

Vigorous Waves of East Asian Economic Integration and the Sino-South Korea Trade Relationship

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January 8, 2010

Since the global financial and economic downturn in 2008-2009, China, Japan, South Korea, and many other East Asian countries have begun to accelerate trade liberalization and economic cooperation in East Asia. Presaging this cooperation, China and South Korea have been developing their bilateral trade relationship over the last decade. First, China became South Korea's largest trade partner in 2003, replacing the United States. Then trade volume between China and South Korea reached \$160 billion in 2007, or 32 times higher than it was in 1992 when two countries established formal diplomatic ties. More recently, during Chinese President Hu Jintao's state visit to South Korea in August 2008, the two nations agreed to make efforts to increase bilateral trade to \$200 billion per year by 2012.¹

In 2006, even before the recent downturn, China stressed the need to push forward free trade agreement talks. Beijing seeks a Free Trade Agreement (FTA) with Seoul to help reduce its long-term trade deficit with South Korea. Though South Korea has generally favored bilateral FTAs, the previous Roh Moo-hyun administration in Seoul was reluctant to rush into an FTA with China due to fears that low-priced Chinese agricultural products could hurt Korea's domestic market. Specifically, Seoul's unwillingness to have FTA talks with China before the financial crisis may have been due to the following reasons:

First, both economic and political factors always play vital roles in the trade negotiations, and the South Korean government tends to protect the vulnerable agricultural sector, though that sector's share of gross domestic product (GDP) dropped from 5.2 percent in 1996 to 2.7 percent in 2006.² Accordingly, South Korea imposes an average 52.5 percent tariff for Chinese farm imports compared to China's average of 25.6 percent tariff on South Korean farm imports. Korea's farming and agriculture sectors continue to feel that it is difficult to compete with inexpensive Chinese agriculture products, the barriers remain in place, and these sectors are still an obstacle in the Seoul-Beijing FTA talks. Though a joint study on a China-ROK FTA was begun in 2004 and China pushed again in 2006, the talks have been stalled in the past few years.

In strategizing its approach to regional economic integration, South Korea differentiates potential FTA partners according to their political power. First, in 2002, the Korea-Chile FTA was concluded after four years of discussions. The Korea-Singapore FTA was signed in 2005, the

¹ "China-ROK Joint Communiqué," Ministry of Foreign Affairs of the People's Republic of China, September 17, 2008, <http://www.fmprc.gov.cn/eng/wjdt/2649/t513632.htm>; accessed January 4, 2010.

² Food and Fertilizer Technology Center for the Asian and Pacific Region, Major Agricultural Statistics, 2008, "Table 21: Share of agriculture in GDP," <http://www.agnet.org/situationer/stats/21.html>; accessed January 4, 2010.

Korea-EFTA (European Free Trade Association) was also sealed in 2005, and in 2009 the Korea-India Comprehensive Economic Partnership Agreement (CEPA) was reached which calls for tariff reduction in auto and other manufacturing sectors in both countries. In the meantime, South Korea began to negotiate FTAs with OECD countries which are closer to South Korea and are along the Pacific Rim, including New Zealand, Canada, and Australia. OECD countries presumably would not pose such strong competition in farming sectors as China does.

Second, the political impacts of FTAs are always vital. National and regional security factors can outweigh economic gain to some extent. Seoul put the Korea-U.S. FTA (KORUS) as its top priority, reflecting in part the strong military alliance between the two countries. In March 2007, Korea and the United States successfully completed FTA negotiations, but the implementation of the agreement has not moved forward due to strong political opposition in both countries; neither legislature has ratified the agreement. The political impact also influences third parties: indeed, the KORUS FTA acted as an incentive for Japan and China to revive their discussions on bilateral trade with Korea. South Korea and Japan have been in FTA discussions since 1998, and the prolonged process implies that South Korea is carefully adjusting its position with two of its biggest trading partners and neighbors. South Korea tends to find a balanced wedge point among the USA, China, and Japan.

Due to the financial crisis, South Korea's attitude toward a Korea-China FTA has changed. In October 2009, Chinese Minister of Commerce Chen Deming and South Korean Minister for Trade Kim Jong-hoon signed an agreement to increase economic cooperation between the two countries, and Seoul began to consider serious talks with Beijing about the FTA.

