



China-Korea Relations:  
**Teenage Angst: 15<sup>th</sup> Anniversary of Diplomatic Relations**

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China and South Korea commemorated the 15<sup>th</sup> anniversary of diplomatic normalization Aug. 24. In contrast to the unbridled optimism and buoyant lure of mutual economic opportunity that characterized the 10<sup>th</sup> anniversary of normalization, this one was greeted with more realism and mixed feelings about the future of the relationship. China's relationship with North Korea, in contrast, remained estranged as ever despite an important meeting between Foreign Minister Yang Jiechi and National Defense Commission Chairman Kim Jong-il in Pyongyang. This was the first Chinese high-level contact with Kim Jong-il since Tang Jiaxuan went to Pyongyang as a special envoy immediately following North Korea's nuclear test in October of 2006.

Changes in the Sino-South Korean economic relationship, driven by China's rising international competitiveness, changes in Chinese investment regulations safety, and concerns attached to Chinese consumer products, were reinforced by the sudden death due to medical error of South Korea's number two diplomat in Beijing. South Korean caution regarding Chinese policies toward North Korea remained a central focus of concern, as China's economic growth and influence continued to expand in both parts of the Korean Peninsula.

**Happy Fifteenth! Past accomplishments and future anxieties**

The China-South Korea relationship has shown vibrant growth over the past 15 years. Trade has grown over 18 times, from \$6.4 billion in 1992 to over \$118 billion in 2006. Sino-South Korean trade is projected to top \$150 billion this year and to reach \$200 billion by 2012. China has been South Korea's largest trading partner since 2004 and is set to surpass Japan as the leading source of South Korean imports this year. South Korea is China's fourth largest export market. Although South Korea ran a trade surplus of \$20.9 billion in 2006, the level of that surplus is steadily shrinking as South Korean imports from China are growing at twice the rate of exports to China. Meanwhile, nearly 43,000 Korean companies are operating in China. Official studies on a prospective Sino-South Korean FTA continue, but actual negotiations will have to wait until after a new president takes office in South Korea next year.

Over 3.9 million Korean tourists (almost 10 percent of South Korea's population) visited China and 900,000 Chinese visited South Korea last year. Almost 900,000 Koreans went

to China during the two-month July-August summer vacation period alone, making China the leading vacation destination during that period. Chinese make up 44 percent of the approximately 1 million foreign residents in South Korea, while the 57,000 South Korean students in China represent a third of all foreign students in China. The popularity of Korean pop culture and films in China known as the “Korean wave” appears to have peaked as Chinese authorities are now limiting distribution channels and popular Korean dramas are now emphasizing episodes from the Koguryo period that vilify China’s role on the Korean Peninsula. Needless to say, those dramas will not find commercial success in China.

The growth in trade has also had a significant influence on South Korea’s trade dependence profile in recent years. Korean exports to the U.S. during the first seven months of the year represented only 12.9 percent of Korean total exports, down from 29.8 percent in 1990 and 20.2 percent in 2002. Meanwhile, China received 22 percent of South Korean exports, double China’s share in 2000, and up from less than 2 percent at the time of normalization in 1992.

Despite the rapid expansion, the tone surrounding the Sino-South Korean relationship has changed dramatically compared to the 10<sup>th</sup> anniversary of diplomatic normalization five years ago. Perhaps the best indicator of the shift is that Korean citizens keep voting for King Kwanggaet’o the Great, a Koguryeo dynasty ruler, as the figure they want to see on a new ₩100,000 note, even though the Bank of Korea has not listed him as a choice for fear of antagonizing China. China’s exports have eroded Korean export shares by 6.9 percent per year as China continues to replace Korea in third-country markets according to a Korea Development Institute report by Seoul National University economics professor Kim Dae-il. The report projects that the decline in Korean exports is negatively influencing Korea’s domestic job market.

