



China-Korea Relations:
Strategic Maneuvers for the “Sandwich Economy”

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China’s shadow over the Korean Peninsula is growing larger, stimulating strategic efforts in Seoul and Pyongyang to draw in the U.S. As soon as KORUS FTA negotiations were concluded, the South Korean media played up the FTA as having both strategic and economic significance as a counter to the centripetal pull of China’s economic rise. Likewise, despite a quarter of delay, North Korea’s eagerness to accept a surprise visit by Assistant Secretary of State Christopher Hill in an effort to confirm North Korea’s intention to shut down the Yongbyon reactor has stimulated concern among some Chinese analysts that a rapid U.S.-DPRK rapprochement would cut China out of the picture. Meanwhile, the Sino-DPRK trade and aid relationship continues to grow, creating another source of anxiety for South Koreans worried that China is taking advantage of special concessions in economic relations with the North.

During Chinese Premier Wen Jiabao’s meetings in Seoul on April 9-10, he pressed for an early opening of FTA negotiations with Seoul, celebrated the 15th anniversary of China-ROK diplomatic normalization, and cultivated deepening economic ties. In seeming parallel with the improved mood in U.S.-DPRK relations, China and South Korea agreed to open a military hotline and exchanged top-level visits between defense ministers and army chiefs of staff. While the Sino-South Korean economic relationship continues to grow steadily, China is gradually cutting the technology gap, either because South Korean employees are willing to sell proprietary technologies for personal gain or because of China’s continuing wage advantages and increasingly modern plant.

Strategic implications of the KORUS FTA

The trade negotiators barely made their April 2 deadline for completing negotiations and notifying the U.S. Congress that the agreement would be considered under the expiring Trade Promotion Authority legislation, which prevents Congress from raising individual exceptions to international trade agreements negotiated by the executive branch. As soon as the negotiations were completed, the Korean media and opinion leaders highlighted the strategic significance of the KORUS FTA as an economic hedge against China’s growing dominance and as a vehicle for bolstering the U.S.-ROK security alliance. Chinese Premier Wen Jiabao wasted no time in asking to be next in line for an FTA negotiation with South Korea in an interview with Korean journalists on April 5, a few days prior to his April 9-10 visit to South Korea.

The Korean trumpeting of the FTA as a hedge against China's economic dominance was one of the motivations of the Roh Moo-hyun administration that was less publicized when the decision was made in early 2006 to move forward with a KORUS FTA; nonetheless, the decision coincides with high-level recognition in Seoul that China's economic rise constituted a source of anxiety and potential threat to South Korea in several key industries. It also marked the completion of a dramatic shift in South Korean views of FTAs. Only a few years ago they were seen as a primarily economic tool; now they are viewed as ways to achieve strategic objectives in South Korea's foreign policy. Having successfully negotiated the KORUS FTA, Korean officials seemed to be on a mad dash to complete FTAs with the European Union, Canada, China, and Japan. President Roh commented about the advisability of going forward with a China-Korea FTA in mid-May, but in so doing revealed the core of South Korean worries about the impact of a China-South Korea FTA on the ROK agricultural sector. Roh commented in an interview with *MBN* that "An FTA with China is inevitable. Some have asked why China was not first, but frankly, our agricultural situation would have needed major restructuring for such a deal. We need to strengthen the agricultural sector first with an FTA with the United States before heading for China." Negotiation of a KORUS FTA might also be seen as a means to give South Korea a leg up on Chinese and Japanese competition in the U.S. market and as a way of promoting diversification in Korean trade to forestall growing dependence on the Chinese market.

The speed of Premier Wen's call for the early initiation of Sino-South Korean FTA talks gave the impression to some in Seoul that the KORUS FTA challenged China's strategy of using FTAs to strengthen its position at the economic center of Asia. At a meeting of the Korea-China Friendship Association in Seoul, Wen again called for FTA negotiations to begin based on the results of a joint study between the two sides to be concluded early next year. The study apparently projects that South Korea's agriculture, fisheries, clothing, and leather sectors would be badly hit by a Sino-South Korean FTA, but it might provide significant benefits to the automobile, steel, and petrochemical sectors. The Korean International Institute of Economic Policy estimates that a Sino-South Korean FTA would add 2.3 percent per year to South Korea's economic growth. A KOTRA survey of Chinese business leaders revealed enthusiasm for a China-ROK FTA, with over three-fifths of those surveyed indicating that they might benefit directly from the conclusion of such an agreement. Chinese business leaders saw an FTA as likely to promote Chinese exports to South Korea.

