

## **CHINA'S IMPACT ON THE KOREAN ECONOMY**

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## I. Introduction

Events on the Korean peninsula in the autumn of 2006 have again put Korea and Northeast Asia at the forefront of great-power concerns. These events are a reminder of the dynamic and volatile quality of geopolitics on the peninsula and in the region, and of the significance that Korean developments hold for the strategic interests of the United States, Japan, China, and Russia.

The spectacular quality of recent North Korean nuclear activity and the spasm of international response that activity has engendered understandably overshadow in the short run certain other features of the rapidly evolving Korean and Northeast Asian landscape. Indeed, if the North Korean situation does lead to hostilities on the peninsula, those other features may be obscured for some time to come.

But short of the collapse of peace and security on the peninsula, it is important to remember that developments on the economic front over the past decade and a half have also become a central element in South Korea's domestic and international evolution. Those economic developments are likely to have a significant impact on the lives of South Korean citizens and on the economic and political relationships among the major actors in Northeast Asia and beyond.

In particular, if for a moment the acute crisis over North Korean nuclear issues can be set aside, it will be obvious that Korea's rapidly expanding economic relations with China have become a topic of heavy interest and concern in some quarters, within both Korea and the Asia-Pacific region more generally. The United States, linked to both Korea and China by massive trade and investment flows and representing a market to which both Korea and China look for their own prosperity, is at the very least an intensely interested observer of the cascading economic relationship between South Korea and the People's Republic of China.

This short paper will review recent perspectives on the developing economic relations of Korea and China with an eye particularly toward their impact on Korea itself. The subject is not without controversy in Korea, just as economic engagement with the rapidly advancing and increasingly influential People's Republic is the subject of controversy in many nations throughout the world. Just as Korea's spectacular advance from poverty to prosperity and global economic significance in the space of a few decades has lent the quality of an onrushing express train to Korean self-perceptions, the sudden and massive acceleration of Korea's economic ties with China—from virtually nothing in 1992 to a very substantial level of interdependence in 2006—partakes of that same express-train quality. Where the express train is heading and where Korea—as both engine driver and passenger—is traveling have become the subjects of introspection and speculation.

In mid-October 2006, according to Chinese press reports, Chinese Premier Wen Jiabao and Korean President Roh Moo-hyun agreed that their two nations would commence negotiations on establishment of a free-trade area (FTA) between them. This latest development, significant on its own economic terms, is also a reminder that beneath—or alongside—the tumultuous course of Korean peninsula strategic upheavals the current of Korea-China economic interchange continues to broaden and deepen. The next five years should give a fairly definite picture of where all this is taking both countries and of what economic and social impact their embrace will have upon governments, companies, and citizens of Korea and the PRC.

## **II. Features of the Korean-Chinese Engagement**

Driving around Beijing in one of the elegantly dressed Korean taxis that fill the streets of the capital and watching Chinese of all ages calling and messaging one another on their Korean-brand cell phones, one might gain the impression that Korea has conquered the Chinese market in a manner few other countries have even approached. There is some truth to the surmise. The growth of Korean-Chinese economic action has been even more impressive than China's expanding ties with other trade and investment partners. The Korea-China engagement has shown the following characteristics:

First, it is driven above all by changes in China, not only by the quantitative expansion of the Chinese economy and high rate of growth but by changes in Chinese policy, most notably its opening to foreign investment and more recently the PRC's accession to the World Trade Organization. Change in China appears to have derived less dramatically from changes in Korean policies, which suggests that, thus far, prospects for future Korean-Chinese economic engagement remain heavily dependent on Chinese policy decisions as well, of course, as the general health and continued robust growth of the PRC economy.

Second, the economic relationship between the two countries has developed with extraordinary speed, even by the standards of China's rapid economic development and growing engagement with other economies. Korea got off to a late start with China, with diplomatic relations coming only in 1992, well over a decade after China and the United States normalized relations. The real takeoff in China's heated economic expansion, especially the growth of international investment ties, awaited Deng Xiaoping's famous post-Tiananmen reaffirmation of the reform-and-opening basic strategy in 1992, the very year of Korean-Chinese diplomatic relations. By that time, other major economies had had more than a decade's start on the development of business contacts, particularly the establishment of sourcing operations in South China and the entry into such Chinese markets as opened gradually throughout the 1980s.

