

# Analysis on the Issues of and Prospects for a China-Korea FTA

Zhang Jianping

Korea Institute for International Economic Policy

CNAEC Research Series 06-04

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## Executive Summary

China and Korea are the two most vigorous economies in East Asia and both are accelerating the FTA process. A China-Korea FTA would be a key leverage point from which to move forward multilateral institutional economic cooperation in Northeast Asia, as well as a major move to strengthen economic and trade interactions between China and Korea. The strong growth in economic and trade relations and industrial complementariness (revealed comparative advantage index and trade specialization coefficient calculations) between both sides has laid the solid foundations for an FTA. Partial equilibrium model calculations reveal that a China-Korea FTA would have remarkable economic effects on both sides and bring much more benefit to Korea than a Korea-US FTA. The so-called barriers (agriculture, hollowing-out, SMEs) are not the major issues of a China-Korea FTA. The real problem blocking the process of a China-Korea FTA is geopolitical. Deciding on a China-Korea FTA is dependent on the Korean government and experts in different fields changing their worrying minds about China. We suggest that China and Korea complete feasibility studies and enter into negotiations for the purpose of enjoying mutual benefits from an FTA at the earliest possible time. Should Japan's political position remain substantially unchanged, a China-Korea FTA is likely to be signed before a Korea-Japan FTA.

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# **Analysis on the Issues of and Prospects for a China-Korea FTA**

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## **I . Introduction**

Along with the trend of regional economic integration, studies on FTAs in the Northeast Asia (NEA) economic circle have taken many years to complete and many different kinds of proposals have been provided. Due to political, economic, and energy status complications, the political relationship between China, South Korea (hereafter Korea), and Japan has become strained, and prospects of a trilateral FTA look gloomy. Now, in the 21st century, the bilateral economic and trade relationship between China and Korea has been developing very rapidly and mutual investment and trade are both growing sharply. As a result, an FTA between China and Korea in the near future is quite possible. Moreover, China-Korea FTA will play an important role in NEA economic integration and promote the economic and trade relationship between China and Korea to a higher level. Further studies on the feasibility of and issues facing a China-Korea FTA based on recent findings will contribute theoretically and practically to the establishment of China-Korea FTA.

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## **II. The International and Regional Background of a China-Korea FTA and Its Position in China's FTA Strategy**

### **1. International Trends of Regional Economic Integration**

Within the context of the recent slow progress in global multilateral trade negotiations, regional economic cooperation, mostly in the form of FTAs, is blooming throughout the world. At the end of June 2005, regional trade arrangements filed with the WTO amounted to 328, the majority of which were made recently. It is estimated that at least 50 percent of international trade is conducted under various regional trade arrangements. Developed countries such as the United States and Japan have expedited their research and negotiation process on FTAs, though they have not been very interested in regional economic cooperation in the past. Korea has also joined in the ambitious practice of forming FTAs. In a global setting, three trade blocs are emerging: Europe, the Americas, and East Asia. The European Union (EU) is a regional economic organization with the highest-level of economic integration. The North American FTA (NAFTA) and the South American Common Market (MERCOSUR) are striving to build an FTA of the Americas (FTAA). In contrast, Asia lags a good distance behind the Western countries in regional economic integration, which has had some negative effects on its economic development.

### **2. Regional Background of a China-Korea FTA**

Asia has seen improvements in the conditions for regional economic cooperation, as evidenced by the establishment of a 10 plus 3 (APT) mechanism, and the 13 economies in East Asia being engaged in a viability study on an East Asian FTA (EAFTA) as proposed by China, despite past US

objections to Dr. Mahathir bin Mohamad's EAEC proposal. However, an EAFTA still has a long way to go, for economic cooperation in Northeast Asia often tends to be more complicated. Forming an EAFTA may take two paths. One is through a Northeast Asia FTA, teaming up with the Association of Southeast Asian Nations (ASEAN). In effect, the potential for an FTA between China, Japan, and Korea is impaired by the political tensions between Japan and its two neighbors, and FTA negotiations between Japan and Korea have come to a standstill. Accordingly, a Northeast Asian FTA may be realized through two steps: the first is a China-Korea FTA plus a Korea-Japan FTA; the second is a China-Japan-Korea FTA or a Northeast Asian FTA. Another way is for each of the three countries to set up an FTA separately with ASEAN, with the eventual goal of having the three ASEAN+1 FTAs blend into a single EAFTA. This path is consistent with the expectations of ASEAN, but it is the least likely. The three parties would not turn to ASEAN for help unless they were unable to reach a consensus about an FTA. As for cooperation between the three countries, the political relationship between China and Korea is stronger than that between China and Japan, though Japan is more important to China than Korea in economic terms. Korea has an advantage over China in bilateral trade, maintaining a trade surplus with the latter, but is disadvantaged through its trade deficit with Japan. As a result, it seems that a China-Korea FTA should be given priority over a Korea-Japan FTA. Five rounds of Korea-Japan FTA negotiations have already been carried out, now brought to a deadlock for political reasons as well as for Japan's unwillingness to open up its domestic agricultural products market. In the actual international environment, it is difficult to activate a regional economic cooperation organization without a sound political foundation, no matter how important the economic relationship is. In a word, it is more likely that a China-Korea FTA will take the role of pushing forward Northeast Asian regional cooperation.

