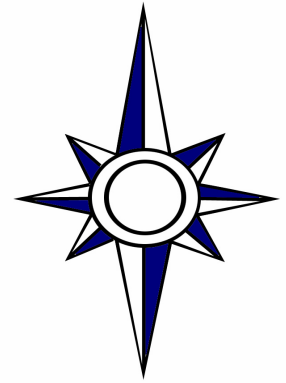


Comparative Connections

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China-Korea Relations: A Quarter of False Starts

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A series of false starts characterized Chinese efforts to reinvigorate diplomacy to address North Korea's nuclear weapons program this quarter. Chinese negotiator Wu Dawei failed in his efforts to jump-start six-party contacts through a nonofficial meeting in Tokyo between U.S. Assistant Secretary of State Chris Hill and DPRK Vice Minister Kim Gye-gwan. Then attention shifted to whether the Bush-Hu summit might catalyze a resumption of Six-Party Talks, but the summit produced no apparent agreement between the two leaders and probably gave North Korea no reason to come back to the negotiations. Chinese State Councilor Tang Jiaxuan's meetings with Kim Jong-il following that visit likewise yielded no diplomatic progress, while the quarter ended with another widely anticipated, but (as of the end of this quarter) nonevent: North Korea's widely anticipated and widely publicized launching of *Taepodong 2*, a multi-stage rocket. [Editor's Note: The multiple launches of missiles July 4-5 will be taken up in next quarter's analysis.] The lack of progress took its toll on South Korea-China relations due to mounting frustrations in Seoul until Foreign Minister Ban Ki-moon visited Beijing for consultations on a coordinated approach toward North Korea at the end of June. China's defense minister did manage a successful visit with counterparts in both North and South Korea in April.

China-South Korea economic relations centered on a shift in the bilateral trade balance as Chinese imports to South Korea have begun to outpace growth in South Korean exports to China. South Korean foreign direct investment in China has continued to grow, while facilities investment in South Korea has remained low, leading to worries in South Korea over its own long-term competitiveness vis-à-vis China. SK Telecom's attempts to gain a significant stake in China Unicom are emblematic of South Korean investment opportunities in China, while South Korean telecommunications companies face slowing exports as China's market matures. POSCO completed a major new investment in a steel mill in Zhang Jia Gang, China, while Hyundai's striking success in China was overshadowed by CEO Chung Mong-koo's legal problems over questions of political influence buying and illegal wealth transfers to his son. Finally, despite efforts in recent years to curb "yellow dust" from China by planting trees in the Gobi Desert, this spring was one of the worst, with the dust containing considerably higher levels of toxic materials than in the past.

Six-party stalemate prolonged

An unfortunate series of missed opportunities to get six-party diplomacy back on track accompanied an unofficial dialogue hosted in Tokyo in early April. The track-two Northeast Asia Cooperation Dialogue (NEACD) attempted to bring all the parties together for private contacts among officials that might help end the standoff. During the meetings, Chinese diplomats tried to unlock the stalemate that had resulted from North Korea's objections to U.S. financial "sanctions," or to be more precise, a U.S. Treasury warning that resulted in the freezing of North Korean accounts at the Macao-based Banco Delta Asia during the last quarter of 2005. Chinese officials had hoped that a U.S. briefing in March in New York for North Korean officials on the Treasury sanctions would result in progress and bring all parties back to the table, but the Treasury delegation was not empowered to negotiate, but could only offer a briefing on the financial measures taken in response to counterfeiting and money laundering concerns involving North Korea.

The principal negotiators as well as nongovernmental experts turned up for the NEACD, fueling speculation that the private meeting might serve as a catalyst for official negotiations. Even the DPRK's chief negotiator Kim Gye-gwan announced on the eve of the meeting that it would be a good opportunity for the parties to meet. Both South Korean and Chinese officials urged U.S. chief negotiator Chris Hill to meet with Kim privately. But Hill had been instructed not to meet with Kim on the pretext that a bilateral meeting would be useless while North Korea continued to boycott the Six-Party Talks. Hill stated following his meeting with the ROK's chief negotiator Ambassador Chun Young-woo that "We can talk about a lot of things at the Six-Party Talks, but what we can't do is talk about things with someone who is boycotting the Six-Party Talks." One Chinese conclusion from the failure to bring about a meeting between Hill and Kim appears to be that until the U.S. is ready to make North Korea a priority, there is little reason for China to expend capital in pursuit of six-party diplomacy.