Thus, Korea's economic engagement with China has moved with lightning speed through several stages, not mutually exclusive but nonetheless successive: light-industrial and labor-intensive sourcing operations on the part of small- and medium-size enterprises (SMEs) first, then investment by large Korean conglomerates, then the movement to China of Korean suppliers to those conglomerates, and, most recently, the rise of Chinese domestic competition to the Korean firms, in both the Chinese and the Korean markets.

With these successive stages, there emerged rapidly a huge Korean trade surplus with the mainland, unlike the large and now gigantic trade deficits that have come to characterize U.S. economic relations with Beijing.

All this in less than 15 years. If recent observations by Scott Snyder (2006, 111) are correct, we may now be entering a fifth stage characterized by continued growth of Korean efforts to secure major opportunities arising from PRC domestic growth (including per capita income growth) as well as increased competition between Korean and Chinese firms in third-country markets as China's own enterprises reach the stage at which they can attempt to secure their own positions in overseas economies.

The speed of this engagement has, I think, its own implications, although they are hard to pin down. Certainly, for a society as capable as Korea's and in an economy of the limited size of Korea's, the sheer magnitude of this rapid-fire plunge into economic relations with the giant and dynamic economy so very near at hand has left a feeling of breathlessness, in both a positive and a negative sense, on the Korean side that is simply not mirrored in Chinese self-perceptions.

Third, Sino-Korean economic relations involve enormous magnitudes. Little needs to be said about this; the numbers and rankings are readily available in numerous sources. China has risen to the top of the list of Korea's trade and investment partners worldwide. The key factor, with noneconomic overtones, is that China has displaced the United States in this sense. For Korea, China is not just an important economic partner: it is a superpartner, so to speak, whose significance to Korea's overall external economic position might be said to be disproportionate except for the uneasily dawning realization that it is probably just the opposite: it is in fact proportionate to China's size and the looming immensity of its dynamic economy.

Fourth, Sino-Korean economic engagement has come to epitomize the emergence of an Asian production system and the rearrangement of labor allocations: Korea, China, and the Asian integrated circuit.

This is an extremely striking feature of the Korean-Chinese engagement. Putting production of shoes, clothing, toys, and other labor-intensive but relatively low-value

products into China to economize on labor costs and retain competitiveness is one thing, and a familiar thing at that; the same process took place from the 1980s onward with production transfers from Taiwan, Hong Kong, and other traditional suppliers of labor-intensive low-tech products to the world's developed economies. But the Korean experience has gone far beyond that. What has evolved in the past decade is a complex system of intraindustry trade between Korea and the PRC, mainly characterized by the shipment of vast quantities of Korean intermediate goods to China for final assembly and sale within China or for Chinese export, both back to Korea and on to third-country markets. This still partakes of the more widespread use of China as a low-cost labor site for final assembly of non-Chinese products, but in the fields where Korean companies start with a strong competitive position, it represents a degree of integration between two national economies that is particularly striking—especially since it has thus far produced for Korea such handsome trade surpluses. Taiwan, similarly, enjoys massive trade surpluses with the mainland for like reasons, but the Taiwanese integration with the PRC is less diverse, in part because Taiwan's economy does not possess the same array of massive conglomerates and globalized mega-enterprises that Korea's does.