### **3. Position of a China-Korea FTA in China's FTA Strategy**

China is undergoing growing economic internationalization at present, and opening its economy requires reliance on both domestic and international resources and markets. On the other hand, with its vast market and economic size, the Chinese economy faces issues like foreign trade friction and resource and energy bottlenecks. By signing an FTA, China will demonstrate its political and diplomatic interest focus while gaining economic benefits including trade and investments. Against such a backdrop, China is also picking up the pace of research and signing FTAs with various nations around the world. Participating in regional economic integration has become an indispensable part of China's external economic and trade strategy in the new century.

China is committed to accomplishing the following strategic objectives through implementing FTAs: create a sound external environment featured by stable relations with neighbors and sustainable economic development; explore new markets to avoid the troubles of multilateral framework agreements; provide the critical strategic resources required for economic development; push Chinese enterprises "to go abroad" on the FTA platform; enhance the overall competitiveness of domestic industries via reasonable competition, and resolve the issues of its market economy status with FTAs. Since 2001, China has signed FTAs with the ten countries of ASEAN, CEPAs with Hong Kong and Macau of China, and Chile; it is also in negotiations with the six countries of the Gulf Cooperation Committee (GCC), Pakistan, India, New Zealand, and Australia; and China has undertaken feasibility studies with the five countries of the Southern African Customs Union (SACU), Iceland, and MERCOSUR.

Neighboring Asian countries are strategic partners for China in developing regional economic collaboration, which echoes its diplomatic policy of "Neighbors are a top priority." The trade value between China and its adjacent countries and areas accounts for more than 60 percent of China's total foreign trade value, and inbound investments from those countries and areas account for more than 70 percent of China's total. China will give priority to adjacent

countries in developing regional economic cooperation, which will help introduce economic development opportunities and China's vast market potential, while facilitating the better utilization of their resources and markets. China has a vast territory and many neighboring countries, and accordingly it will adopt a multi-dimensional diversification approach in developing a regional integration strategy.

China and Korea are the two most vigorous economies in East Asia. China is the number one trade partner of Korea and Korea is the fourth biggest trade partner of China, following the EU, the United States, and Japan. Since China might be unable to arrive at free trade agreements with Europe, the United States, and Japan, an FTA with Korea would be the best option with mutual benefits for both sides, which would also help promote the institutionalization of Northeast Asian cooperation. Initiating FTA talks with Korea has become a crucial step for China to push forward its long-term strategic planning for regional economic cooperation. Both sides will be major forces in the process of East Asian cooperation, as they have the strong desire as well as favorable conditions for strengthening cooperation and promoting mutual prosperity in this region. As the two countries nowadays pursue economic growth, higher standards and a strategically-enhanced level of economic and trade collaboration will inject new blood into East Asian economic cooperation. Therefore, institutional economic cooperation, namely an FTA, is necessary.

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### **III. Overall Understanding of a China-Korea FTA**

China is a major economic power with immense growth potential. Korea, as a medium-developed country adjacent to China, has increasing influence on the latter's economy with its economic dynamics, standards, and scale. An FTA would be a key strategic choice for further integration of the Northeast Asian economy for both countries and a major move to strengthen economic and trade interactions between both sides. It would be an important instrument in balancing China-Korea trade as well as the pragmatic requirements for fully tapping the comparative advantages of the two countries.

#### **1. A China-Korea FTA as a Key Leverage Point from which to Move Forward Multilateral Regional Economic Cooperation in Northeast Asia**

An FTA is the long-term goal of economic cooperation in Northeast Asia. As regional economic integration involves political barriers, a China-Korea FTA will serve as the key lever to move multilateral regional economic cooperation in Northeast Asia. Amid ongoing FTA research and development, a China-Korea FTA agreement may be the most likely product in the near future. The two countries have the basic conditions for the activation of an FTA because of the smooth development of political and economic relations and much consensus on regional economic cooperation. The China-Korea FTA will contribute politically and economically to the progress of Northeast Asian economic cooperation, particularly in light of the two countries' political strain with Japan. At the end of 2005, Korea declared that it would recognize China's full market economy status, which creates new conditions for a China-Korea FTA. It is unimaginable that Korea will be able to build itself into a real economic hub of Northeast Asia without a China-Korea FTA.

## **2. A China-Korea FTA: A Natural Product of Full-Range Closer Economic Cooperation between China and Korea**

Geopolitical and historical ties provide a strong foundation for the development of bilateral economic and trade relations between China and Korea, while their complementary economies present big opportunities for mutually beneficial requirements to realize pragmatic interests. To look for bigger and more stable markets to promote bilateral economic growth, both of them need to develop institutionalized regional economic cooperation to maintain their ever-closer ties in trade and investment.