Wen Jiabao's visit and other ministerial exchanges

Premier Wen made his first visit to Seoul and the first visit by a Chinese premier in over seven years. During his two-day visit in early April, Wen participated in events designed to mark the 15th anniversary of Sino-South Korean diplomatic normalization, celebrated the opening SK Telecom's Access Research Center designed to promote joint research with China on the development of third-generation mobile phone technology, and agreed in discussions with Roh Moo-hyun to open a military hotline between the two countries, in addition to calling for negotiations on a bilateral FTA and discussing the latest diplomatic efforts to deal with North Korea's nuclear program. Wen's stopover in Seoul

was essentially a warm-up for the main event, a historic “ice-thawing” meeting with Prime Minister Abe Shinzo in Japan. Wen’s public diplomacy accentuated a sharp change in the political mood between China and Japan, a rapprochement from which South Korea draws clear benefits. But the apparent success of Wen’s visit also indirectly highlighted Roh’s failure to mend ties with Japan.

China and South Korea rapidly followed up on the agreement by Wen and Roh to establish military hotlines with an exchange of top-level military visits. South Korean Minister of Defense Kim Jang-soo paid a courtesy call within weeks at the invitation of PRC Defense Minister Cao Gangchuan to Beijing in late April, and PLA Chief of the General Staff Liang Guanglie visited Seoul in late May for further consultations on the military hotline, marking a flurry of activity in the development of Sino-South Korean military-to-military ties. None of the activities marks a strategic change in relations; one explanation for the heightened activity is that it comes in anticipation of improvements in the U.S.-DPRK political relationship following the Feb. 13, 2007 six-party agreement.

An unfortunate maritime incident occurred in mid-May that served to underscore the need for more effective emergency communications between China and South Korea. The 4,800-ton Chinese freighter *Jinsheng* collided with South Korea’s 3,800-ton *Golden Rose*, a freighter loaded with 5,900 tons of steel at Dalian harbor. The two boats collided off Yantai Peninsula amid thick fog and the *Golden Rose* went missing, but the Chinese crew did not inform authorities until at least eight hours after the collision, and Chinese authorities did not officially inform South Korean counterparts of the accident for over 21 hours. Sixteen sailors on the *Golden Rose* including seven South Koreans were killed in the accident. The incident drew a protest from South Korean Foreign Minister Song Min-soon in an early June meeting with PRC Foreign Minister Yang Jiechi on the sidelines of a trilateral meeting of foreign ministers from Japan, China, and South Korea in Jeju Island. The trilateral foreign ministers’ meeting marked the first time that the three had met independent of a regular multilateral forum, and dealt with cooperation on trilateral economic, cultural, and environmental issues. At a trilateral meeting of finance ministers on the sidelines of an Asian Development Bank meeting in Kyoto in May, Korea, China, and Japan agreed to cooperate on regional currency stabilization measures and to support efforts to further develop the Asian bond market.

Developments in Sino-DPRK relations

The visit of PRC Foreign Minister Yang Jiechi to North Korea on July 2-4 marked the first high-level exchange between China and North Korea since the Feb. 13 agreement in Beijing. Although barely acknowledged by Chinese officials, an accumulation of strains in the bilateral relationship is more apparent than usual following Vice Minister Kim Gye-gwan’s unusually public attempt to distance the DPRK from China on the sidelines of bilateral talks with the U.S. in New York in March. The Chinese sat out the prolonged stalemate over the transfer of North Korean funds in Banco Delta Asia after Chinese banks determined that they would not take the risk of serving as an intermediary for the North Koreans to transfer money from accounts in Macao, choosing to help neither North Korea nor the U.S. (especially following the U.S. Treasury’s “unilateral” decision to

finalize its action against the Macao-based bank). Assistant Secretary of State Christopher Hill's surprise visit to North Korea in late June further illustrated a shift in the six-party dynamics as the U.S. showed more willingness to pursue direct contact with North Korea unmediated by Beijing. A side-effect of these developments is that the Chinese are less central to the unfolding diplomacy and briefed on a less timely basis by either the North Koreans or the Americans. Some Chinese specialists are unsettled by these developments and are anxious about the implications for China's strategic interests of an overly rapid U.S.-DPRK rapprochement.