Fifth, the headlong growth of Sino-Korean economic linkages has thus far displayed a distinct regional focus. As Korean conglomerates, in particular, become more and more heavily embedded in the Chinese economic and political system, we can perhaps expect that the geographic spread of Korean operations within the PRC will expand and that, given evidence of rising costs in the coastal regions of China, Korean firms gradually will follow other multinationals inland in search of both new markets and lower production costs. But, to date, the focus of Korean activity has been distinctly on North China and, in particular, on the Yellow Sea littoral region. In this, geography tells: no other place, except Hong Kong on China's southeastern coastal edge, can begin to approach Korea for the advantages of proximity to China. This has produced, among other things, a mini-boom for Korea's west coast ports that hitherto had remained small and sleepy by comparison with the great manufacturing and transportation hubs through which Korea has developed its powerful global position. But, more important, Korea's proximity to China has created enclaves of Korean presence in certain specific areas of China, most notably Shandong Province but also, to an extent, China's Northeast. By contrast, while Japan has certainly established a prominent position in northeast China (which it once dominated), Japanese investments are more fully spread across China or at least down the entire coastal belt from northeast to southeast. U.S. and European investments can be found widely, too, but it is perhaps a safe generalization to say that their prominence in the lower Yangtze region outstrips that of Korea's.

The rise of both an integrated transnational production system and a geographic concentration of Korean activity in the coastal areas bounding the Yellow Sea has led

to considerable speculation about the possibility of a unique, long-term special economic system of a somewhat regional nature within the larger framework of Korean-Chinese economic engagement,

### **III. Impacts on the Korean Economy**

Realistically, while the arrival in China of giant investment projects associated with major Korean industrial groups is of heavy significance to China's own economy, the unavoidable fact is that, given the disparate sizes of the two nations' economies and populations, China is likely to be less heavily affected by its economic ties with Korea than Korea is by its economic ties with China.

The pattern so far is not that dissimilar to that found elsewhere. Companies producing low-tech but labor-intensive products, dependent for their survival on moving into China in search of lower labor costs, found salvation and often real profit early on. Major firms that, more recently, have placed huge investments in China are making more complex bets on the prospects for China's continued domestic growth and China's continuing emergence as a strategic global production center. In either case, decisions by Korean enterprises seeking economic benefit and (especially for the conglomerates) long-term position in a very complex global business environment form the pattern of economic engagement (again, all predicated on the existence of a Chinese legal and regulatory environment at the very least permissive toward and, ideally, more fully supportive of such decisions).

Without the benefits of the China opportunity flowing to Korean companies, the engagement would not take place. But, of course, the question of whether benefits to Korean companies represent the full balance of benefits and disadvantages to Korea as a whole remains to be debated, just as it does in the U.S. case. It has long been noted that a very high percentage—well over half—of all the Chinese exports pouring into the United States are produced by factories either wholly owned by or invested in by U.S. parent companies.

A full exposition of the economy-wide benefits of such a system is needed in the United States, but it is seldom made. A recent Congressional Research Service (CRS) paper (Elwell et al. 2006) entitled "Is China a Threat to the U.S. Economy?" is a rare and overdue attempt to lay those benefits out. But the reason that the CRS paper has been written at all has been the rising tide of social and political uneasiness about the impact of production transfers from the United States to China, particularly on employment and wage levels in the United States. While the CRS paper remarkably indicates how little of the behavior of U.S. labor markets can be directly attributed to trade and investment with China (the heaviest effects are concentrated so far in a relatively small number of affected sectors, mainly textiles, furniture, and others where

low-end U.S. labor simply cannot compete against Chinese labor on cost), the sense of menace occasioned by Chinese economic rise is a fact of life in the United States, particularly in Congress.

For Korea, the sudden rush of Korean corporate investment into China—and the clear indications among SMEs that they, too, have plans to move into the PRC if they are not already there—is the occasion for much soul searching, some hand wringing, and even some shirt rending.

Unlike the situation in the United States, Korea's situation is not defined by massive trade deficits with the PRC; quite the contrary. Moreover, China is not turning the vast holdings of U.S. dollars arising from its trade surpluses with the United States into investments in Korean government securities, the way it is purchasing and holding hundreds of billions of dollars' worth of Treasuries and other government-backed U.S. securities.