Chinese goods now make up over 35 percent of South Korea’s imported consumer products, according to a survey by the Hyundai Research Institute, up from 9.8 percent in 1992. The survey reports that the market share of Chinese steel products has expanded from 4.03 percent in 1992 to 26.2 percent in 2006 and the market share of Chinese electronic goods rose 26 times from 0.92 percent in 1992 to 26.1 percent in 2006. The report concludes that South Korea has been losing competitiveness against Chinese goods since 2004. To add insult to injury, South Korea is even being invaded by a type of cicada indigenous to southern China, the *Lycorma Delictula White cicada*, which feeds on tree sap and has no natural enemies on the Korean Peninsula.

A recent KOTRA survey of South Korean firms operating in China showed that half believe they have lost their comparative advantage in technology. These firms are also facing challenges from the Chinese government’s application of much stricter criteria for overseas investment in China. The new criteria encourages projects involving transfer of high technology and promoting effective management of environmental issues while restricting investments focused on processing or that attempt to take advantage of low labor costs. According to one Korean businessman, “Competition is getting fiercer in

China. China, once recognized as ‘a land of opportunity,’ has been transformed into a battlefield for survival.”

There were also new trends. First, individual Korean investors have begun to take an interest in the Chinese equities market. This quarter Korean investments in Chinese equities have doubled while investment in other markets dropped. The U.S. sub-prime mortgage crisis has further encouraged this trend. In addition, two Chinese companies – an artificial fingernail manufacturer and a plywood producer – have shown interest in building factories in the Gaesong Industrial Zone. The South Korean company Nodestystem has found a niche in China’s software sector by working with Chinese partners to develop GPS navigation and smart payment systems for Chinese consumers. Japan, South Korea, and China continue to cooperate on environmental issues related to yellow dust, with the establishment of a steering committee for joint research on dust and sandstorms resulting from consultations at the director general-level held in Tokyo.

### **China-North Korea relations and the nuclear issue**

PRC Foreign Minister Yang Jiechi visited Pyongyang at the beginning of the quarter. He was the first high-level Chinese visitor to meet Kim Jong-il since PRC State Councilor Tang Jiaxuan visited Pyongyang as a special envoy in October of 2006 shortly after North Korea’s nuclear test. Yang reaffirmed Sino-North Korean economic cooperation, but the main focus of the visit was to convey China’s hope that all parties would “fulfill their commitments and take initial actions in a comprehensive and balanced manner.”

China has continued to play a key role as host for the Six-Party Talks despite anxieties related to the growth of U.S.-DPRK bilateral talks as a venue for discussion of the core issues on the six-party agenda. China’s hosting and drafting role provides an opportunity for Chinese input and leadership, but this role is constrained to the extent that the U.S. and DPRK remain the key parties and China has little leverage to decisively influence either one, especially following North Korea’s active defiance of – despite Pyongyang’s reliance on – Beijing. The PRC hosted a Working Group on denuclearization in Shenyang and, for the first time, has been called upon to provide 50,000 tons of heavy fuel oil to North Korea under the six-party framework, just prior to the latest round of talks at the end of September. The joint statement, released in Beijing Oct. 2, addressed implementation of “second phase” commitments under the Feb. 13 implementing agreement. Specifically, North Korea pledged to disable three nuclear facilities and make a declaration regarding its nuclear program by the end of the year, while the U.S. pledged to take steps to improve diplomatic relations and promote expanded exchanges with North Korea. The parties also pledged to complete the delivery of 1 million tons of heavy fuel oil or energy equivalent.

A recent study by Li Kaisheng of Xiangtan University used quantitative methods to analyze the policy effectiveness of Chinese interactions in the Sino-North Korean relationship. He concluded that China’s efforts to intensify regular high-level visits with Pyongyang had positive results in easing nuclear tensions and that without Chinese pressure, the situation was likely to move in a negative direction. The study shows that

China does not have the capacity to fundamentally resolve the North Korean nuclear crisis and U.S. policies toward North Korea are the primary limiting factor affecting China's influence. China is playing the role of coordinator and rescuer, but the final solution of the issue will be mainly determined by the U.S. and the DPRK. On this basis, Li concludes that U.S. attempts to push China toward using greater pressure on North Korea are counterproductive to China's interests and should be resisted.