For South Korea, the lack of progress in the Six-Party Talks was particularly frustrating since the stalemate revealed the limits of South Korean influence and coincided with difficulties in inter-Korean relations. One result was increasing frustrations with China's perceived unwillingness to take action to get North Korea back to the negotiating table. These frustrations were even higher in light of China's increasing leverage over North Korea derived from an exchange of high-level visits between Hu Jintao and Kim Jong-il (covered in the last issue of *Comparative Connections*). Aware of China's expanding investments in North Korea's critical natural resource sectors where South Korean opportunities remain blocked, ROK government officials and public increasingly saw China as taking advantage of its economic relations with North Korea to block Korean reunification. For instance, South Korean TV and newspapers reported that China planned to "take control of" North Korea by pursuing "reciprocal investment" in a "give and take" mode and that Chinese negotiations to invest in North Korean copper, coal, gold, and zinc mines were underway, heightening South Korean concerns that China stood to block Korean unification and exploit North Korean resources for its own use.

South Korea's frustrations were not only reserved for China, but also with hardline U.S. policies that were increasingly focused on human rights, illustrating a triangular interaction among China, South Korea, and the United States that has become increasingly important in managing North Korea-related issues. Seoul expected that Hu Jintao's summit meeting with President Bush in Washington would yield a basis for jump-starting the Six-Party Talks, but that meeting did not go well, and it became clear that Washington's priority was on dealing with Iran's nuclear program and (by meeting with North Korean refugees and the family of a Japanese abductee in the Oval office) raising the rhetorical profile of the North Korean human rights issue in ways likely to dampen Chinese cooperation over North Korea's nuclear program. Rising tension and protracted stalemate robbed South Korea of the scope to pursue independent actions, especially in the absence of North Korean cooperation to expand inter-Korean relations. South Korean policymakers felt increasingly frustrated and marginalized by all parties in this situation.

Absent U.S. coordination with China, the likelihood that Chinese leaders would independently deliver North Korea back to the negotiating table was low, but South Korean dependence on the U.S. to take action with China (possibly bypassing Seoul) to break the deadlock was also grating for South Korea. The Chinese did conduct consultations with North Korea's leadership following the Bush-Hu summit, dispatching State Councilor Tang Jiaxuan in late April to Pyongyang for a debrief on Hu's consultations in Washington. However, the message that Tang brought was insufficient to convince Kim Jong-il to return to the talks. Regardless of whether Kim Jong-il feels comfortable with North Korea's dependence on China (and a North Korean announcement requiring reciprocal visa requirements for Chinese and North Korean visitors to each other's country suggests that he is not), he understands how to maneuver. Kim recognizes that neither the U.S. nor China is prepared to take actions that would require North Korea to return to the negotiating table at this stage.

The biggest false start of the quarter may have been North Korea's preparations for a test of a multi-stage rocket scheduled for mid-June, which catalyzed international diplomatic efforts to forestall a North Korean launch. These efforts might be compared with diplomatic actions in the aftermath of North Korea's Feb. 10, 2005 announcement that it possessed nuclear weapons and the diplomatic response in June 2005 to an intelligence leak that North Korea might be preparing for a nuclear weapons test (a leak that proved to be either premature or decisive in preventing the test). North Korea's use of crisis escalation tactics is well-known, and U.S. diplomacy within the six-party framework has to a certain extent proven to be a useful countermeasure in blunting the effectiveness of those tactics. But if the current stalemate is broken by renewed diplomatic efforts, it will also be arguable that muted versions of North Korean tactics have served their purpose by catalyzing diplomacy.

Likewise, North Korean preparations for a multi-stage missile launch in late May and early June effectively catalyzed an international diplomatic response designed to send North Korea a clear warning regarding the consequences of such a test. U.S. and Japanese intelligence observed preparations for a launch and responded by placing

military assets on alert to observe (and possibly shoot down) any North Korean test. By late June, the preparations, along with U.S. diplomatic warnings to North Korea not to launch delivered through several channels, had motivated diplomacy by both South Korea and China in response to U.S. and Japanese concerns and possible counter-responses about the ramifications of a North Korean missile test.