For Korea, the question is partly one of the fear of hollowing out. For all the uneasiness and political paranoia in the United States about the transfer of productive capacity to China and the loss of both capacity and employment at home, the facts are that manufacturing in the United States has commanded a diminishing share of the U.S. workforce for four decades, to the point that manufacturing today accounts for 12 percent of the workforce; that study after study has shown that developments in industrial productivity, chief among a number of factors, have been responsible for the diminution of the U.S. manufacturing labor force; and that just as Japan's perceived threat to the U.S. economy 20 years ago proved less momentous over time, China's impact on the U.S. manufacturing sector and its labor force to date are much more modest, economy-wide, than sometimes perceived. Put another way, the apparent collapse of the U.S. automobile sector in 2006 cannot be blamed on China; I suspect that most observers would not even blame it on Japan, whose competition with the big three automakers over the last four decades has been so decisive.

Korea faces challenges at once similar and dissimilar. First of all, as a newly industrialized economy whose achievements have been the envy of developing nations around the world, the Korean economy is much more heavily manufacturing focused than the U.S. economy now is, and it is in manufacturing that both the heavy engagement with China and the potential disruptiveness of economic engagement with China will be most heavily felt. No one really expects, this year or this decade, that the drama of Korea's encounter with China is going to be played out in the service sector. By contrast, the U.S. encounter with China involves huge interests in the service sector as well as the manufacturing arena but perhaps operates in only a limited number of sectors directly overlapping with Korea (chemicals and some information technology come to mind).

Because the Korean economy is newly industrialized but not considered to be developed and manufacturing thus bulks much more prominently, the hollowing-out question has a salience not found in the United States, despite Korea's current enjoyment of robust trade surpluses and in spite of the loud debate in the United States about the impact of China's economic arrival.

Another aspect of the particular Korean consideration of the future of its economic relationship with China, if Korean sources are to be accepted as authoritative, derives from the continuing heritage of a much more dirigiste political-economic nexus than is found in the United States.

It is noteworthy in the many commentaries on the implications of Korea's vigorous plunge into economic engagement with China that those offering prescriptions to deal with Korean concerns about hollowing out and other threats come back, repeatedly, to aspects of Korea's own system that may have supported Korea's economic progress to date but are perceived to be less helpful to Korea's ability to meet future—and imminent—challenges, including those posed by China.

Here, of course, the contrast with the United States is not black and white. While U.S. politicians and advocates struggle to define the challenges and opportunities presented by the rapid growth of China's global economic presence, and calls for wholesale reexamination of the premises and priorities on which U.S. economic policy is predicated can be heard with increasing frequency on the political margins, it is rare to see a serious exposition of the "China challenge" that calls for fundamental reorientation of the policy content and the role of government in the national life of the United States. Such calls are closer to the surface in the Korean situation.

The views of an intellectual tourist, stopping briefly to observe local customs, are hardly sufficient for definitive analysis, let alone powerful recommendations. Instead, I can only refer to the kinds of thoughtful dissections of current problems and recommendations for the future found in recent Korean or Korean-commissioned analyses.

In essence, close observers of the Korean economy prescribe a series of not unfamiliar but nevertheless fairly general responses to the challenge and opportunity China presents to the ROK.

At the firm level, these analysts start from a given that may not be self-evident to all sectors of the Korean economy: economic sectors whose day has passed should not be protected by the state. Korea, these analysts argue, must come to terms with the fact that some of the older sectors of the Korean economy, including textiles, have



passed their prime and cannot be restored to vigor, no matter how much public support, in any forms, is devoted to them.

Next, sophisticated analysts speak of the need for Korean mid-sized and even small firms to find their competitive niches in the larger Asian regional and global trading systems, where they will be able to maximize opportunities presented by China's robust economy while they preserve their competitive position. The elegant formation by Françoise Nicolas (2005) is that firms must "reposition in the value chain with China as a new partner. . . . The only option left is to anticipate the possible changes in the competitive setting and prepare for it." Thus—again, speaking in generalities—observers recommend that Korean firms develop their own internal advanced research and design functions so that the firms may grow beyond their current roles as original equipment manufacturers of intermediaries to Korean conglomerates and become, instead, owners of their own successful design innovations or even the owners of globally successful brands. This emphasis on the upgrading of Korean companies' skills and products is given greater urgency by what is perhaps the biggest challenge already emerging on the Chinese horizon: the rise of Chinese competitors, both for the Chinese market and the Korean market, in product areas where hitherto, at least for the past several years, Korean companies have held a clear advantage. There is a palpable sense that the most recent phase of Korean-Chinese economic interaction, like the phases that have come and passed since 1992, may be short-lived.