China-Korea economic and trade cooperation has grown at a rapid pace. Bilateral trade value climbed to \$111.93 billion<sup>1)</sup> in 2005 from \$5 billion 14 years ago when they established diplomatic relations, an accomplishment equal to the result of 30 years of trade cooperation between China and Japan. In 2005, China's exports to Korea amounted to \$35.11 billion and imports from Korea \$76.82 billion, up 26.2 percent and 23.4 percent respectively over the previous year. China's trade deficit reached \$41.71 billion, an increase of 21.1 percent over the previous year. Korea is China's fourth biggest trade partner, its fourth most frequent export market, and its third largest import source (the EU and ASEAN excluded). China is Korea's biggest trade partner, export market, and source of trade surplus. China exports textiles and garments, coal, electronic parts, frozen aquatic products, corn and steel, etc. to Korea, and imports wireless communication equipment, petrochemical products, chemical materials, electronic products, steel and iron, and transportation machinery. Both governments expect to increase their bilateral trade value to \$200 billion by 2012, which would provide the conditions and impetus for an FTA.

Korea has witnessed slackening growth in its market share of exports to the EU since the late 1980s and a sharp decline in its market share of exports to NAFTA (Table 1). At the same time, Korea's market share of exports to China has soared, with an increasing reliance on the Chinese market (Table 2). As

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1) \$ indicates US dollars unless otherwise stated.

Korea's economic growth slows down and China continues to open up, both sides are looking to the possibility of institutionalized regional collaboration. Once a China-Korea FTA is realized, both of them will gain enhanced competitiveness in the international arena.

In direct investment, Korean enterprises have rapidly expanded their investments in China, with substantial increases in the average amount of projects, and big jumps in the proportion of technology and capital intensive projects; areas for investment have spread from the eastern coast to the middle and west inland. Based on statistics from China's Ministry of Commerce, Korean enterprises invested directly in 38,900 projects in China by the end of 2005, with a contractual amount of \$70.32 billion and a realized amount of \$31.101 billion. China has been Korea's biggest outbound investment target for three consecutive years, while China has also speed up direct investment in Korea. As of the end of 2005, China's accumulated non-financial direct investment in Korea totaled \$1.52 billion, including large mergers and acquisitions.

**Table 1. The Main Export Markets of China and Korea**

	Year	Exports (million dollars)	Export market share					
			ASEAN	EU	NAFTA	Australia, New Zealand	Japan	China
China	1985	31,356	10.5	10.0	14.7	1.2	20.8	
	1995	232,623	4.5	13.9	22.7	1.6	15.4	
	2001	415,879	5.0	15.3	29.5	1.6	13.9	
Korea	1985	25,207	5.2	11.5	47.7	1.7	16.4	0
	1995	117,907	13.8	12.7	24.2	1.8	14.7	8.7
	2001	163,645	10.0	12.0	26.7	1.8	10.5	14.3

Source: IMF

**Table 2. The Export and Import Market Shares of China and Korea**

China's share of Korean trade			
Year	China's share of Korea's exports	China's share of Korea's imports	China's position in Korea's total trade
1992	4 percent	5 percent	5
2003	18 percent	12 percent	2
Korea's share of Chinese trade			
Year	Korea's share of China's exports	Korea's share in China's imports	Korea's position in China's total trade
2003	4.6 percent	10.4 percent	6

Source: China Customs

As shown by the trade and investment relations between China and its major partners, the growth of the bilateral trade value has clearly been in direct proportion to changes in direct investment amounts. And the temporal sequence analysis finds that there is an obvious Granger causation between the two factors (i.e. the change in trade value leads to a change in investment amount). The direct investment of Korean enterprises in China would inevitably increase, as an FTA would spur the growth of bilateral trade between the two countries. Therefore, a China-Korea FTA would influence on Korea's future investment in China. FTA-related industry opening and investment facilitation arrangements will stimulate the investment of Korean enterprises in China.

### **3. A China-Korea FTA: Boosting the Full Utilization of the Comparative Advantages of Both Countries**

China is an enormous market with 9.60 million square kilometers of territory and 1.3 billion people, whereas Korea has less than 100 thousand square kilometers of territory and more than 45 million people, with a limited market capacity. Regarding factor endowments, the per capita land in Korea (0.30

hectares) is only half of that in China (0.76 hectares),<sup>2)</sup> but the per capita capital of Korea (\$2427.5) is nearly 10 times the figure for China (\$282.7, 1999<sup>3)</sup>). Such a fundamental status determines that China has obvious advantages in developing agriculture while Korea has an advantage in developing manufacturing. To thoroughly study the competitive and complementary relations in industries between China and Korea, we performed a qualitative analysis by using the regional revealed comparative advantage (RCA) method and trade specialization coefficient (TSC). In reviewing the international market share of both industries, we made comparisons of the market shares of both countries to the United States.

