



# IMPACTS AND MAIN ISSUES OF THE KOREA-CHINA FTA

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## **Abstract**

In May of this year, after Korea finalized all necessary domestic measures, Korea and China officially launched bilateral FTA negotiations. This paper looks at the FTA from the Korean perspective. The FTA talks will be conducted in two stages. In the first stage, they will finalize the modalities for trade in goods, services, investment and other areas. In the second stage, they will discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. For its part, Korea needs to protect sensitive sectors including agriculture and fishery, among others. The FTA will be beneficial for the sustainable growth of Korean economy and the service and investment liberalization will be no less important than the tariff reductions for the impact of the FTA. The FTA will also benefit Korea as China has shifted its policy directions in favor of domestic demand rather than exports. However, the agreement is expected to have negative effects on the Korean agricultural and fishery sectors. Beyond economic benefits, the Korea-China FTA is expected to contribute to stabilizing the diplomatic and geo-political relationship between Korea and China. It can also be seen as a first step in accomplishing Northeast Asian regional integration.

In January 2012, Korean President Lee Myung-bak had a summit meeting with Chinese counterpart Hu Jintao and announced that Korea would initiate steps domestically to officially launch Free Trade Agreement (FTA) negotiations between Korea and China. The two countries decided to officially launch bilateral FTA negotiations in May after Korea finalized all necessary domestic measures regarding a public hearing and the ministerial meeting for international economic affairs.

In retrospect, there was more than seven years since the two countries agreed to begin joint research on a Korea-China FTA by private institutions in 2004. The joint study investigated the macroeconomic benefits expected from the bilateral FTA. From 2007 to 2010, the joint research of industry, government and academia on Korea-China FTA focused on impacts to industrial sectors, such as agriculture and manufacturing industries, discussing how to deal with sensitive products.

Until recently, China strongly hoped to launch Korea-China FTA negotiations as soon as possible. For its part, Korea needs to protect sensitive sectors including agriculture and fishery, among others. In order to facilitate the negotiations, the two countries will take the following two-stage approach. In the first stage, they will finalize the modalities for trade in goods, services, investment and other areas. They are expected to focus on the share and composition of the tariff lines placed in the sensitive as well as highly sensitive list. In the second stage, they will discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. That means nothing is considered final until everything is actually agreed upon.

This paper deals with the Korea-China FTA from the Korean perspective. It reviews the current status of economic relations between Korea and China, dealing with the benefits and potential costs of a Korea-China FTA. It also touches upon the main issues of the bilateral FTA, comparing it to the proposed Korea-China-Japan FTA.

## Economic Relations between Korea and China

The interdependency between Korea and China has rapidly increased in recent years. According to research conducted by KIEP<sup>1</sup>, Korean exports to China will increase by about 2 percent and real GDP will increase by about 0.22-0.38 percent, if the Chinese real GDP increases by 1 percent. China has become the biggest exporting and importing country for Korea since 2004 and 2007, respectively. Currently, Korea is China's number four trading partner after the U.S., Hong Kong and Japan.

Korean exports to China amounted to \$134.2 billion in 2011, occupying 24.1 percent of total Korean trade, followed by

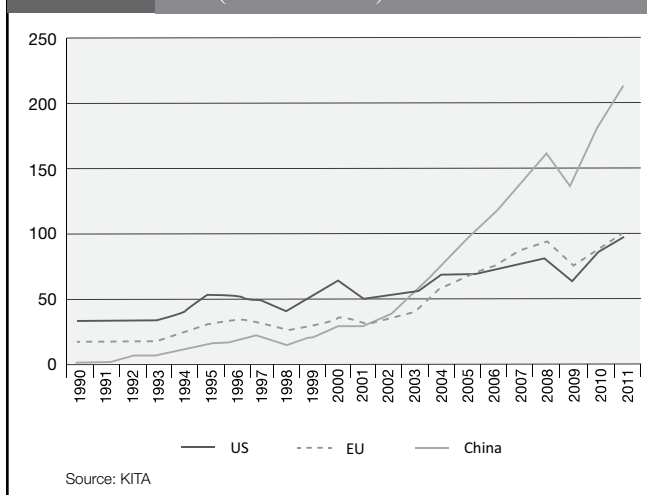
the U.S. (10.1 percent), Japan (7.1 percent), Hong Kong (5.6 percent), and Singapore (3.7 percent). Korea imported \$86.4 billion from China, occupying 16.5 percent of total Korean imports, followed by Japan (13.0 percent), the U.S. (8.5 percent), Saudi Arabia (7.1 percent), and Australia (5.0 percent).