South Korea weighed in diplomatically with the North and President Bush called President Hu to discuss North Korea's missile test preparations in mid-June. In contrast to routine consultations with the North following the Bush-Hu summit, China's diplomacy related to a North Korean missile launch ramped up – driven perhaps by fear that a test would be a catalyst for more U.S.-Japan joint efforts on missile defense, a result that would conflict with China's national interests. As a public manifestation of Chinese diplomatic efforts, PRC Premier Wen Jiabao opposed a North Korean missile test, saying on June 28 that “China is paying close attention to news that North Korea is possibly planning a missile-launch . . . I hope all parties will continue their efforts to maintain the stability of the Korean Peninsula.” On the same day, South Korean Foreign Minister Ban Ki-moon visited Beijing for consultations on the North Korean missile launch (in addition, no doubt, to seek critical Chinese support for his bid to lead the United Nations as secretary general). The result, despite South Korea's strategic anxieties about China's growing influence on North Korea, was to stimulate a joint Chinese-South Korean proposal to North Korea and the U.S. to resume diplomatic contacts, including bilateral U.S.-DPRK talks to address the missile issue following the resumption of the Six-Party Talks.

China's military diplomacy and the two Koreas

Another development of note was a visit by PRC Defense Minister Cao Guangchan to both North and South Korea during April 2006. Cao's visit to Pyongyang marks the first visit by a Chinese defense minister to North Korea since 2000. Rather than visiting North and South Korea together, however, the two Koreas served as bookends for a trip that also took Cao to Vietnam, Singapore, and Malaysia. Although there is limited public information available about Cao's visit to Pyongyang, there have been rumors that the PRC has agreed to provide spare parts for tanks, armored personnel carriers, and other military equipment following PRC President Hu's visit to Pyongyang last fall. Despite longstanding military-to-military relations, however, many of China's security concerns related to North Korea may now be too sensitive to discuss in Pyongyang, such as China's reinforcement of troops near the border with North Korea and Chinese military concerns and plans for military intervention to maintain “environmental controls,” i.e., to forestall a nuclear accident or bring under control “loose nukes” in North Korea.

The agenda for China-ROK mil-to-mil cooperation is equally sensitive in light of the U.S.-ROK security alliance, but the agenda may have been more substantive than that with the North. During Cao's five-day visit, issues that were addressed include the establishment of a hotline between naval and air force counterparts in order to manage possible incidents in the Yellow Sea and a proposal to hold joint search and rescue exercises. Another matter of concern is joint coordination in response to Chinese fishing

boats that encroach on South Korea's exclusive economic zone or other sea areas yet to be clearly demarcated. In addition, South Korean officials were eager to hear Cao's insights based on his visit to the DPRK. According to some analysts, there is interest in China in developing a dialogue with Seoul as a way of promoting greater South Korean independence from U.S. military strategy. Chinese specialists inquire about the purpose of U.S. realignment on the Korean Peninsula and the implications of Pyongyang as the main base for U.S. forces in Korea.

South Korea's economic opportunity, and worries about dependence on China

The South Korean business sector continues to worry about losing its competitive edge to China. One indication of China's new strength is that reports no longer focus on how long it will take for China to catch up and cut in to South Korea's technological edge. Rather, a report from the Korea International Trade Association (KITA) shows that increased competitiveness of Chinese goods is cutting into South Korea's longstanding bilateral trade surplus with China. Trade statistics from 2005 show that China's imports expanded by over 30 percent in 2005, a rate higher than the growth of South Korea's exports to China. KITA noted that Chinese growth in the share of the Korean high-tech market has increased to over 17.3 percent. The KITA report concludes with a recommendation that South Korea consider negotiating an FTA with China to manage the increasing overlap in competition of industrial products between the two countries.

The appearance of globally competitive Chinese companies such as Haier, Legend, and Chery Automobile marks a new stage of competition for South Korean firms in third country markets, as well as poses stiff challenges to South Korean efforts to make inroads in China's domestic market. South Korean export growth in the first half of 2006 has dropped by over half compared with 2005 to a level of just over 10 percent, reflecting the maturation of high-growth markets in which South Korean products have done well and increasing competition from Chinese domestic production.

Among those Korean companies who have felt the impact of increased Chinese competitiveness are LG Electronics, which dominated the "white goods" sector, and Samsung Electronics: both are facing severe price competition and maturation of the Chinese mobile handset market. Samsung Electronics and LG are likely to record single-digit profit margins this year due to flagging global competitiveness in the telecommunications sector. Likewise, Hyundai Motor Company, quite aside from the troubles it is facing as a result of the incarceration of Chairman Chung Mong-koo shortly after an April trip to China to preside over the opening of Hyundai's second factory in China, is facing price competition from Chinese models that have cut into sales expectations. POSCO is about to open a new 380,000 ton capacity hot-rolled stainless steel mill in Zhang Jia Gang, China (its second plant following an investment in a plant that has a production capacity of 180,000 tons located in Qingdao) in order to compete with Chinese producers Baosteel Group and Tiayuan Iron and Steel Company to supply increasing Chinese demand. Presumably, such an investment provides POSCO with an opportunity to avoid being undercut on labor costs while retaining its management and production experience in China's domestic market and for international production.