The calculation results indicate that the industries of both sides have complicated and diversified characteristics, i.e. several forms of trade coexist in certain sectors. China's comparative advantage over Korea is mainly in resource and labor intensive sectors, e.g. animal and plant products, edible materials, mineral products, textile materials made of animal and plant products, suitcases and bags, garments, metal products, electro-mechanic products, and low-end miscellaneous products. Korea's competitive comparative advantage over China is mainly in capital-intensive heavy chemical sectors, especially the three key sectors: automobiles, medicines, and organic chemicals. Competition between the two countries is focused on rubber and rubber products, paper and cardboard, presswork, boilers, and mechanical products. There is a great number of intra-industry trade as well (Table 3).

There are four features of the industry division of China and Korea. The first is the obvious overall complementariness between both countries, with complementary industries occupying more than half of the total. The complementary scope is further expanded by some industries with intra-industry trade. This is the result of the clear difference in the factor endowments between them. The second is processing trade, which dominates intra-industry trade from both sides. The third is the increasingly narrowing gap, diminishing complementariness, and intensifying competition in manufacturing between

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2) IMF (2001), *International Financial Statistics Yearbook*.

3) *Ibid.*

China and Korea. The fourth is the ever-complicating forms of intra-industry trade between China and Korea. Vertical division and horizontal division go hand in hand, in addition to which there is a large amount of intra-industry trade. Overall, the industries of both countries are more complementary than competitive.

**Table 3. Comparison of Industry Competitiveness between China and Korea**

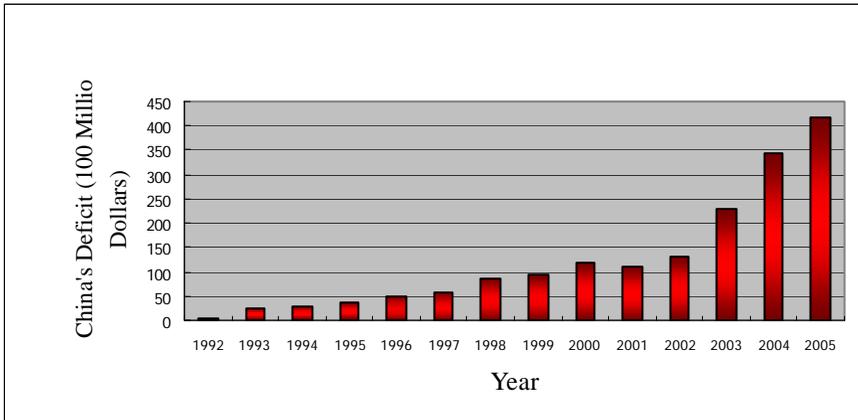
Competitive	Complementary	Non-competitive and Non-complementary	Inter-industry trade
Electrical machinery and equipment Machines, boilers Audio visual equipment Miscellaneous chemical products, rubber and its products Textile material from propagation Paper and cardboard Garment materials	Electrical machinery and equipment Audio visual equipment Vehicles, base metals and its products Railway vehicles, shipping Inorganic chemical products Fertilizer Detonators, fireworks Protein, glue products Textiles, finished products Leather and its products Suitcases and bags Wood and woodwork Shoes, caps, pottery, glass Optical instruments, photo equipment, timepiece, furniture, toys, miscellaneous products	Electrical machinery and equipment Audio visual equipment Leechdom, extracted oil products, plastic and its products, mineral fuels Mineral oil and the pharmaceutical industry Peltry and lather products	Electrical machinery and equipment Audio visual equipment Organic chemicals Textile materials from chemical products

Source: Author compiled.

#### **4. An FTA's Potential Contribution to the Trade Balance between China and Korea**

As a result of mounting China-Korea trade, China's trade deficit against Korea jumped from \$11.9 billion in 2000 to \$34.4 billion in 2004, an increase of 1.8 times over five years. In 2005, China's trade deficit reached \$41.713 billion, up 21.15 percent from the previous year. China's accumulated trade deficit totaled \$173.19 billion by the end of 2005 (Figure 1). This has become the biggest issue in Sino-Korean economic and trade cooperation, owing to Korea's robust exports of steel and iron, chemicals, cosmetics, electronic equipment, and electronic products. However, the trade deficit is subject to the differences and complementarity between both countries' industry structures and will therefore remain as is for a period of time. There are two reasons for China's growing trade deficit against Korea. One is the unique features of the China-Korea trade structure. Beginning in the 1990s, Korea has been moving those industries that are losing comparative advantages to China. The re-division of industry between China and Korea has led to the drastic increase of China's trade surplus against the United States, the ultimate market for those industries. Korea is seeing an increasing reduction in its trade surplus against the United States, and the latter has put a lot of economic and political pressure on China. The other is the market entry barrier for China's products set by the Korean government, e.g. additional regulatory duties on imported commodities from China, especially for agricultural products. China does not pursue an absolute trade balance, but the continuously soaring trade deficit will impair the healthy development of trade between both parties. For the sake of long-term, stable economic and trade ties, the two neighbors should achieve balanced and expanded growth by signing an FTA, thereby cutting tariffs, removing non-tariff barriers, and encouraging imports from China.