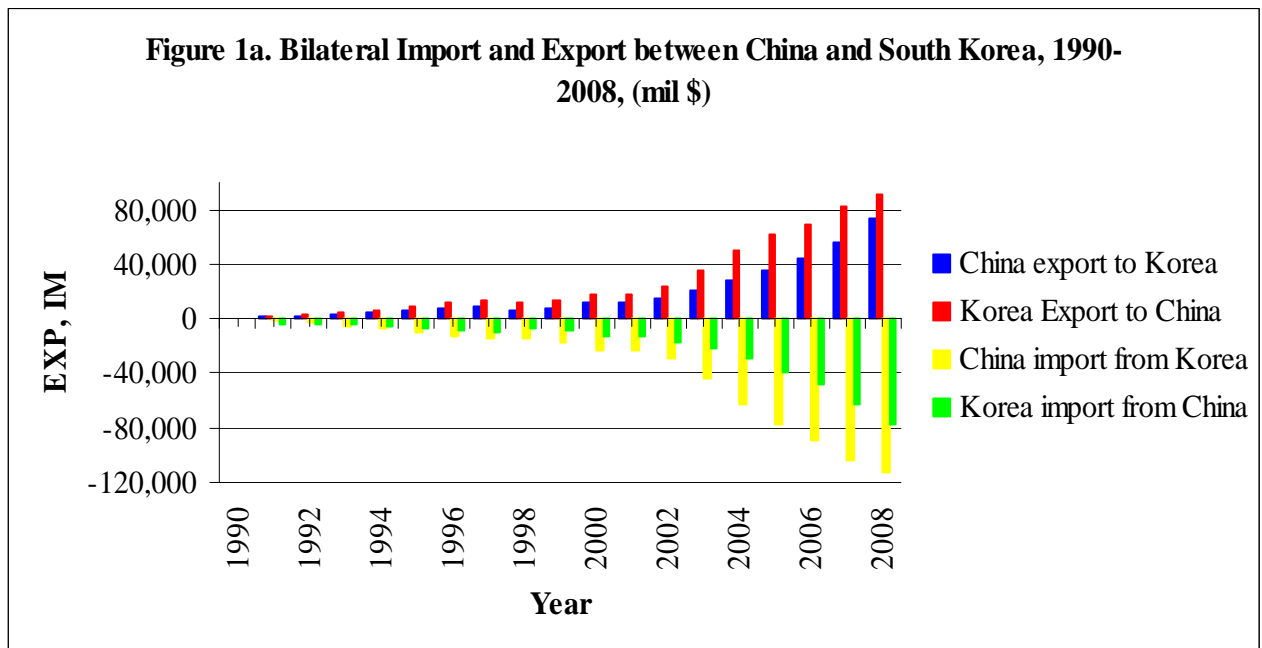
South Korea's motivation to return to the FTA negotiation table with China may be caused by the following factors: First, the strong tide of recent Asia economic cooperation meetings such as ASEAN and APEC meetings after the financial crisis has shaped the macro environment at the regional level. The stagnation of the Doha Round of trade talks in the recent years has also contributed to the high waves of bilateral FTAs in East Asia countries, and South Korea does not want to be left out and be left behind. Second, Japan's new Hatoyama administration seems determined to seek close but equal partnership with the U.S. and focus more on its ties with the rest of Asia. South Korea and China both notice this change and welcome this new attitude as they may see an opportunity for greater access to the Japanese market, both for themselves and for the other. In October 2009, China, Japan, and South Korea agreed to launch a joint study of FTAs among the three parties.³ Third, an Economic Cooperation Framework Agreement (ECFA) between China and Taiwan in early 2010 is likely to improve Taiwan's competitiveness in the China market at South Korea's expense. Reduced tariffs on Taiwan's products – especially electronic equipment, semiconductors, and other IT products – will erode the market shares of similar products from South Korea; Seoul has to jump back onto the free trade bandwagon with China. Fourth, China's rapid recovery from the 2008-09 financial crisis also played an important role in generating waves of FTAs in Asia. A significant drop in exports to the USA market has made both Japan and South Korea turn their eyes to China's huge market.