A breakdown of Korean exports to China by final usage shows that the majority are products for re-exports, such as parts and material. According to a Korea International Trade Association (KITA) report<sup>2</sup>, Korean exports for domestic use to China in 2011 were 34.4 percent, which was very low compared to Japan (51.7 percent), Hong Kong (59.5 percent), and the United States (66.7 percent). As we are all aware, the tariffs on exports for use in re-exporting are exempt or refunded in most countries including China. Therefore, almost two-thirds of Korean exports are not disadvantaged by high levels of Chinese tariffs.

On the other hand, Korea's bilateral trade with China was \$220.6 billion, which amounted to 20.4 percent of total trade in 2011, followed by Japan (10.0 percent) and the U.S. (9.3 percent). Korea recorded a bilateral trade surplus of \$47.8 billion, which represents 155.2 percent of the total trade surplus in 2011. That means Korea would have recorded a trade deficit of \$17 billion without its trade with China. According to the Bank of Korea, the average Korean GDP growth rate from 2008 to the first half of 2010 was 4.2 percent, while the contribution level of exports to China was 2.2 percent, indicating that the contribution of exports to China on the Korean GDP is approximately 52 percent.

China has been one of the most important partners for Korea in terms of inbound as well as outbound FDI. Outbound Korean FDI to China increased rapidly in recent years in order to make the most of China's expanding market<sup>3</sup> and low labor costs.

**Figure 1** Korea's Trade with China, the US and the EU (in U.S. billion)



**Table 1**

Chinese Contribution to Korean Inbound and Outbound FDI (in U.S. million)

	Before 1990	1991-2000	2001-2011	Total Chinese Contribution	Chinese Share (%)
Foreign Direct Investment	2.8	149.1	3,584.8	3,736.7	2.0
Overseas Investment	22.5	5,369.1	28,718.8	34,110.4	17.7

Source: Ministry of Knowledge Economy and Korea Eximbank

As of 2012, China is second among Korea's overseas investment destinations, surpassed only by the United States (20.4 percent). Korean outbound investment to China amounted to \$35.9 billion, or 18.9 percent of total Korean overseas investment, followed by Hong Kong (6.5 percent), the UK (4.6 percent), Vietnam (3.9 percent), Canada (3.4 percent), Netherlands (3.3 percent), Indonesia (3.0 percent), Singapore (2.2 percent), Australia (2.1 percent), and Brazil (2.0 percent).

On the other hand, inbound FDI from China from 1991 to 2000 amounted to \$149.1 million, jumping to \$3.58 billion from 2001 to 2011, which means that Chinese investment to Korea has been accelerating during the last decade. The total of China's FDI stock in Korea amounted to \$3.74 billion from 1962 to 2011, and its share in the total inbound FDI in Korea turned out to be 2.0 percent. This number is relatively small compared to the U.S. (24.6 percent), Japan (15.1 percent), Netherlands (11.2 percent), the UK (6.2 percent), Germany (5.7 percent), Singapore (3.9 percent), Malaysia (3.9 percent), France (3.3 percent), Canada (2.8 percent), and Hong Kong (2.5 percent).

### FTA Policies of Korea and China

Korea designated Chile as its first FTA partner because Chile was regarded as being in a strategic position for advancement into other Latin American countries. After completing the negotiations with Chile in 2002, Korea concluded FTA negotiations with Singapore, the European Free Trade Association (EFTA), the Association of Southeast Asian Nations (ASEAN), India, the European Union, Peru, and the United States.

Notably, Korea diversified its FTA partnership among the Americas, Europe, and Asia. As an export-oriented economy, Korea urgently needed to access the major markets and minimize the negative effects from the FTAs of competing countries. Interestingly, Korea finalized FTA negotiations without any hesitation with regional bases such as Chile in America, Singapore in Asia, and the EFTA in Europe.