**Figure 1. China's Trade Deficit to Korea**



Source: Chinese Customs.

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## IV. Model Analysis

### 1. PEM Model Introduction

In order to make a quantitative analysis of the influence of a China Korea FTA, the partial equilibrium model (PEM) was created. Different from the computable general equilibrium model (CGE) that focuses on calculating the beneficial effects of the trade policy, this model is focused on the effects on the price and demand of the imported products under the conditions of tariff reduction. An FTA signed by China and Korea would have both countries reduce tariffs and abolish non-tariff barriers. Such measures would have two effects in the short term: trade creation and trade diversion. While trade creation is mainly focused on the positive effects on Korea brought about by an FTA, the trade diversion effect mainly considers the negative effects on other countries in the global multilateral system caused by a bilateral China-Korea FTA.

$$\text{Trade Creation: } d_{TC} = \frac{IM_{KOREA} * E_M * t}{1+t}$$

$$\text{TradeDeviation: } d_{TD} = \frac{IM_{KOREA} * IM_{REST} * E_S * t / (1+t)}{IM_{KOREA} + IM_{REST} + \frac{IM_{KOREA} * E_S * t}{1+t}}$$

Where  $d_{TC}$  is the value of trade creation and  $d_{TD}$  is the value of trade deviation.  $IM_{KOREA}$  is the CIF value of products imported from Korea by China.  $IM_{REST}$  is the CIF value of the same products imported from the rest of the world.  $E_M$  is China's domestic price elasticity for imported goods,  $E_S$  is the elasticity of substitution between goods imported from Korea and goods imported from the rest of world.  $t$  is the initial customs tariff plus the non-tariff barrier. The first formula is relatively simple, which is actually a

transfiguration of the price elasticity formula

(  $E_s = \frac{dQ/Q}{dP/P}$  ), while the second formula is concluded through complicated calculations that has the following two special conditions: when  $E_s = 0$ , i.e., when there is no substitutive relation between two types of imported products, other countries will not be affected by preferential tariff reductions between China and Korea. When  $E_s = \infty$ , i.e., the substitutive elasticity between two types of imported products is infinite, other countries will be severely affected by the FTA. Once the FTA is implemented, all those products originally imported from other countries will be imported from Korea.

## 2. Data Sources

The PEM model is based on the trade structure and trade data between China and Korea in 2003, while the duty is based on the duty rate stipulated in the Duty Charge Rule for the Most Preferential Countries, announced officially by China that year. Both  $IM_{KOREA}$  and  $IM_{REST}$  come from Chinese customs data, and  $t$  comes from the 2003 Rule for Import/Export Products in the People's Republic of China. Some of the specific duties are converted into an ad valorem duty according to the relation between the quantity and the value.

The elasticity index,  $E_M$ , was estimated. The quantity and unit price of the imported products were obtained in terms of Chinese Customs Bulk Products Import Quantity/Price Statistics Table (8 digits) from 1994–2003. Then the logarithm of the quantity and unit is calculated and a constant is added; at last the result is concluded through a regression analysis via the method of least squares. For those products that are not included in the 1994–2003 Chinese Customs Bulk Products Import Quantity/Price Statistics Table, a weight is granted to the elasticity by referring to similar products categories.

$E_s$  is based on the countries' substitute elastic data provided by GATP and converted via Amington arithmetic operators. Similar to all other

quantificational analysis on elasticity, the elasticity data here is only a rough estimate.

### **3. Calculating the Results**

Calculated with the model, the results reveal many things. Firstly, a China-Korea FTA would bring obvious economic effects. In the short term, zero tariffs on China's imports from Korea would result in considerable trade creation effects, with a total value of about \$2.42 billion, which corresponds to 5.6 percent of China's imports from Korea in 2003. In most industries, the trade creation values equal 5–15 percent of China's import from Korea in 2003. Secondly, for those industries for which the import value from Korea is quite large, such as machines and electronic equipment (item 16), plastic (item 7), textiles (item 11), base metals (item 15), optics (item 18), mineral products (item 5), etc., their trade creation values would be higher than other industries and surpass \$100 million. The trade creation value on machines and electronics is over \$540 million, and for food and tobacco the trade creation proportion on total imports from Korea is over 30 percent. Thirdly, a China-Korea FTA would not influence other countries while the total trade diversion value is about \$1.68 billion which is equal to 0.5 percent of other countries exports to China, as well as the 3.9 percent of Korea's exports to China.

### **4. Model Limitations**

Obviously, the results of the PEM model have some limitations. Due to issues regarding the availability of data, the model just analyzed Korea's exports to China without consideration of the impact on China's exports to Korea after signing an FTA. Meanwhile, the model mainly analyzed the short-run influences on the commodity market, and mutual investments, employment, influences on the third sides were not included. Furthermore, the results of any model, whether it is a PEM, CGE, or GTAP model, need to be combined with practical analysis, and are not an end in and of themselves. The

Chinese research used the CGE model for a CJK FTA analysis. The results showed that China's electronic and information industries and vehicle industries would be seriously impacted, which contradicted generally recognized viewpoints. When the Korean side analyzed a Korea-China FTA using the model, the results showed that China's vehicle industry was stronger than Korea's and that Korea's fishery was stronger than China's. The model inevitably has certain limitations, and its results need to be modified by using general research methods.