In addition to South Korea's increasing trade dependence on China, reflected in the impact on the Korean equities market of recent Chinese interest rate increases last April, there are concerns that South Korea has directed too much of its outward investment to China. China remains South Korea's favorite destination for foreign direct investment, with approximately 60 percent of South Korean overseas investment headed there; by contrast 40 percent of Japan's overseas investment goes to China. Nonetheless, China remains a tempting prospect for Korean firms. SK Telecom is seeking a \$1 billion convertible bond investment in China Unicom, Ltd., in a competition with Sprint Nextel and Japan's KDDI. This is an attempt to build on an existing tie-up in the Chinese wireless/broadband sector, which is projected to continue to grow rapidly. Likewise, SK Petrochemical is looking for opportunities to capitalize on projected growth in the Chinese energy sector. SK is well-suited to enter the China market as one of the major oil refiners in Asia. China's demand for refined and synthesized oil-related products continues to grow. Another growth sector for South Korean firms lies with China's high demand for plasma display panel televisions in which LG Electronics and Samsung SDI are both major competitors.

An ill wind from China

Since 2002, the visitation of spring "yellow dust" from China to South Korea has been a regular occurrence, stimulating new forms of cooperation on transnational environmental issues at the nongovernmental level as well as institutionalizing a tripartite meeting of environmental ministers from China, Japan, and South Korea since 1999. Despite those efforts, the failure to forecast the arrival of more "yellow dust" in Korea last April has stimulated further concern in Seoul about how to accurately predict the occurrence of the dust and has led to additional studies of the toxic elements it contains. Reports this spring suggest that the dust has become more toxic than in 2002, containing 12 times the normal level of iron and nine times the normal level of manganese in the air during a normal spring day. Lead and cadmium in the 2006 dust storm were twice the levels recorded in previous years. The Korea Environment Institute concluded in a 2004 study that damage from the 2002 "yellow dust" amounted to roughly 5.5 trillion won related to poor visibility, respiratory problems, and defective products. The National Institute of Environmental Research released a study showing that 37 percent of the sulfur dioxides that trigger acid rain in South Korea originate in China. These are direct environmental effects that will leave South Korean residents in an increasingly bad mood if they are not addressed effectively by "upwind" neighbors.

Conclusion

The second quarter has ended with strong hints that further Six-Party Talks may be around the corner and that China and South Korea are overcoming Seoul's strategic anxieties about China's leverage on the North in an attempt to encourage China to use that leverage to relieve tensions on the Korean Peninsula. However, the North Korean missile test could mark a paradigm shift in the region's approach toward North Korea, forcing a harsher, more decisive, and more unified approach.

Triangular interaction among the U.S., China, and South Korea related to policy toward North Korea has been increasingly on display. The United States employs coercive diplomacy, stimulating Chinese efforts at cooptation to bring the North under control while ensuring political stability in Pyongyang, and negating American coercive efforts. Meanwhile, South Korea has suffered strategic anxieties and political frustration over its marginalization as it observes China's economic and political influence on the Korean Peninsula while being stiff-armed by the North in inter-Korean relations. The other development of interest to Washington is an internal shift in the policy debate in Beijing over whether the North Korea issue should be viewed in isolation or whether this issue should be considered as part of the management of U.S.-China relations, given that ultimately China has much greater stakes in regional and global stability as a prerequisite for China's growth than it does in extending an unconditional lifeline to Pyongyang.

North Korea's missile launch may change this dynamic. If the six-party process gets back on track and if the U.S. commits to serious diplomacy while China uses its leverage in ways that decisively constrain North Korea's options for crisis escalation, there could be progress in that might lead to the denuclearization of the Korean Peninsula. There is also the possibility that the North Korean missile launch or internal instability in the North could heighten competitive impulses and contradictory policy aims on the part of China, the United States, and South Korea. This could lead to heightened competition or conflict in the event of a change in the status quo on the Korean Peninsula, heightening the costs for all concerned parties.

Chronology of China-Korea Relations

April-June 2006

April 3, 2006: *Kyodo* report states that China and North Korea agree to set up a joint economic development zone near Nampo, an east coast port in North Korea.