³ Ding Qingfen, "China-ROK Free Trade Deal Urged," *China Daily*, November 24, 2009, http://www.chinadaily.com.cn/china/2009-11/24/content_9026811.htm; accessed January 4, 2010.

Review of Sino-South Korea trade, 1990-2008

Trade policy and foreign policy often go hand in hand. China's trade relationships with other countries are certainly not immune from politics, and trade relations between China and South Korea have been strongly affected by their political relationship. Throughout the Cold War, there were no official relations between communist China and capitalist South Korea. China maintained close relations with North Korea, and South Korea maintained diplomatic relations with Taiwan. These political relationships hindered trade and economic development between China and South Korea. It was not until 1992 that South Korea and China established a formal diplomatic relationship. Trade volume and trade variety have increased significantly since then. Between 1989 and 2004, Korea's merchandise exports to China grew from US\$1.3 billion to US\$49.8 billion while China's merchandise exports to Korea grew from US\$472 million to US\$27.8 billion.⁴ China's economic boom has had certain effects on its major trading partners in Asia, including South Korea. As Chinese manufactured goods became major export products, the market shares of some South Korean products in the international market, especially the U.S. market, began to suffer.

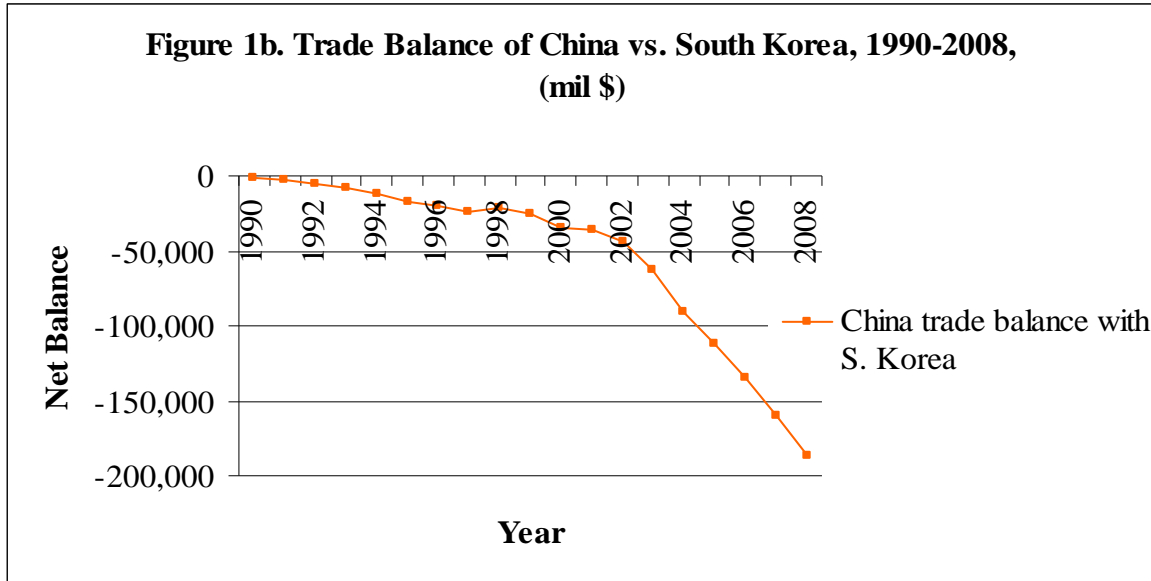
As shown in Figure 1a, bilateral trade between South Korea and China has increased steadily and significantly since 1990. China's total exports to South Korea jumped from US\$2 million in 1987 to US\$73,905 million in 2008. South Korea's exports to China have also increased since 1992, but while China's imports from South Korea have remained the highest volume among components of the bilateral trade, China's exports to South Korea have remained the lowest component over time.