During a speech in New York in September, former ROK President Kim Dae-jung made an appeal to the international community to promote investment and to allow international financial institutions to assist North Korea based on the rationale that there is a need to balance Chinese economic dominance in North Korea. Kim and others have noted that up to 80 percent of the goods in North Korean markets originate in China and that China supplies over 90 percent of North Korea's energy and most of its food supplies. No doubt, one motivation behind the push for an inter-Korean summit was South Korean fear that China has consolidated its economic influence in the North in ways that could either prevent Korean unification or suck all the economic value out of the North during Pyongyang's period of economic dependency and hardship.

### **Sino-South Korea military issues**

China and South Korea have marked slow and gradual improvements in military-to-military relations in recent years, but this quarter highlighted new challenges. An agreement last quarter to establish military hotlines between South Korea and China has foundered over which operational facilities should be linked, apparently due to concerns about the response of the North Korean military. The PRC has proposed that a naval hotline link be handled via the ROK Navy's 2<sup>nd</sup> fleet at Pyongtaek rather than the naval operations command at Jinhae.

China has recently protested South Korea's occupation of a small geographic feature known as Ieo-do in Korean and Suyan Jiao in Chinese. The feature, located 149 km southwest of South Korea's southernmost Mara Island and 245 km from China's Tongdao Island, has been the site of a South Korean maritime observation facility and helicopter landing pad since 2001.

### **China consumer product safety reverberations**

Questions about consumer safety of goods produced in China have been a persistent concern in the South Korean media for years, but the international focus on quality of Chinese products has had additional reverberations in the Korean market. Korean consumers are paying extra attention to product origin. More distributors are noting customer preferences and attempting to provide "China-free" products, for instance by providing high-quality Korean teas rather than distributing Chinese imports. In July, the Korean International Trade Association (KITA) called for more active crackdowns on fake goods made in China. There have also been attempts by KOTRA to encourage Korean companies to take advantage of China's current consumer safety concerns by moving into key areas to secure market shares on the basis of better quality.

Issues regarding Chinese health safety were driven home in a much more personal way by the sudden death of South Korean Minister Whang Jounge-il, who became sick while eating a sandwich and sought treatment at a well-known private clinic in Beijing. Whang died suddenly following the administration of Ringer's solution, raising questions about whether the clinic provided proper treatment or committed a medical error. The subsequent investigation became a point of difference between South Korean and Chinese officials. The timing of this incident served to illustrate the difficulties associated with China's unwillingness to take active responsibility for problems in these areas.

The international furor over food safety has again put the spotlight on the Korea Food and Drug Administration (KFDA), as various types of food products continue to show up in the Korean marketplace that contain higher than allowable amounts of chemicals. The KFDA has been slow to regulate or to pass limits on what is allowable, a concern that has been fed by Chinese imports of confectionary or instant noodle products containing high amounts of aluminum. In September, the concern was that sauces from China and other countries were found to contain high levels of di-phthalate, or DEHP, stimulating product recalls by KFDA. The oriental medicine market is also unregulated and those medicines, the bulk of which are imported from China, have recently been found to contain higher than acceptable levels of chemicals. Ironically, even South Korea's discount retail stores based in China such as E-mart have been influenced by consumer safety and quality concerns: the most popular consumer product at such stores is Chinese Wuliangye liquor, which Chinese consumers prefer to buy at Korean outlets because they are viewed as more trustworthy retailers than their Chinese counterparts!

### **China's shipbuilding challenge**

This is by all accounts a good year for Korean shipbuilders, as prices have increased and orders remain backlogged by at least four years as a result of increased demand driven by growth in China's international trade. Korean shipbuilders gained a 43 percent share of new shipbuilding orders during the first half of the year worth \$33.2 billion. The growth has assured orders for most Korean shipbuilders through 2010. Korea has distinguished itself in high-margin double-hulled large container vessels, and several major Korean shipbuilders are actively pursuing expansion plans.