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## **V. Major Issues and Barriers Confronting a China-Korea FTA**

### **1. Agriculture**

China is the number one global producer of cotton, oil plants, fruit, vegetables, meat, poultry and eggs, and aquatic products, boasting 130 million hectares of cultivated land. Its per capita production of cotton, oil plants, meat, poultry and eggs, and aquatic products has matched or exceeded the global average. China created RMB 2271.8 billion added value of agriculture in 2005, a 5.2 percent increase over the previous year, which accounted for 12.4 percent of GDP. It harvested 484.01 million tons of grain for the year, up 3.15 over the previous year. Also in 2005, China's agricultural product trade value totaled \$55.83 billion, including \$27.18 billion in exports and \$28.65 billion in imports. China's agricultural product trade has moved from a surplus to a deficit since 2004 and this deficit may continue in the future. The proportion of Korea's agriculture in GDP declined from 40 percent in 1960 to 4 percent in 2000. Its agricultural employees were reduced to 8.5 percent of the total labor force in 2000 from 50 percent in 1970. In 2004, Korea's agricultural output value totaled \$33 billion, one third of which came from rice. Owing to the rise in land prices and labor costs, the prices of Korean agricultural products are 2.5 times higher than the international market average. Korea imported \$12.19 billion in agricultural products in 2003, a deficit of \$9.21 billion. In 2004, Korea imported \$2.1 billion worth of agricultural products from China, a deficit of \$1.92 billion.

Some Korean people are concerned that the influx of Chinese agricultural products may deal a blow to the domestic market, and this argument holds some water. Agriculture is Korea's most sensitive sector, especially with rice. An uproar over agriculture arose during the FTA negotiations between Korea and Chile, elevating it to a political issue. For a China-Korea FTA, the agricultural issue may become a major challenge partly due to political

considerations, rather than for purely economic reasons. Meanwhile, Chinese agricultural products only have limited export competitiveness. In recent years, some exports have been made with assistance from overseas countries in productive technology, quality varieties, and market exploration. With China's economic growth and improved living standards, the Chinese market has shown an increasing demand for high quality, healthy green food, indicating that high quality agricultural products developed and produced by Korea will flood into China.

The Korea-Chile FTA paved a new path for resolving the agricultural issue. It set down a long period of transition, allowing for step-by-step liberalization of those sensitive markets of rice, apples, pears, etc. China can also follow suit to compromise on some sensitive agricultural products in Korea, or even put aside the agricultural issue, as Premier Wen Jiabao said. Another way out is to increase Korea's agricultural investments in China. As the neighbor nearest to the northeastern and eastern developed areas of China, Korea is able to mitigate agricultural trade disputes with China by encouraging enterprises to invest in and set up agricultural production and processing bases. In addition, Chinese agricultural authorities also need additional access to funds and technology to improve product quality. Under this initiative, Korean farmers will play a role in arranging investments in China to establish plantations and breeding bases, undertaking deep processing business, and then selling products to their home country. However, only a few Korean enterprises are currently making agricultural investments in China. This approach of investment and cooperation may be instrumental in easing trade disputes in agricultural products and bring benefits to farmers of both parties.

## **2. Manufacturing Competition and Collaboration (the Hollowing-Out Issue)**

In an emerging industrialized country such as Korea, manufacturing has been in a transition period from a focus on heavy chemicals to a technology

intensive focus, while China has just entered the medium stage of heavy industrialization. Chinese manufacturing falls behind Korea overall, and Korean manufacturing also outshines China's in terms of technology level and market competitiveness. Clearly, Korea has a scale advantage over China in the pillar sub-sectors of manufacturing including electronic information, automobiles, shipbuilding, petrochemicals, machinery, and fiber, with higher levels of technology and stronger competitiveness in international markets. China does have some sectors with productivity matching or outrunning Korea, but is left far behind by Korea in production scale and concentration degree, technology, and labor production efficiency. Within sectors, Korea usually dominates capital and technology intensive markets at the medium and high end, whereas China is active in labor-intensive market at the low and medium end. Notwithstanding its disadvantage against Korea in manufacturing, China is still actively pushing forward its plan to build an FTA with Korea in consideration of the overall benefits to the economic growth of both countries. The critical reasoning is that China's huge market potential and labor resource advantage, combined with the technology and capital advantage of Korea, will generate tremendous power, promoting the mutual prosperity of both economies. For Korea, the China-Korea FTA will also play an active role in helping settle issues like the domestic market, salary costs, labor shortage, etc.