Source: IMF financial statistics data, 2009

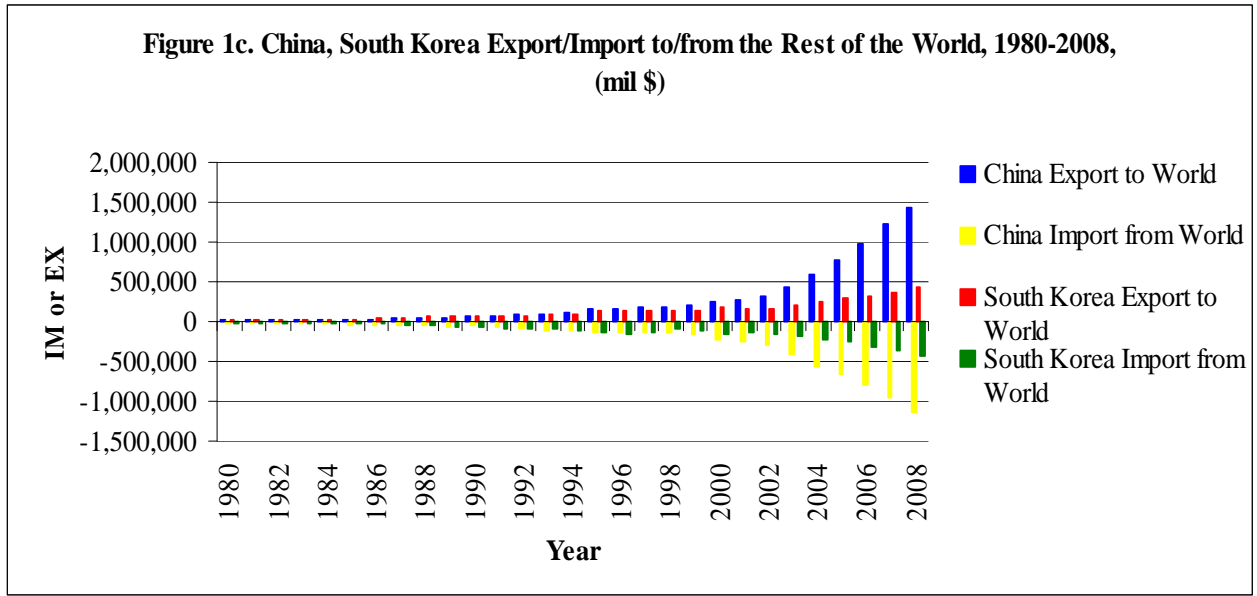
⁴ Kim, J. K., Kim, Y.S., and C. H. Lee. 2006. "Trade, Investment and Economic Interdependence between South Korea and China," *Asian Economic Journal*, 20(4): 379-392.

Though China has run a huge trade surplus with many of its trading partners since 1992, China has had a continuous trade deficit with South Korea since 1992, Figure 1b shows China's net export with South Korea from 1990-2008. China's trade deficit against South Korea has widened over time.



Source: IMF financial statistics data, 2009

At the global level, the bilateral trade picture is quite different. Figure 1c shows China's exports to and imports from the rest of the world and South Korea's exports to and imports from the rest of the world from 1980-2008. China's exports and imports jumped significantly in the past decade and China has run a huge trade surplus since its accession to the WTO in 2001. Both South Korea's imports and exports climbed slightly after 2002, and imports and exports have remained quite balanced over these years.