April 5, 2006: Plans by the Korea Exchange to internationalize the Seoul stock exchange by inviting Chinese companies to list are stalled by roadblocks from Chinese regulators. Shenzhen-based PowerLeader Science and Technology Company, Ltd., was one of the first Chinese companies to apply for a listing on the Korean stock market, but its application remains blocked.

April 4, 2006: A report released by KDI states that China is expected to pose a full-fledged challenge to South Korea's semiconductor, electronic parts, and consumer electronics exports globally.

April 4-6, 2006: PRC Defense Minister Cao Guangchan arrives in Pyongyang for meetings with his counterparts.

April 8-11, 2006: South Korea hit by an unexpected series of "yellow dust" storms from China, leading to calls for more effective forecasting of the storms and heightening concerns about high levels of dangerous elements in the air during those storms.

April 11, 2006: Korea International Trade Association releases a report warning that imports from China are beginning to outpace Korea's exports to China, and calling for a Sino-Korean FTA and industrial dialogues to better manage economic relations.

April 12, 2006: Based on the popularity of Korean-made products in the Middle East, some Chinese counterfeiters have produced products with a "Made in Korea" label, according to a report by GNP Assemblyman Kwak Sung-mun.

April 15-19, 2006: PRC DM Cao arrives in Seoul for meetings with counterparts.

April 27-28, 2006: PRC State Councilor Tang Jiaxuan makes a secret trip to Pyongyang and briefs Chairman Kim Jong-il on the results of Hu Jintao's summit with George Bush.

April 28, 2006: China's unexpected move to lift interest rates by 0.27 percent to 5.85 percent hits markets in Seoul, raising concerns that higher interest rates may dampen prospects for Korean exporters.

May 3, 2006: ROK Ministry of Environment announces that record levels of harmful materials were contained in "yellow dust" from China during this spring season. The dust contained iron levels 12 times higher than that during a normal day in Seoul.

May 8, 2006: PRC Vice Minister of Commerce Ma Xiuhong leads a government economic and trade delegation to Pyongyang for the second meeting of the DPRK-China Economic, Trade, and Scientific and Technological Cooperation Committee.

May 10-14, 2006: Director of the IT bureau of Hainan Province Ma Er Qiang and a delegation from China arrive in Seoul for training in e-governance systems.

May 13, 2006: A delegation of the China Development Bank headed by Gov. Chen Yuan visits Pyongyang and meets with Vice Premier Ro Du-chol.

May 15-18, 2006: China Council for Promotion of International Trade Chairman Wan Jifei leads a Chinese delegation to a four-day international trade fair in Pyongyang.

May 16, 2006: Ministry of the People's Armed Forces gives a reception in honor of a Chinese delegation led by former Deputy Department Director of the Chinese Academy of Military Science Shao Hua, on the occasion of their visit to the gravesite of Mao Anying, son of Mao Zedong, who died in North Korea during the Korean War.

May 19, 2006: Ministry of Justice announces the issuance of a new employment visa, the H-2 visa, from July, enabling ethnic Koreans from China and Russia to freely enter, depart, and work in Korea for up to five years.

May 22, 2006: SK Corporation, South Korea's top refiner, is exploring investments in the Chinese coalmining sector, according to SK's senior vice president for the China division, Kim Sang-kook.

May 27, 2006: ROK Commerce and Industry Minister Chung Sye-kyun meets counterpart Bo Xilai in Seoul to discuss trade issues. Bo calls for progress in bilateral free trade agreement talks and called on Seoul to better manage labor-management disputes, while Chung mentioned difficulties that South Korean businessmen have in managing differences between local and central government policies in China.

May 30-June 6, 2006: DPRK Foreign Minister Paek Nam-sun visits China for consultations with PRC Foreign Minister Li Zhaoxing.

June 14, 2006: The Export-Import Bank of Korea releases report stating that South Korean exporters would be at risk if the PRC further raises interest rates and tightens control on bank loans to cool its overheating economy.

June 21, 2006: SK Telecom Company announces that it will invest \$1 billion to buy convertible bonds in China Unicom Ltd., a strategic investment designed to tap a growing market in China for wireless services and products.

June 27-28, 2006: ROK Foreign Minister Ban Ki-moon visits Beijing to meet counterpart Foreign Minister Li Zhaoxing. They agree on a “concrete and persuasive proposal” to North Korea to return to the Six-Party Talks as a precursor to bilateral talks over North Korea’s missile program with the United States.

June 28, 2006: PRC Premier Wen Jiabao states that “China is paying close attention to news that North Korea is possibly planning a missile-launch . . . I hope all parties will continue their efforts to maintain the stability of the Korean Peninsula.”