An additional, and potentially problematic, aspect of Korean companies' challenges vis-à-vis China is the perceived need for Korean firms to do a much better job at adjusting to the Chinese environment in which they seek to work, particularly since the opportunities presented by China's massive market are a critical dimension of Korea's economic engagement with the PRC. Discussions by Korean analysts move to the question of whether and how Korean investing companies in China can do a better job of disseminating positive information about working conditions in Korean companies; addressing Chinese concerns about working for Korean companies; and improving recruiting, integrating, training, empowering, and retaining Chinese managerial personnel, a task seen as a key prerequisite for long-term commercial viability and growth in China.

The challenge of localization of staff is, of course, not confined to Korean companies. Stories are legion about the shortage of trained managerial candidates, the poaching of key managers, the table hopping of Chinese managers among foreign companies, and in some cases the astronomical compensation levels now imposed by the market. But one suspects that the challenges facing Korean companies have a culturally specific cast to them as well.

The discussion of what small and mid-size Korean companies must do to remain healthy in the face of the opportunity and challenge posed by China is one of three major strands of discussion in this arena. The two others are the need for structural changes in the Korean macroenvironment and the possibility of bilateral or multilateral trade agreements between Korea and other non-Chinese trade partners.

No question about it: the rise of China, for all the excitement and Sinomania it can sometimes generate in trading-partner nations suddenly gripped by the magnitude of opportunities seemingly offered in the Chinese market, also causes soul searching of varying depths. In the United States, the massive economic relationship that now links the United States and the PRC in its embrace has produced a steady stream of political and congressional criticism, centered on the reality that the wages of U.S. workers have stagnated as corporate profits and corporate executive compensation have leaped upward as well as the perception among critical observers that U.S. businesses continue to provide to China, in the interests of gaining market access and lower production costs, the technical and managerial secrets with which China may ultimately destroy the U.S. companies themselves and the lives of their employees in the United States. The U.S. dialogue about what to do tends to be dominated by demands for legislatively mandated protection against imports from China, legislatively mandated sanctions against China over its allegedly unfair manipulation of its currency, and executive branch pursuit of antidumping and unfair-trade cases. These efforts have largely failed to alter the trajectory of U.S.–China trade and investment.

In Korea, it would appear that China occasions a deeper discourse about the structure of the Korean political and economic system and its scleroses. Examples include the need to erect the structures that would enable new companies to germinate and SMEs to survive, for example, by gaining more effective access to financing. The political power of labor unions regularly arises as a constraining or even paralyzing factor influencing government policies in ways that restrict the flexibility needed in the corporate sector to respond effectively to challenges and opportunities in China. International businesspeople will attest, without much provocation, to the implicit and outright protectionism that they encounter in the Korean bureaucracy, often in ways that make Korea a less-than-desirable place to try to invest. Others with greater exposure to the specifics of Korean realities can comment and elaborate on this point; suffice to say that Korea's specialists, at least, have perceived that flexibility and adaptation to the fluid and dynamic changes posed by China's rapid evolution are crucial to Korea's future but that they will not come easily in a system whose essential elements have long since hardened into place.

Finally, as Korea uneasily confronts the emergence of its giant neighbor and as China advances up the technology curve while gaining confidence in its international economic clout, some observers wonder aloud whether new forms of bilateral or multilateral

preferential trading arrangements—either with China itself or with other countries that might join in economic alliance as a means of strengthening their own hands vis-à-vis China—are now called for.

Here, the image of Korea as a “shrimp wedged between whales” has been used; Korea lies between China and Japan both geographically and metaphorically.

Throughout East Asia, a multiplicity of special arrangements, some economic and some focused on political and security issues, are under discussion. China itself has actively pushed the idea of FTAs with many of its Asian trading partners. Other discussions, while scrupulously avoiding any reference to balancing against or defending against China’s already huge and growing economic influence, nevertheless arise from a spreading concern over China’s challenge. Much of the discussion lies within the Pacific region itself, but some of it is transoceanic: witness the U.S.-Korea FTA negotiations now under way.