But China's capacity is growing and is expected to double by 2010. China will be able to compete in construction of liquefied natural gas carriers by 2012. Chinese shipyards have expanded output for lower value-added ships, increasing market share in the low-margin segment of the market. In recognition of anticipated tough competition from China, shipbuilders such as Samsung Heavy Industries are moving to compete in higher-value added sectors such as cruise vessel and ferry construction, currently the stronghold of Scandinavian producers. Korea's maverick shipbuilder STX has hit a roadblock in its aggressive expansion strategy through construction of new facilities in Dalian. The Chinese government is reluctant to see STX construct a dry dock, a move that will prevent STX from constructing larger or more profitable ships; i.e., over 100,000 tons. The company had secured permission from Dalian local authorities, but has been unable

to get permission from the central government, which has cited concerns regarding oversupply.

### **South Korean auto sales in China stall**

Hyundai Motor has faced a paradoxical situation this year in the China market: while its locally produced models have fallen into a tailspin, requiring lowered sales targets and deep discounts on production of local models, its share of the import vehicle market was 10 percent, second only to Toyota. Hyundai sales of locally produced vehicles have dropped to eighth place in terms of market share after having been as high as fourth in 2005. Locally produced models such as the Avante, Sonata, Accent, and Tucson are apparently less attractive to Chinese consumers than the higher-end import models like the Grandeur, Equus, Santa Fe, and Veracruz. Overall, South Korean exports of automobiles to China dropped slightly to \$600 million in 2006 from \$620 million in 2005 and exports of Korean-made auto parts to China have also stagnated. However, this is partly explained by the fact that South Korea auto and parts makers have rushed to invest in Chinese plants in recent years.

### **Following the inter-Korean summit and six-party process**

The latest Six-Party Talks statement released on Oct. 3 provides a clear roadmap for implementation of North Korean pledges to disable three existing nuclear facilities and make a declaration regarding all its nuclear programs by the end of the year. It is less clear what the timing will be for the U.S. to make tangible steps to improve its diplomatic relationship with the DPRK through promotion of exchanges or possible removal of North Korea from the U.S. list of state sponsors of terrorism. North Korea's chief negotiator has stated that the U.S. should remove North Korea from the State Sponsors of Terrorism List by the end of the year, but this appears to be based on bilateral U.S.-DPRK talks, not the Six-Party Talks. As the emphasis shifts to U.S.-DPRK bilateral coordination, one effect is to sideline China, even though the U.S. is doing exactly what China has called upon the Washington to do. Despite North Korea's economic dependency, China still struggles with its lack of political leverage over the North and fears that the U.S. and North Korea will achieve a reversal that damages China's strategic position vis-à-vis the Korean Peninsula. Combine this with former President Kim Dae-jung's public call for investment in North Korea as a way of balancing China's influence and a picture emerges that might fan Chinese strategic concerns about the future of the peninsula.

For this reason, it is instructive to examine Chinese reactions to the 2007 inter-Korean summit, which by its nature emphasizes autonomous inter-Korean peacebuilding efforts. Back in 2000, Chinese North Korea specialist Yu Meihua had predicted that the summit would increase pressure on U.S. forces to withdraw. Yu said at that time, "If the 'North Korean threat' no longer exists, the U.S. will find no convincing reason to keep its troops in the ROK or even in East Asia as a whole." An early Chinese response to the 2007 summit came from the Hong Kong-based *Wen Wei Po*, which again emphasized that with an improvement in inter-Korean relations, "U.S. troop withdrawal from the ROK has

become inevitable.” Yet both North and South Koreans have made statements that publicly challenge Chinese expectations regarding the peninsula, and the inter-Korean summit declaration talks about peace talks through either a three- or four-party format, raising questions about which of the four parties most directly involved in this issue could be excluded from peace talks. This comes despite Chinese verbal expressions of support for reduction of tensions on the Korean Peninsula, criticisms of U.S. policy, and emphasis on China’s contributions, “displaying the demeanor of a responsible power.” Now that concrete steps are outlined in the joint statement, China’s leaders should have additional opportunities to reassure the two Koreas while further demonstrating that sense of responsibility.

## **Chronology of China-Korea Relations July-September 2007**

**July 2-4, 2007:** Chinese Foreign Minister Yang Jiechi visits Pyongyang and meets National Defense Chairman Kim Jong-il.

**July 5, 2007:** South Korean wireless network producer Nodestory announces a deal with China’s Zondy Cyber Group on the use of China’s digital map, which can be used to produce GPS car-navigation systems for the Chinese market.