Upon a review of Korea's FTA policy, we found that Korea uses the FTAs to liberalize its domestic markets, as seen in the FTAs with the United States and the European Union. It

also has taken care of its sensitive sectors by providing restructuring programs for the agricultural sector and designing assistance related to trade adjustment.

On the other hand, China shifted its international economic policy in favor of FTAs after joining the WTO in 2001. Specifically, China pursued FTA negotiations with neighboring countries including ASEAN in 2005, Pakistan in 2006, Chile in 2006, and New Zealand in 2008. Currently, it has been negotiating with many countries including Iceland, Norway, the Gulf Cooperation Council (GCC), and the South African Customs Union (SACU).

A review of the Chinese FTA policy reveals that China uses FTAs with neighboring and strategic base countries to support its diplomatic policy, as demonstrated by its designation of ASEAN as its initial FTA partner. China has not shown an interest in FTAs with developed countries such as the United States and the EU because they have not granted China market economy status. Specifically, it concluded FTA negotiations with Pakistan which imports armaments from China. It has been negotiating with Australia and the GCC, in consideration of the importance of energy resources and geo-political interests.

### Benefits and Potential Costs

The Korea-China FTA is expected to provide economic and geo-political benefits. First of all, it will be beneficial for the sustainable growth of Korean economy. According to KIEP, the Korea-China FTA is expected to increase Korea's real GDP by about 0.95-1.25 percent in five years and 2.28-3.04 percent in ten years<sup>4</sup>. The KIEP study included only concessions of the tariff schedule in its Computable General Equilibrium (CGE) simulations. It did not consider service and investment liberalization in the model. According to KIEP, the service and investment liberalization will be no less important than the tariff reductions for a FTA feasibility study, which indicates that the potential dynamic effects will be possibly greater than the static effects of tariff reductions.

Specifically, Korea can use the Korea-China FTA to make further advances into the Chinese domestic market, which is being regarded as the market with the biggest potential after

the global economic crisis in 2008. China has shifted its policy directions in favor of domestic demand rather than exports. It is currently putting more emphasis on domestic demand than exports, according to the five-year economic development plan released in 2010.

It is noticeable that tariffs on exports for domestic use are neither exempted nor refunded. Thus, the Korea-China FTA will be very conducive to exports for domestic use. This is because China's major trading partners have not negotiated bilateral FTAs with China, with the exception of Taiwan which has finalized the Economic Cooperation Framework Agreement (ECFA) in 2010. The ECFA is reputed to be a preliminary step for China-Taiwan FTA negotiations. Thus Taiwanese products that have been competing with Korean export commodities in the Chinese market were given advantages by the ECFA, specifically in the chemical and electronic sectors. If main negotiations in the various areas such as goods, services, investment, and economic cooperation are concluded, it will have great impact on Korean exports. The Korea-China FTA will be expected to address Korean concerns about the potential increase for Taiwan in Chinese market shares.

On the other hand, the effects from the service and investment liberalization are expected to be substantial because beyond-the-border barriers in China are reputed to be very high. More specifically, a Korea-China FTA will contribute to the market expansion of producer services embodied in the Korean manufacturing exports. It is also expected to provide an impetus for substantial increase in the outbound FDI to China as well as intra-firm exports of services, in light of the rapidly expanding Chinese domestic demand.

In contrast to the benefits for the manufacturing and service sectors, the Korea-China FTA is expected to have negative effects on the Korean agricultural and fishery sectors. China is different from previous Korean FTA partners in that it can export fresh vegetables and live fish for the Korean market because it is geographically closer to South Korea. Therefore, potential costs from the Korea-China FTA are expected to accrue to the agricultural and fishery sectors.

Specifically, the imports of sensitive products from China have been increasing very rapidly in recent years. Korean agricultural exports to China amounted to \$556.1 million while its agricultural imports from China reached \$3.23 billion. The trade deficit in the agricultural sector amounted to \$2.67 billion. Marine products from China also represent a sensitive problem for the Korean economy, as Chinese products have account for more than 30% of Korean fishery imports.