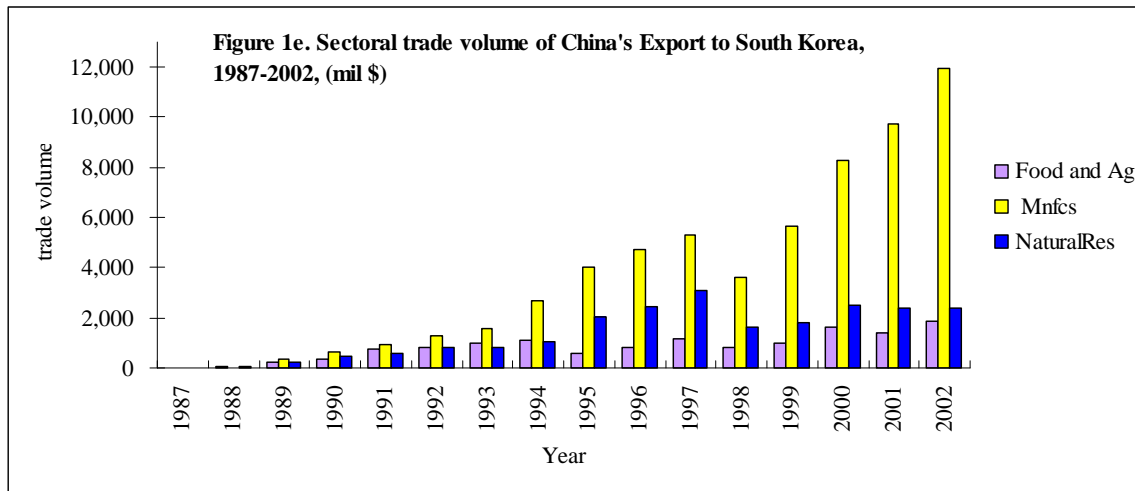
Source: IMF financial statistics data, 2009

In terms of trading partners at the global market level, Korea had more trading partners than China during 1974- 1986, China had more partners during 1987-1997, and they had an equal number of trading partners from 1998-2002 (Figure 1d).

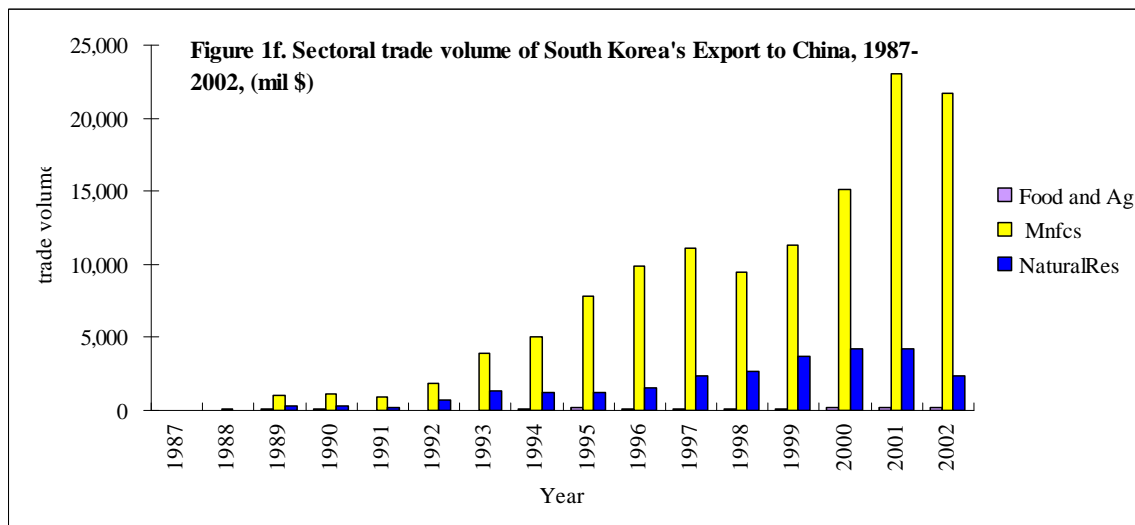


Source: Computation based on UN COMTRADE data

As shown in Figure 1e and Figure 1f, over the past decade, China exported manufactured products, food and agriculture products, and natural resources to South Korea. Most of these products are low skilled labor-intensive products. South Korea mainly exported manufactured products and electronic products, but very few food and agricultural products to China. China has a comparative advantage in natural resources, food and agriculture products, and low-tech or middle-tech manufactured products, while South Korea has a tremendous advantage in manufactured products, especially in high-skill, labor intensive manufactured products. In addition, China is Korea's biggest petrochemical export market. In 2000, about \$4.2 billion worth of petrochemicals were exported from South Korea to China, accounting for 45 percent of Korea's total petrochemical exports (and about 21 percent of China's total petrochemical imports⁵).



Source: Computation based on UN COMTRADE data



Source: Computation based on UN COMTRADE data

⁵ "Korea and China Reach Agreement to Minimize Trade Disputes," *Chemical Week*, October 17, 2001, pp. 23.