Aside from reverberations from China's decision to back the UN Security Council resolution condemning North Korea's nuclear test, a number of additional factors have strained Sino-DPRK political relations. Long-time North Korea specialist Ambassador Li Bin has been relieved of his duties for allegedly leaking information about Kim Jong-il's visit in January of last year to foreign media sources. An apparent espionage/corruption scandal has also affected the standing of the international liaison department of the Chinese Communist Party, which plays the primary role in managing Sino-DPRK relations. Ongoing frustrations with North Korea in the wake of the nuclear test have weakened the standing of North Korea specialists within China's policy apparatus in favor of career professionals such as China's new Ambassador to the DPRK Liu Xiaoming, an America specialist with no prior experience in Korean affairs. Taken together, these developments suggest a loss of capacity and the possibility that North Koreans will continue to pursue low-level defiance of China while seeking to maintain and expand economic ties. The PRC Embassy in Pyongyang reports that Sino-DPRK trade increased by 11.8 percent in the first four months of the year. This increase is likely driven in part by Chinese investments in North Korea's natural resources sector.

South Korea “sandwiched” by China's economic rise

The question of whether South Korea's economic growth will be “sandwiched” by its geographic position between high-tech Japan and low-cost manufacturing powerhouse China was raised early this year by Samsung Chairman Lee Kun-hee. That theory has been reinforced this April by a Japanese researcher, Nomura Research Institute's Ono Hisashi, who concluded at a seminar sponsored by the Korea Chamber of Commerce and Industry that South Korea is increasingly “sandwiched” by China and Japan in the areas of technology, corporate earnings, market share, and the competitiveness of the high-tech industry. Hynix Semiconductor CEO Kim Jong-kap argued in June that the theory was an exaggeration, emphasizing that China's continued growth will bring greater opportunities.

These conflicting views are informed by a divergence in performance and competitiveness vis-à-vis China in traditional manufacturing sectors vs. the semiconductor, high-tech, and financial sectors. South Korean industry continues to feel pressure from China's rising competitiveness in electronics and household appliance as well as heavy industry sectors such as automobiles and shipbuilding where South Korea has traditionally enjoyed a competitive advantage. For instance, LG Phillips has announced that it will gradually move its LCD panel manufacturing lines to China due to

rising manufacturing costs and low margins. But the semiconductor sector has led South Korean exports to China since 2005 and continues to see strong China-driven growth, whereas exports of steel and household appliances have faced stiff competition from low-cost local products.

One factor that has unfairly aided China in its attempts to challenge in some sectors has been industrial espionage involving the sale of proprietary technology developed by South Korean firms to Chinese competitors. Other Chinese efforts to promote technology transfer to China have involved hard negotiations over permission to open new plants and cases in which Chinese subcontractors have provided services to Korean automotive firms and then tried to walk away with proprietary information. At last November's Beijing Motor Show, Hyundai Motors executives suspected that Chinese companies received technology and design information for some of its popular models such as Hyundai's Santa Fe and Kia Motors' Sorento. Those suspicions now appear to have been justified. In May, nine current and former employees of Kia Motors were charged with industrial espionage for sharing proprietary information with a Chinese company on nine separate occasions. According to the prosecution, a former employee set up a consulting company and received proprietary data from current employees, which was then sold to a Chinese firm. The Korean National Intelligence Service reports over 100 known cases of industrial espionage from South Korea since 2003 that cost Korea at least \$100 billion. The estimated damages from undetected industrial espionage could amount to an additional \$100 billion.

South Korea's shipbuilding sector leads the world in market share and dominates the market for LNG carriers, so one might think that Korean shipbuilders have little to worry about from China's capacity expansion in the near-term. But China's rapid expansion (from 17.3 percent of the market to 25.4 percent of the market by tonnage in 2006) must remind South Korean competitors (which represented 40.3 percent of the market by tonnage in 2006) of the days when they were the underdog. In addition, new Chinese capacity is slated to come on-line by 2012, and China aims to have enough capacity to become the world's number one shipbuilder by 2015. The sense of crisis was heightened due to China taking the lead in total monthly orders for two months earlier this year.