Besides the above-mentioned economic effects, the Korea-China FTA is expected to have geo-political effects in Asia. Above all, it will contribute to stabilizing the diplomatic and geo-political relationship between Korea and China, thereby

contributing to the reunification of the Korean peninsula. The Korea-China FTA is expected to result in the expansion of bilateral cooperation and greater interdependency. It will also help the Chinese leadership and private sector to realize the importance of political as well as military security in the Korean peninsula. For its part, Korea can use the Korea-China FTA to develop a strategic and cooperative relationship with China while maintaining the Korea-U.S. alliance.

## Main Issues

Korea and China concluded (at the joint research of industry, government and academia) that a Korea-China FTA will lead to positive effects for both economies. However, they did not launch official negotiations because they have reacted sensitively to various products imported from each other. This demonstrates the importance of dealing with sensitive products. The two countries should design concession lists to maximize the expected benefits and maintain the balance of economic interests for both countries. The two countries are planning to negotiate the modality of market access for goods in the first stage of the FTA negotiations.

Specifically, Korea has a keen interest in how to liberalize the agricultural sector in the Korea-China FTA negotiations because most of the negative impacts of the bilateral FTA will be felt in that sector. On the other hand, China recorded huge trade deficits in the manufacturing sector including automobiles, chemical, and electronics among others and has an interest in these areas. In addition, rival companies of the two countries are engaged in competition to increase their market shares in third-country markets. For its part, China is expected to place many manufacturing tariff lines in the sensitive as well as the highly sensitive list.

Regarding rules—including intellectual property rights, anti-dumping, environment and competition policies, and government procurement—Chinese legal institutions substantially improved during the process of WTO accession in 2001. However, there were many complaints from Korean companies about the effective enforcement of Chinese rules. It is highly probable that a compromise on rules will be very difficult to achieve. It would be tough to apply domestic rules differently to member and non-member countries of a FTA.

Notwithstanding the geographic proximity and economic interaction between the providers and consumers of each country, the trade in services between Korea and China has been trivial compared to trade in manufactured goods. Yet the potential for future expansion in services trade is substantial in light of cultural homogeneity and the bilateral trade volume between the two countries.

A review of China's FTAs with New Zealand, Hong Kong, Macao, and Taiwan revealed that China liberalized various

services sectors including telecommunication, transportation, government-related services, and business services. However, New Zealand is not noted for being competitive in the above service sectors. On the other hand, Hong Kong, Macao, and Taiwan all belong to the greater China economic area. Thus, it is not surprising to see that China has been reluctant to liberalize the service sectors in the case of the other previous Chinese FTAs. Part of the reason is that the competitiveness of China's own service sectors are lagging and the Chinese government tends to regard domestic regulations as security issues.

In the second stage of Korea-China FTA negotiations, the two countries are scheduled to discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. In previous FTA negotiations, China's position in services and investment liberalization was a decidedly negative one. Thus, enhanced access to Chinese service markets and improvement of the Chinese investment environment are expected to be top priority agendas in the Korea-China FTA negotiations. Specifically, a guarantee of future liberalization, transparency, rational domestic regulation, and mutual recognition will likely be the main issues in negotiations for services and investment.

### A Comparison with the Proposed Korea-China-Japan FTA

Discussions about regional economic integration in Asia have not been as enthusiastic as those in other regions. For example, European countries launched an ambitious program for regional integration in the 1950s, and the North American countries concluded North American Free Trade Agreement, or NAFTA, in the 1990s. The Korea-China FTA will have potential effects not only on the two countries, but also on neighboring Asian countries.

A review of recent economic statistics finds that greater interdependency has developed among Korea, China, and Japan in terms of trade, investment, and technology cooperation in recent years. Amidst head-to-head competition among the three countries, there are also many opportunities for them to cooperate with each

other to expand mutual economic relations through FDI, strategic alliances, and technology transfers.

For example, as we can see in Table 2, shares of trilateral trade among Korea, China, and Japan increased very rapidly for Korea and Japan. In the case of China, it decreased to 15.78% in 2010 because China diversified its trade partners for its aggressive advance into the global market.