Some Korean people worry about a potential hollowing out of their industries as a result of Korean enterprises' investments in China, and object to the establishment of a China-Korea FTA. As indicated in Korean investments in China, when Korean enterprises that invest in China operate in manufacturing, the trade or service sectors always follow. And there have been just a few cases of closing down domestic practices before investing in China. Hence we should have an objective analysis of the impact of a China-Korea FTA on the development of industries of both countries. Moreover, Korea is confronted with keen competition in China and needs to expand its investment scope and enhance the diversification of its products in trade. Korea may be restricted in trade development, provided that it gives up investment opportunities out of fear of the hollowing-out of industries. It is unnecessary to

worry about hollowing-out if the industries of a country lose competitiveness. With the industrial structure being upgraded and marginal income changing, industries will transfer across the border according to objective economic rules. Some sectors of manufacturing in Korea with declining marginal income will be moved to China in a phased manner, a reality out of the control of the human will. Businessmen need to consider how to survive in a market. According to statistics from the Development Research Center under the State Council of China, 70 percent of respondent Korean enterprises indicated that they would expand their business in China by increasing investments, reinvesting profits, setting up new operations, etc. A China-Korea FTA is undoubtedly of great appeal to Korean manufacturing operators.

### **3. Small and Medium Enterprises and the Employment Issue**

Regarding import growth, an FTA would not have a negative effect on employment in labor-intensive manufacturing in China, for the two countries have different labor division structures at different development stages. In terms of exports, the growth of China's exports to Korea resulting from an FTA will certainly drive up the quantity of employment. The increase of Korean enterprises' investment in China will generate more employment opportunities in China. On the contrary, another concern of Korean people is that a China-Korea FTA will put the small and medium-sized companies in Korea into the plight of scrambling for survival or even close down and have a significantly negative effect on employment in Korea, in addition to the aforesaid two worries of agriculture and hollowing-out. In response to the presence of an FTA, companies would have to reconsider the cost of productive elements, and these Korean enterprises in China may have to focus more on investment than on trade. The continuing transfer of Korean manufacturing operations into China will have a definite impact on the survival of domestic enterprises and employment in Korea. Those Koreans who are familiar with and have an understanding of the Chinese market may be

engaged in production and operation in both countries, but those unable to do so will need to find new outlets within the upgraded industrial structure of Korea. Korean employees in the service sector take up only 55 percent of the total number of employees, far behind developed countries with a rate of 70 percent. Low and medium end manufacturing in Korea will continue to move to China in the future, as the former prioritizes the development of high end manufacturing and service sectors. A booming service sector will play a crucial role in resolving the issues of small and medium enterprises and employment.

#### **4. Impact on Other Countries**

Presently both China and Korea are aggressively pushing forward FTA arrangements with other countries. It is difficult to comment on the overall influence of a China-Korea FTA on other countries. For reasons of economic scale, industry type, and trade structure, the FTA arrangements of both countries will be of insignificant impact on the economic and trade ties with their minor trade partners on both sides. But we should have a specific analysis on the influence of their FTAs, built respectively or jointly, with major trade partners. The influence on the United States, among others, should be given particular consideration. As a Korea-US FTA will come into being earlier than a China-Korea FTA, the latter will not hamper the economic interests of the United States in this area. And the United States has invested a lot of funding in this area, so its enterprises have a considerable share of the export market in the region. A China-Korea FTA would promote the economic interests of the United States in this area. China, however, should be proactive in researching the impact of a Korea-US FTA on itself.

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## VI. Prospects

When only considering the economic effects, the prospects for a China-Korea FTA seem brighter. It's obvious that a China-Korea FTA would bring more benefits and welfare to Korea than a Korea-US FTA (Tables 4 and 5). Meanwhile, the benefits arising from Korea's advantage in manufacturing will offset the disadvantages to agriculture. China could even consider allowing Korea to protect its agriculture industry. Some of the Korean people are concerned about the possibility of China's surpassing Korea in the manufacturing sector, which could be delayed by refusing to sign an FTA. In fact, they are two separate matters. The above-mentioned barriers are not actually major issues. The real problem blocking the process of a China-Korea FTA is geopolitical. While China is ready to move forward, Korea still needs time to appropriately prioritize the United States, Japan, and China. A China-Korea FTA is largely a matter of time, and whether it is necessary or workable to set up this FTA is beyond dispute.

**Table 4. The Effects of a Korea-China FTA (Static Model)**

(Unit: percent)

Scenario 1	GDP	Welfare	Exports	Imports	ToT
Korea	2.443	1.132	4.756	5.512	1.235
China	0.395	0.073	3.537	4.732	0.154
Scenario 2					
Korea	2.472	1.164	4.787	5.182	1.237
China	0.401	0.084	3.561	4.763	0.154

Source: KIEP (2005), *Economic Effects of a Korea-China FTA and Policy Implications (I)*.