South Korean industry leaders convened this quarter to weigh longer-term strategies for capturing higher-end sectors, including the launch of a major research project sponsored by the ROK Ministry of Commerce, Energy and Industry to explore a greater share in the cruise ship market. Another trend is that leading South Korean shipbuilders are starting to invest overseas. For instance, Samsung Heavy Industry and Daewoo Shipbuilding have recently made investments in China. Some shipbuilders have expressed concern about South Korean shipbuilders such as STX, which has aggressively expanded its market presence and has invested in the construction of complete production facilities at a shipyard near Dalian. Other South Korean shipbuilders worry that such investment might increase the possibility of technology leakage to Chinese competitors already on the rise, based on lessons learned by South Korean firms in the automobile sector.

On the other hand, there are new opportunities for Korean firms as China's opening proceeds. For instance, Woori, Hana, and Shinhan Banks taking advantage of the opening of China's retail banking sector and Woori Financial Holdings, Inc., along with the Korean Asset Management Company (KAMCO), have bought Chinese non-performing debts. Korean power plant supplier Doosan Heavy Industries and Construction is entering the Chinese energy sector with a contract to supply core facilities for Chinese nuclear reactors in Shanmen and Haiyang. Doosan Infracore will build a second plant in China in response to continued demand for excavators, a sector Doosan has dominated with a 20 percent share of the total market.

Korea's security sandwich

South Korea celebrated the launch of its first *KDX-III* destroyer this quarter, a 7,650-ton *Aegis*-equipped ship, the *Sejong the Great*. The launch of the destroyer was touted in the Korean press as a major accomplishment that provided new capabilities amidst strategic uncertainty as South Korea's larger neighbors are also expanding their naval capacities. The South Korean Ministry of National Defense announced in May that it has decided to construct a naval base on Jeju Island by 2014. But it is uncertain how South Korea will utilize its newfound capacities. The tendency in Seoul is to hedge against Japan, but China's long-term naval expansion may also have implications for South Korean maritime interests. South Korea's territorial dispute with Japan over Dokdo/Takeshima is well-known, but there is also a lesser-known dispute with China in the East China Sea over the tiny Leodo, claimed by both South Korea and China. Plus, accidental disputes over fisheries with China may intensify as South Korean and Chinese fishing fleets compete for limited resources. South Korea and China may need not only a military hotline, but a much more developed protocol for handling incidents at sea. Longer-term, the removal of inter-Korean tensions over the Northern Limit Line (NLL) may also be replaced by heightened disputes between China and a reunified Korea over rights to fishing grounds in that disputed area. The security implications of Korea's sandwiched geographical situation may pose dilemmas as serious for the Sino-South Korean relationship as those posed by China's economic rise for Korea's "sandwich economy."

Looking to the future

August marks the 15th anniversary of the establishment of diplomatic relations between the South Korea and China. There is much to celebrate in the economic sphere, but there will be serious challenges. Competition between China and South Korea to influence the North's economic and political development, the challenges of restructuring a Sino-ROK economic relationship where South Korean companies compete with China's homegrown companies for domestic market share rather than for global market share, and South Korea's efforts to strike a right balance in its relations with China and the U.S. will likely be major themes for the near- to mid-term.

For the China-DPRK relationship, the primary challenges lie in the adjustment from the traditional special relationship to what Chinese analysts refer to as a "normal" relationship, a process that was accelerated by North Korea's nuclear test. In this respect,

the symbolism of the foreign minister rather than a senior party figure taking the lead in communicating directly with North Korea's Chairman Kim Jong-il offers a clue to Chinese thinking about the future. Meanwhile, Chinese concerns about economic instability in North Korea appear to have lessened, although there is a recognition that serious challenges remain for North Korea if a true economic recovery is to take hold. China's priority is on maintaining momentum in implementing the six-party agreements in order to provide North Korea with a stable economic environment, which Chinese analysts argue is a prerequisite for successful economic reform.

Chronology of China-Korea Relations April-June 2007

April 1, 2007: U.S. and South Korea conclude free trade agreement (FTA) negotiations.

April 1, 2007: The Korea Meteorological Administration issues a nationwide warning against yellow dust from China for the first time since monitoring dust particles in 2002.

April 5, 2007: Korea, Japan, and China announce that their ministries of health will jointly form a \$1 million fund to fight avian influenza.

April 5, 2007: PRC Premier Wen Jiabao urges more rapid preparations for a PRC-ROK FTA in a joint interview with South Korean journalists.

April 9-10, 2007: Premier Wen visits Seoul for a summit with ROK President Roh Moo-hyun to discuss bilateral and regional economic and political issues including the North Korean nuclear problem and a prospective ROK-PRC FTA.