**July 10, 2007:** Following a second feasibility study in preparation for negotiation of a China-South Korea free trade agreement (FTA), focusing primarily on the impact of an FTA on the South Korean agricultural market, ROK Minister of Trade Kim Hyun-chong predicts that South Korea’s next administration will begin FTA negotiations with China.

**July 11, 2007:** The Korea International Trade Association requests that the ROK government crack down on the sale of Chinese counterfeit goods in Korea.

**July 18-20, 2007:** Six-Party Talks resume in Beijing to discuss further steps in the implementation of the Feb. 13 agreement.

**July 24, 2007:** POSCO announces the completion of a cold-rolling steel mill in Liaoning province with Benxi Iron & Steel Company.

**July 26, 2007:** Samsung Economic Research Institute President Jung Ku-hyun says that South Korea is not being “sandwiched” between Japan and China, arguing instead that Southeast Asia has been hurt by diversion of global investment to China.

**July 29, 2007:** ROK Minister Whang Jung-il, the number two official at the South Korea embassy in China, dies suddenly after eating a sandwich and receiving incorrect medical treatment at a clinic in Beijing.

**Aug. 4, 2007:** China's State Oceanic Administration affirms its claim to Ieo Island, known in China as Suyan Rock, a feature on which South Korean authorities have erected a maritime observation facility and a helicopter landing site.

**Aug. 4, 2007:** Nodestystem, a Korean wireless network equipment manufacturer, wins a contract to provide 80,000 smart payment terminals to CnOffice.Net, China's top portal site for mixed-used office and residential buildings.

**Aug. 16, 2007:** Two Chinese companies apply to build factories at the Gaeseong Industrial Park, the first foreign companies to express interest in the project.

**Aug. 16, 2007:** The Korea Institute of Science and Technology announces that many oriental medicines including those from China exceed government-set standards on the density of lead, mercury, cadmium, and arsenic.

**Aug. 16-17, 2007:** Six-Party Talks Working Group on Denuclearization meets in Shenyang.

**Aug. 24, 2007:** Fifteenth anniversary of the normalization of relations between the ROK and the PRC.

**Sept. 3, 2007:** Hyundai Motors announces deep discounts on automobile prices in response to sluggish sales in China.

**Sept. 3, 2007:** The Korea Food & Drug Administration announces that a health-threatening chemical known as di-phthalate, or DEHP, has been found in food products from China.

**Sept. 6, 2007:** Hynix sells its 200 mm DRAM (8-inch) chip wafer line at its Wuxi plant to Chinese Resources Holdings (CRH) for about \$400 million.

**Sept. 7, 2007:** LG Chem Ltd., announces completion of a primary products plant for production of polyvinyl chloride (PVC) based in Tianjin.

**Sept. 8, 2007:** Presidents Roh Moo-hyun and Hu Jintao meet on the sidelines of the APEC meeting in Sydney.

**Sept. 13, 2007:** Allegations surface that South Korean high school students in Pyeongtaek, South Korea bought sex on a school-supervised trip to Shandong, China, sparking a government investigation.

**Sept. 17, 2007:** Date for Six-Party Talks is delayed from third week of September, apparently in connection with NK not yet receiving anticipated PRC supplied oil.

**Sept. 18, 2007:** China begins shipment of 50,000 tons of heavy fuel oil to North Korea as part of its commitment to the Six-Party Talks Feb. 13 Implementing Agreement.



**Sept. 19-20, 2007:** A meeting in Tokyo among director generals from the ministries of environment of China, Korea, and Japan calls for the establishment of a steering committee for joint research on dust and sandstorms.

**Sept. 20, 2007:** ROK opens new consulate general in Xian, responsible for consular affairs in Shaanxi and Gansu Provinces and the Ninxui Hui Autonomous Region.

**Sept. 25, 2007:** Former South Korean President Kim Dae-jung encourages the U.S. and international financial institutions to provide investment and economic help to North Korea to balance Chinese influence on the Korean Peninsula.

**Sept. 27-30, 2007:** Six-Party Talks reconvene in Beijing to discuss second-phase commitments under the Feb. 13 Implementing Agreement.