Recognizing the importance of trilateral economic cooperation, discussion of the FTA among Korea, China, and Japan started in 2002. Specifically, the three countries launched a joint study of private institutions to investigate the feasibility of the trilateral FTA from 2003 to 2008. The joint study dealt with a wide range of topics including macroeconomic effects, impacts on industries, and rules of origin, among others. Since 2009, the joint research of industry, government and academia indicates that the trilateral FTA will lead to substantial macroeconomic effects in all three economies, meaning that it will be a win-win strategy to be adopted for regional integration.

Reportedly, China recognizes the importance of Korea's bridging role because of its intermediary position between China and Japan in terms of development level. Currently, both China and Japan are courting Korea to launch FTA talks. For its part, Korea may possibly restart the FTA with Japan and has announced it will launch a trilateral FTA with China and Japan after officially starting FTA negotiations with China. Thus, a Korea-China FTA can be seen as a first step in accomplishing Northeast Asian regional integration. In addition, it will also provide momentum for an East Asian FTA including ASEAN+3 because the three countries all concluded their FTAs with ASEAN. Furthermore, a Korea-China FTA will have international political impact on the discussion of a greater Asian FTA among China, Japan, Korea, ASEAN, India, Australia, and New Zealand.

It is highly probable that politico-economic factors are more important than economic ones in the process of trilateral FTA negotiations. Thus, the three countries need to set up the modality,

**Table 2** Bilateral/Trilateral Trade Shares (as a %)

Year	China			Japan			Korea		
	Japan	Korea	C-J-K	China	Korea	C-J-K	China	Japan	C-J-K
2000	16.14	5.63	21.77	8.91	5.79	14.70	8.02	14.95	22.96
2005	12.49	6.72	19.20	15.98	6.27	22.26	17.51	12.77	30.28
2010	9.63	6.14	15.78	19.58	6.14	25.72	20.46	10.06	30.52

Source: Comtrade Database, UN



scope, and framework for the trilateral FTA, considering the template of the Korea-China FTA and the dynamic economic as well as political relations between China and Japan.

## Conclusion

The Korea-China FTA is expected to have substantial benefits for the two countries, but they have conflicting views on the main issues. Thus it will take a certain period of time to reach a compromise in goods, rules, and services areas. The Korean government is known to have precluded the possibility of concluding a Korea-China FTA within a pre-specified period.

Specifically, it is very important to negotiate successfully on the modality in market access for goods. If the two countries reach a compromise for a low-level FTA to take gradual concession schedules, then it will not be consistent with Article 24 of GATT 1948. In addition, it will not be the optimum choice in terms of economic benefits for the two countries to liberalize only a limited range of tariff lines.

Thus, one of the acceptable options for the two countries is to consider an ‘ASEAN FTA plus’ in order to protect the sensitive products of each country. This is because the level of concessions in the goods area of the Korea-ASEAN FTA is higher than that of the Korea-India Comprehensive Economic Partnership Agreement (CEPA), but lower than the FTAs with developed countries including the U.S. and the EU.

To conclude, the Korea-China FTA will provide more benefits for the Korean economy than potential costs, considering that it will strengthen its market competitiveness and upgrade its industrial productivity. If it is successfully concluded, Korea can become a business hub that connects the United States and European countries to Asian economies. In addition, the Korea-China FTA is expected to be an effective catalyst in speeding up the discussion about Asian regional economic integration.

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<sup>1</sup> KIEP, “Recent Trends, Main Issues, and Prospects of Chinese Economy,” 2010.

<sup>2</sup> KITA, “Effects of Korea-China FTA on Korean Trade,” presented at the public hearing on Korea-China FTA, 2012.

<sup>3</sup> China has emerged as the number one global market in such goods and services as automobile sales (13,640 thousand units), mobile phone (747.38 million persons), and internet usage (380 million persons) in 2009.

<sup>4</sup> KIEP employed the CGE (Computable General Equilibrium) model to investigate the potential economic effects according to the two scenarios of concession. See KIEP, “Macroeconomic Effects of Korea-China FTA,” presented at the public hearing on the Korea-China FTA, 2012.