Koreans are themselves of many minds, apparently, with regard to free trade and other preferential agreements with others. It has been noted, for example, that an FTA between Korea and Japan would almost certainly redound to Japan’s advantage because the Japanese and Korean economies compete in many industrial sectors where Japan has the upper hand in terms of technological and innovative prowess and in manufacturing muscle itself. The U.S. FTA talks have occasioned bitter debate, particularly from the agricultural sector, and are a reminder that all trade agreements involve trade-offs among sectors likely to gain or lose from the new arrangements. While “hedging” is the phrase of the day among nations both tantalized and alarmed by the growth of Chinese economic and political power, the pursuit of complex and domestically sensitive preferential trade arrangements as a defensive mechanism to deal with China is not likely to prove decisively beneficial—especially when Korea, more than so many other countries, is at present reaping such major gains from its current economic engagement with the People’s Republic.

In sum, the impact of China on the Korean economy and more broadly on Korean perceptions of the Chinese economy has been relatively sudden and far reaching. The enthusiasms that gripped Americans’ emotions in, say, the early 1980s have come late to Korea, thanks to the much later date from which economic engagement with China commenced; we still see moments of Sinomania, for example in the realm of popular culture or education, just as gusts of Koreamania occasionally sweep over China. Korean firms deserve credit for the alacrity with which they made tactical decisions to move into China and, in some cases, their more far-reaching strategic decisions that have locked China heavily into their most existential planning. In the short term, as many analysts have pointed out, for Korea more than for many countries, the benefits of the China opportunity have so far outweighed the detriments.

That Korea has benefited so strongly from its rush into economic relations with China over the past 15 years should perhaps give Koreans greater reason for optimism about the future than it seems to do. While China's purchases of commodities from low-income least-developed countries (LDCs) has provided significant benefits, too, in reality such LDCs—for example, in the Asia-Pacific region—face competitive pressures from low-wage Chinese labor that make for a different and probably darker mix of effects arising from Chinese economic dynamism than does Korea, where—perhaps more than some in Korea might still like to admit—the low-end sectors of the economy have lost economic and political salience.

The factor that makes Koreans powerfully uneasy is the speed with which China is advancing up the ladder of technological sophistication and value-added manufacturing. This is what gives analysts the sense that a window of opportunity is already closing and that the advantages Korea has reaped in the short history of its economic engagement with China to date may soon run their course. Indeed, although it is theoretically certain that all countries find competitive advantage in some areas and disadvantages in others, it would be foolish to assume that China, at this stage of its exuberant advance into middle-income status and global economic centrality, will somehow, through government fiat or entrepreneurial choice, leave any sector of economic opportunity to others. Korea cannot expect to plant its flag in any economic area and rest confident that China will not be active there at present or in the future.

Thus, Korea's what-to-do shibboleths are not so very different from anyone else's: emphasize education and manpower development, concentrate on innovation and high value-added phases of the design and production cycle while leaving the lower value-added work to China, free up the arthritic joints of the Korean economy and the political institutions that both sustain and live on that economy, break down traditional forms of cultural isolation and go forth into the world—especially the Chinese world—more effectively, and increase companies' abilities to respond flexibly and rapidly to China's dynamically changing economy. These prescriptions for Korea undoubtedly have unique Korean tones to them, but they can be heard, with varying degrees of urgency, in other major industrial societies with which Korea, like it or not, is now firmly grouped.

#### **IV. Possible Course Changes**

While the precise dynamics of future Korea-China economic interactions cannot be foreseen, and the speed with which the texture of the relationship has evolved over a scant 15 years gives only limited grounds for painting the trajectory for the next 15 or 50, it is possible to imagine some factors that could disrupt what we have seen to date and would otherwise likely encounter in the future. Most of these factors are actually

noneconomic in nature, and I will simply list them, in no particular order of likelihood or significance.