April 10, 2007: Wen participates in the opening of SK Telecom's new test bed center to promote commercialization of Chinese third-generation mobile technology, TD-SCDMA.

April 11, 2007: Korea and China sign an agreement between environmental ministries to cooperate in protecting 337 species of migratory birds in the two nations.

April 16, 2007: Five Korean shipbuilders and the Ministry of Commerce, Energy, and Industry discuss a five-year plan to strengthen high-end production in response to the aggressive expansion of Chinese shipbuilders into the low-end market.

April 18, 2007: Chae Tae-bok, secretary of the Central Committee of the Korean Workers' Party, meets a visiting delegation of the International Liaison Department of the Central Committee of the Chinese Communist Party led by deputy head Liu Hongcai.

April 20, 2007: Ono Hisashi, head of the Nomura Research Institute (NRI) Seoul office, makes a presentation at a Seoul seminar "Diagnosis of 'Sandwiched' Korean Economy and the Relevant Solutions," sponsored by the Korea Chamber of Commerce and Industry, that South Korea is increasingly "sandwiched" by Japan and China.

April 23, 2007: Doosan Infracore, the leading supplier of excavating equipment in China, announces that it will build a second 320,000 sq m production facility in Suzhou in addition to its current plant 500,000 square meter plant in Yantai.

April 24, 2007: Doosan Heavy Industries announces that it will supply core facilities for Chinese nuclear reactors to be built in Shanmen and Haiyang.

April 23-26, 2007: ROK Defense Minister Kim Jang-soo meets Chinese counterpart Cao Gangchuan during a four-day visit to Beijing and agrees to establish military hotlines.

May 10, 2007: ROK prosecutors charge nine former and current employees of Kia Motors with collusion to leak confidential data on Kia's manufacturing process to a Chinese company.

May 12, 2007: A South Korean freighter, the *Golden Rose*, sinks after colliding with the Chinese freighter *Jinshen* in waters off Yantai on China's east coast, killing 16 sailors (seven of whom were Koreans) and sparking a controversy given that Chinese authorities notified the Korean embassy of the accident nearly 21 hours after it occurred.

May 21, 2007: ROK President Roh Moo-hyun states in an *MBN* interview that China should seek an FTA with China following the establishment of a KORUS FTA.

May 23-25, 2007: PRC People's Liberation Army chief of the General Staff Liang Guanglie meets counterpart JCS Chairman General Kim Kwan-jin in Seoul. The two sides agree to set up military hotlines on the 15th anniversary of the normalization of PRC-ROK relations in August.

June 3, 2007: The South Korean, Chinese, and Japanese foreign ministers inaugurate a regular dialogue, engaging in discussions on North Korea, a three-way free trade agreement, and additional cultural exchanges. In a separate bilateral conversation, Song Min-soon requests Yang Jiechi to conduct a thorough investigation into a May 12 freighter accident in the East China Sea.

June 5, 2007: Central Committee of the Korean Workers' Party (KWP) hosts reception in honor of a Chinese Communist Party (CCP) delegation led by Lu Hao, member of the Central Committee of the CCP and secretary of the Gansu Provincial Committee of the CCP. A KWP delegation led by Secretary of the Pyongyang City Committee of the KWP Kim Jin-ha visits the PRC and meets CCP International Department head Wang Jiarui.

June 11, 2007: Newly-appointed DPRK Premier Kim Yong-il meets PRC Ambassador to the DPRK Liu Xiaoming in Pyongyang.

June 11, 2007: *The Korea Times* reports that Hynix Semiconductor CEO Kim Jong-kap sees China as opportunity for growth and argues that the "sandwich" theory is an exaggeration.

June 12, 2007: Woori Bank announces that it has become the first South Korean bank to receive approval from the Chinese government to set up a local retail banking unit.

June 13-16, 2007: The first Korea-China-Japan Industrial fair is held in Seoul to foster industrial and commercial exchange.

June 21-22, 2007: Assistant Secretary Hill visits Pyongyang and meets DPRK Foreign Minister Pak Ui-chan and nuclear talks counterpart Kim Gye-gwan.

June 26, 2007: Woori Finance and Investment Company announces that it has bought Chinese non-performing loans with a face value of \$88 million, the largest Korean investment in Chinese non-performing debt.

July 2-4, 2007: PRC Foreign Minister Yang Jiechi visits North Korea; the first high-level visit since the Feb. 13 six-party agreement.