionaires.

### **Concluding Remarks**

We have reviewed the dynamic development of the Sino-Korean economic relationship of the past two decades. The relationship can be summarized by highlighting two phenomena: that China became the largest exporting country with the largest Korean investment, and that owing to this it was inevitable for Korea to cautiously expand its China business.

First, China rapidly—in fewer than 20 years—became Korea's major economic partner. The speed was beyond our expectation. Although the quantity still does not fully reflect the deep economic integration between the two countries, it is moving toward a stage of recognizing the real importance of China. As of now, despite the explosive trade volume with China, markets in the developed countries of the United States, the EU, and Japan are still the major markets for most Korean businesses. The effective trade dependency ratio ranging from 7 percent to 10 percent with China tells us that the importance of China is on equal footing with those developed countries. China's growth will continue to be dynamic.

Second, since 2010, the Korean business community has started to feel the impact of the reversed status of intraregional economic power. Japan is no longer the biggest economy in the Northeast Asian region. What can be done regarding business in China is an obsession of many business managers in Korea.

Third, China has turned into a complicated economic partner because China is made up of a complex set of identities. It is the largest producer in the export market and key competitor to Korean companies. At the same time, it has emerged as a consumption market for many Korean companies, including the leading conglomerates. Finally, the importance of China's asset market based on the renminbi is gradually increasing.

Fourth, the issue of an FTA is becoming overwhelmingly important in the public arena, and it can no longer be postponed. In a private communication, a high-level Korean government official remarked that Korea should not be criticized for trying to avoid an FTA with China. China is demanding that Korea treats China equally with the United States. These types of demands and questions will increase. In the end, the only solution may be a diplomacy of equidistance. Unfortunately because of the leverage China has over Korea in relation to the North Korean issue, Korea may walk away with less than it originally wanted.

Fifth, who will be the best agent for Korean business in China? There are two million Korean Chinese in China. Unfortunately, Korean Chinese are excluded from many major business activities in China. Also, in Korea, because of historical reasons the Chinese Korean community is not very promising for assuming a liaison role. Chinese Koreans in Korea were excluded and exploited during the Korean economic development process. In this regard, "multi networking," encompassing not only ethnic homogeneity but also educational or career commonalities, may be an appropriate solution.

At the individual level, however, Koreans seem to be well prepared for the Chinese era of the future. A large number of Korean students are studying in China, and they can be a major asset. Also, a common set of factors might result from both overseas Korean and Chinese students. Those students will be a basis for a possible network linking Chinese human capital and Korean human capital.

During the past 20 years since Korea's diplomatic normalization with China, China has rapidly changed its economic fundamentals. It has transformed itself from a poor, developing country into a rich, extravagant consumer. As such, it would be very hard to describe the Chinese economy in a single word. Korean busi-

nesses are at a loss about how to adjust to new challenges and opportunities from China. Domestically, China is observed as having shifted its development strategy from export promotion to a domestic demand expansion. The days when economic partnership with China was based on absolute advantage, focusing on the second-tier market, are gone. A new modality of cooperation should be established so that the gains from comparative advantage can be fully utilized. This, by nature, will promote bilateral economic integration and lead to more cooperation with the local Chinese.

Korea is weighing China as one of the most important economic partners in its survival, while the importance of the Korean economy is weighing less and less in China since China is a gigantic country and in 1998 its economic size reached the critical size of \$1 trillion dollars. This is misleading many Korean political and business leaders. They are hesitant about accepting China as a fully grown, counterpart country.

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## **Appendix: List of Research Topics**

### ***National Research Council for Economics, Humanities, and Social Sciences of Korea Projects***

China's Domestic Demand Promotion Policy and Bilateral Partnership  
Competitiveness of Korean Products in Domestic Demand Promotion Policy of China  
Eco-friendly Agricultural Products and Market Prospects  
Prospects for Market Products to Aid the Aging Population in China  
Household Modification and Policy Comparisons between Korea and China  
Regional Division of Industry Policy between Korea and China, and Korea's West Coast Development Strategy  
Bilateral Logistics Cooperation between Korea and China; Concentration on Yangtze River Case  
China's CO<sub>2</sub> Gas Reduction Policy and Urbanization  
Environment Policy of China and Possible Cooperation with China-Korea  
Sino-Korean Energy Cooperation  
Evaluation of China's Catch-Up Strategy to Korea's Automobile Industry and Electronics  
Investment Success Studies of EU, Japan, and the United States in China  
China's Shipbuilding Industry and Korean Small- and Medium-Size Enterprises  
Possibilities of Trade Clearance in Local Currencies between Korea and China  
Won and Yuan Settlement in Bilateral Trade between Korea and China  
Sanitation Issues of China's Food  
Land Use Rights in China's Civil Law  
Tourist Characteristics of Chinese and Hosting Strategy  
Chinese Economic Jump and Korea  
Sino-Korean Trade Relationship and Korea  
Development Model Shift of China and Korea's Responses  
China's Asset Market Expansion and Korea's Response  
Sino-U.S. Trade Conflict and Its Implication

### ***Korean Association for Contemporary China Studies topics***

Employees' Shareholding System in China  
Informal Sector of Chinese Economy  
China Rising after Subprime Mortgage Crisis in 2008  
Reforming Household Registration System  
Testing Middle-Income Trap Hypothesis in China  
China's Development in 21st Century  
China's Rise and Korea-China Relationship  
Yuan Internationalization  
China's Banking Investments Overseas  
China's Real Estate Market  
Wage Differences in China: Regional Level  
FDI Effect in China  
Shenzhen Special Economic Zone





## **Selected Commentary**

### **Korea and the World Economy**

*C. Fred Bergsten, Peterson Institute for International Economics*

### **Korea's Challenges and Opportunities in 2011**

*Chae Wook, Korea Institute for International Economic Policy*

### **A Reflection on the Seoul Summit**

*Paul Volcker, Former Chairman of the Federal Reserve*

### **The G-20: Achievements and Challenges**

*SaKong Il, Korea International Trade Association*

### **Korean Green Growth in a Global Context**

*Han Seung-soo, Global Green Growth Institute*

### **Korea's Green Energy Policies and Prospects**

*Whang Jooho, Korea Institute of Energy Research*

## **Additional Commentary and Analysis**

Korea: Economic Prospects and Challenges after the Global Recession

Achievements in Seoul and Korea's Role in the G-20

Africa and South Korea's Leadership of the G-20

Korea's Green Growth Strategy: A Washington Perspective

An Ocean in Trouble, An Ocean of Opportunity

System Architecture for Effective Green Finance in Korea

Economic Implications for South Korea of the Current Transformation in the Middle East

Korea-Africa: Emerging Opportunities

U.S.-Korea Economic Relations: A View from Seoul

A New Phase in China-North Korea Relations

Increasing Dependency: North Korea's Economic Relations with China

The Economics of Reunification

Human Resources and Korean Reunification

Korea-China Economic Partnership: The Third China Rush



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