**Significant Korean-Chinese disenchantment over a combination of historical and cultural heritage and territory.** The fury with which Korea has perceived China to be arrogating unto itself certain historical claims, to both territory and Korean cultural identity itself, are not to be scanted. Nationalism, for lack of a better word, is alive and well in Korea and in China. The current regime in Beijing, as it grapples with the massive dilemmas of growth, including increasing social stresses, is not ignorant of the possible uses of nationalist appeals to its own populace. While a conflict with Korea, given Korea's limited size, might not take on the proportions of a conflict with the United States or global Islam, frictions with Korea are potentially intense given the neighborhood relationship, the ambiguous and complex recipe of cultural sharing and cultural distinctiveness, the traditional tributary relations that imperial China maintained with Korea, and so forth. Others can analyze more effectively than I the political potency of the Koguryo issue or others, but we can certainly say that China's peaceful-rise diplomacy increasingly displays a willingness to spread the beneficence of distinctly Chinese cultural goodwill in ways that might play less sensitively in lands farther away than they might in Korea. To the extent that Korean-Chinese disputes over historical inheritances have a specific territorial dimension to them or a highly focused symbolic content—and to the extent that such disputes might in less visible ways be linked to the dangerous and fluid North Korean situation as well—one could imagine the possibility of a major disruption of the current flight plan of the Korean-Chinese economic relationship.

**Major downturn in the Chinese economy occasioned by primarily domestic Chinese factors.** Most observers discount the possibility of a radical cooling of China's hot economic growth, and I am not really in a position to disprove their tranquil optimisms. But there are still voices of concern in the analytical community as well as causes for concern in the Chinese environment. The major areas of continuing concern would include most importantly the banking and state financial systems, which are liquid but (to some observers) insolvent when the full range of unrecoverable obligations is tallied up, and social stresses resulting from growing inequalities of wealth and income by both region and class and exacerbated by seemingly uncontrollable corruption and official abuses of power. Although few observers, even of a hostile predilection, see indications of serious regime challenges, the behavior of the regime itself in recent months suggests that its high-policy rhetoric of concern for the restoration of social equity and the redressing of growing inequalities is matched by a cold-eyed realization of social and political peril arising as much from corruption within the political system as from dislocation and immiseration of those outside the boundaries of economic and social advancement. The helter-skelter growth of China's economy, particularly of seemingly uncontrollable fixed-asset investment stimulated by local officials nearly

beyond the grasp of central government restraint, is suggestive of a systemic fragility that could confound the general tranquility of international observers' estimates of China's short- to mid-term prospects. A serious disruption of current growth patterns, amid social dislocation, could turn the wide-ranging Korean-Chinese interdependence in a negative direction for the Korean economy.

**Any of a number of regional confrontations between China and one or more of its neighbors.** China's diplomacy in recent years has been generally successful in reducing long-standing tensions, eliminating dangerous frictions, and rendering international conflicts more and more unlikely. The PRC's relations with the Association of Southeast Asian Nations have grown much stronger: the old tensions over the Spratly Islands, for example, have evaporated.

On the other hand, at least through the end of the Koizumi premiership, relations between China and Japan have markedly deteriorated, not only in light of the ongoing controversy over Japan's approach to its own modern history (crystallizing in the recurrent furor over prime ministerial visits to the Yasukuni Shrine in Tokyo) but over territorial issues focused on the waters separating China and Japan. Signs of a longer-term reassessment of security challenges in Northeast Asia can be seen in both China and Japan and already involve U.S. defense planning as well. One assumes saner heads will prevail in regard to Sino-Japanese tensions, but the trends are ambiguous; and the outbreak of more acute tensions between the two giants of the Asia-Pacific regional economy would likely have major, if not completely predictable, impacts on the Korean economy as well.

In addition, the Taiwan situation remains unresolved and murky. Again, the trends are mostly favorable: the magnitude of Taiwanese investment on the mainland, the huge number of Taiwanese citizens now resident and working in the PRC, and the degree of economic interdependence between Taiwan and China all augur for a continuation of peaceful relations between the two sides. But uncertainties remain, not the least of which are signs of serious dysfunction in Taiwan's political system and the continual growth of PRC military capabilities apparently under development for the express purpose of prevailing in any exigency ignited by Taiwanese moves that the PRC deemed too extreme to go unpunished. Implications for the Korean economy of a military conflict over Taiwan, particularly if it involved the United States, would likely be severe.