Comparative advantage is one of the key factors that determine trade patterns between regions. Table 1 shows the total world endowment shares of China and Korea in a number of resources – natural resources, capital, labor, and land. The overall share of these resources held by China and Korea is only 6 percent of the total world endowment. China has two percent of world skilled labor, 16 percent of world total land and 9 percent of world natural resources, 6 percent of unskilled labor, and 3 percent of world capital. China’s total endowment share is two times that of Korea’s. Korea has a comparative advantage in skilled labor and China has an advantage in abundant labor force. This endowment structure makes it easier to form an intra-industry trade relationship between these countries. However, South Korea’s advantage in skilled labor may be reduced due to the recent downward trend in its population. South Korea’s comparative advantage will be reduced if China can catch up in the aspects of technological growth and R&D development.

Table 1. China, S. Korea's Endowment Shares in World Total

Endowment	China	S. Korea
Land	16%	3%
Unskilled Labor	6%	2%
Skilled Labor	2%	1%
Capital	3%	2%
Natural Resources	9%	0%
Total	4%	2%

Source: Computation based on UN COMTRADE data

The road ahead

The recent financial crisis has spurred closer cooperation among East Asian countries. In August 2009, ASEAN and its six major trading partners (China, Japan, South Korea, India, Australia, and New Zealand) reaffirmed their commitment to establishing an East Asia Free Trade Agreement (EAFTA) and Comprehensive Economic Partnership in East Asia (CEPEA) within the next 15 years. As these 16 countries comprise 3 billion people (49.6 percent of the world’s total population) and generate one quarter of the world’s GDP, the EAFTA will establish the world’s largest economic region, surpassing the U.S. and the EU.

In 2008, South Korea was China’s fourth largest export destination with a total of \$74 billion, and China’s second largest import supplier with a total of \$112 billion. South Korea became China’s fourth largest trading partner with a total trade volume of \$186 billion (\$74+\$112), a 16 percent increase over 2007⁶ and, as noted above, China is South Korea’s largest trading

⁶ See Tables 7, 8, and 9 in “US-China Trade Statistics and China's World Trade Statistics,” U.S.-China Business Council, <http://www.uschina.org/statistics/tradetable.html>.

partner. According to the South Korean Customs Service, South Korea held a total trade surplus of \$28.68 billion against China in 2009, with an export volume of \$77.61 billion and imports of \$48.93 billion (figures through November).⁷ While running this huge surplus against China (\$28.68 billion), South Korea has experienced a large trade deficit with Japan, totaling \$24.55 billion.⁸ In September 2009, China, Japan, and South Korea agreed in Shanghai to strengthen their partnership to promote regional peace and cooperate on economic development, climate change, and other important issues.

Will a three-sided East Asian economic zone be formed by South Korea, China, and Japan be established in the near future? It is most likely possible but the timing is still a question. For China, the political motivations for a China-Korea FTA are greater than economic concerns, though reducing China's long term trade deficit against South Korea has been the key driver. South Korea perceives both the economic and political impacts of joining the turbulent tides of the East Asia regional integration to be very important. The global financial downturn made Seoul change its attitude toward China's FTA plan, but neither side has put the FTA on the top of their to-do lists, focusing instead on other key domestic issues. An FTA between South Korea and China may have to wait for a while, maybe even after the EAFTA.

However, if the new government of the Democratic Party of Japan really puts economics in front of politics, Japan may act faster than South Korea to sign an FTA with China. When China inks an agreement with either South Korea or Japan, it will immediately stimulate the remaining country to join in. The U.S., lacking operating FTAs with any of the three, may find its influence weakened as a result.

⁷ See "Trade Statistics, Import/export by Country, China CN (2009 Year)," Korea Customs Service, http://english.customs.go.kr/kcsweb/user.tdf?a=user_importexportcountry.ImportExportCountryApp&c=1001&mc=ENGLISH_INFORMATION_TRADE_030; accessed January 4, 2010.

⁸ "Trade Statistics, Import/export by Country, Japan JP (2009 Year)," Korea Customs Service.