**Table 5. The Effects of a Korea-US FTA on Korea (Static Model)**

	Static Model		Dynamic Model	
	Scenario 1	Scenario 2	Scenario 1	Scenario 2
GDP (percent)	0.42	0.59	1.99	2.27
Consumption Expenditure (percent)	0.57	0.65	1.64	1.85
Welfare (million dollars)	2,374	2717	6815	7698

Source: Ibid

### 1. The Korea-US FTA, a Top Priority for Korea Now.

Korea has had intimate economic and political relations with the United States in the past. The Six-Party Talks have brought about subtle changes. To enhance international competitiveness, Korea immediately put the issue of a Korea-US FTA on its agenda. As the seventh largest trade partner of the United States and the tenth largest global economy, Korea will become the biggest economic power to sign a trade agreement with the United States, after NAFTA. Their negotiations will kick off on May 3, and are expected to wind up within one year. FTA negotiations between Korea and the United States are a necessity of the economic and trade interactions between both parties. The United States has close economic and trade ties with Korea. The bilateral trade value hit \$72 billion in 2005, more than twice that of its trade value with Central America. Both countries have invested nearly hundreds of billions of dollars in each other. They will be able to rival China in this area by signing an FTA. China has put more efforts in free trade negotiations with its Asian neighbors, the South American countries, and the African countries since 2001. In the eye of the United States, it will be put at a disadvantage if it does not strengthen bilateral trade negotiations with East Asian countries. Consequently, the United States has decided to accelerate its talks with Korea so as not to be left behind. The third reason is the demand for a liberalized market. The United

States and Korea both have some important areas blocked to each other. Korean automobiles swarm into the United States, but American-made cars are not allowed to enter Korean market freely. The United States is attempting to make its way into Korea's auto market by way of an FTA. Agricultural products in the United States are under government protection, and Korea is seeking to export its agricultural products into the United States under an FTA arrangement. The United States expects to make concessions on Korean agricultural products in exchange for more liberalized service markets (e.g. in the financial sector) in Korea, the free flow of labor and labor standards, etc.

## **2. A China-Korea FTA and a Korea-Japan FTA: Which Will be Next?**

Japan took the initiative in proposing FTA negotiations with Korea several years ago, which was soon followed by government consultations. Yet they have come to an impasse after five rounds of negotiations. Japan is also negative toward a China-Japan FTA in view of agriculture protection, issues of control over regional affairs, and relations with other major powers. Therefore, a key step in China's long-term plan is to initiate FTA talks with Korea. In Korea, more voices are heard about signing an FTA with China than with Japan. In light of the rapid growth in Korea's investments and exports to China, the Korean business community holds that a Korea-China FTA would be more beneficial than a Korea-Japan FTA. Consequently, a China-Korea FTA may not necessarily lag behind a Korea-Japan FTA, although the latter entered into negotiations earlier due to more similarities in economic development and industrial structure between Korea and Japan. This is because those two countries cannot establish regional economic cooperation organization without a sound political foundation, no matter how important the economic relationship is. This has been proven time and again in history. Should Japan's political position remain substantially unchanged, a China-Korea FTA would possibly be signed following the Korea-US FTA. In that way, both China and the United

States will not be exposed to negative effects from trade transfer.

### **3. Timetable for a China-Korea FTA**

Back in 1992, or even in 2000, none could have envisioned today's close relations in economy and trade between China and Korea. Five years are adequate for dramatic changes to take place. As required by the high speed of economic and trade growth between both sides and pressing calls from both business communities, both sides may as well sign a China-Korea FTA within a few years, no later than five years. We suggest both countries endeavor to complete the second phase of joint research on a China-Korea FTA by 2006, embark on bilateral negotiations, conclude negotiations within one year, and arrive at an FTA agreement. By doing so, both parties will not fall under a trade-negative impact from any FTA they may sign with a third party. However, decision-making on a China-Korea FTA needs the Korean government and experts in different fields to change their worrying minds and viewpoints on China.

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## VI. Conclusion

To harmonize regional economic integration across the world, China and Korea have sped up their FTA development. Korea is one of the major targets of China's FTA strategy. A critical step for China in its long-term strategic plan for regional economic cooperation is to initiate FTA negotiations with Korea. The strong growth in economic and trade relations and industrial complementariness (shown in RCA and TSC calculations) between both sides has laid the solid foundations for an FTA. A China-Korea FTA would serve as a key leverage point from which to move forward FTAs in Northeast Asia and East Asia as well. Partial equilibrium calculations reveal that a China-Korea FTA would have remarkable economic effects for both sides. We suggest that China and Korea complete feasibility studies and enter into negotiations for the purpose of enjoying mutual benefits from an FTA at the earliest possible time.

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# Analysis on the Issues of and Prospects for a China-Korea FTA

**Zhang Jianping**

China and Korea are the two most vigorous economies in East Asia and both are accelerating the FTA process. A China-Korea FTA would be a key leverage point from which to move forward multilateral institutional economic cooperation in Northeast Asia, as well as a major move to strengthen economic and trade interactions between China and Korea. A China-Korea FTA would have remarkable economic effects on both sides and bring much more benefits to Korea than a Korea-US FTA, and should Japan's political position remain substantially unchanged, it is likely that a China-Korea FTA will be signed before a Korea-Japan FTA.



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