On the question of tensions over North Korea, I leave an examination of the implications of various scenarios for the South Korean economy to more expert observers than I, but clearly the direst military scenarios arising from current tensions would have economic dimensions as well, involving South Korea, the United States, and China.

## V. Conclusion

In 15 short years, the economic relationship between Korea and China has roared through three successive, overlapping stages, and in each one Korean firms have acted with speed to take advantage of suddenly available opportunities: for low-cost labor production, for openings in a vast and rapidly expanding Chinese consumer market, for manufacturing opportunities in heavy industry, and for heading to China as intermediate suppliers to Korean conglomerates establishing very large investments on PRC soil. As a result, in part, of Korea's unique geographical position and as a result of the stage of Korean economic and industrial development, Korea has found itself in a favored position after 15 years, with a spanking new first-ranked investment partner in China, a new top-ranked export partner, and a trade surplus with the mainland that many other countries, including the United States, would envy.

At the same time, Korea has found China to be a favored source of many imports—not only finished manufactured goods assembled by Korean companies in the PRC from Korean-made intermediates, but also agricultural products such as corn (and, painfully, kimchi).

Yet the very fluidity and dynamic quality of the rapidly evolving Korea-China economic relationship leave the ROK uneasy today, grasping, like other countries, for coping strategies to deal with China even in the midst of China-induced prosperity. For China is still a work in progress itself, and the circumstances that provided Koreans with their opportunities in the first 15 years will not last forever. Chinese labor costs are going up. Chinese firms are entering markets where Korean companies roared to prominence or are rapidly raising their technical skills and abilities to compete with Korean firms on the Chinese outfits' home turf. Pushback from Chinese companies—some of them uncompetitive state-owned enterprises but others aggressive new competitors—is increasingly expressed in bureaucratic behaviors and government regulations that make it harder, not easier, for foreign companies to dominate in the Chinese market. Chinese imports into Korea are rapidly expanding. The trade surpluses that have characterized the great Korean advance into China are, if recent numbers portend future trends, going south.

The impact, therefore, of China on the Korean economy is itself a matter of unfinished business. Even as China focuses its attention, amid mixed predictions from foreign experts, on the development of its own indigenous capacity for scientific and technological innovation, in the knowledge that China's stupendous growth has been too heavy on the assembly of other people's proprietary components and too light on the creation of its own, Koreans ask themselves what Korea can do to stay ahead of the wave in China. They wonder aloud whether Korea as an economy, a society, and a polity is up to the challenge.

For those who believe in the cleansing effects of competition above all other virtues, the answer lies in the creation of a more Darwinian Korean economic environment, a more wide-open free-for-all in which many falter but the victors emerge with the agility and the brilliance necessary to preserve their high-value place in the Asian integrated circuit into which Korea is already inextricably woven. To others more heavily focused on the likelihood that such a struggle will produce high casualty rates, and perhaps unbearable social and political costs, the answer is not so obvious. The bilateral Korean-Chinese encounter is embedded in a much more complex global economic drama, in which every country seeks to understand its optimum position for the present and the future, but few countries understand how to achieve such positions even if they can define them. It would be thus even without the advent of China's presence, but the arrival of China within a single generation makes the quest for understanding of Korea's location, now and hereafter, in the global scheme of things much, much more unsettling and pressing.

On a recent visit to Washington, D.C., my cab driver—a Korean proud to have published a book of poetry that he invited me to admire, a man well aware of exactly the conundrum Korea now faces in its embrace of its giant neighbor across the Yellow Sea—advised me not to worry about any of these weighty matters: concentrate, he advised, on the fulfillment of the human heart, on the cultivation of inner peace—things that he, and I, might actually do something about. The rest, he emphasized warmly, is beyond our humble abilities. As is the task of writing about these issues for this humble observer.



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