

## Implications of the KORUS FTA for Upcoming Sino-Korean FTA Negotiations

*Liu Qun*

The Asan Institute for Policy Studies

On March 15, 2012, the Korea-U.S. Free Trade Agreement (KORUS FTA) entered into force. Following the Korea-EU FTA, which has been provisionally in force since July 1, 2011, the KORUS FTA is a big step for the Republic of Korea. Not only will it strengthen its economic ties with the world's largest economy, but it will also have an important impact on the two countries' trading partners. It is in this context that this issue brief considers how the KORUS FTA will affect the prospects for an FTA between South Korea and China. What kinds of challenges would confront negotiations for a Sino-Korean FTA? What kinds of policy stances should both sides adopt in order to move FTA negotiations forward?

### **How the KORUS FTA Is Influencing Sino-Korean economic relations**

The FTA is a relatively new form of trade agreement among countries desiring to circumvent the imperfections of the multilateral World Trade Organization (WTO), particularly since the WTO Doha Round negotiations were indefinitely suspended in 2006. Many developed countries and regions have turned to bilateral and multilateral FTAs in order to explore new avenues for trade liberalization. With fewer negotiating parties involved, FTAs have the advantage of being simpler to arrange. However, because FTAs only provide their benefits to their signatory countries, they also make it more difficult for outside countries to compete within the signatory countries' markets. For these reasons, China, as an important trading partner for both the United

States and South Korea, will also be affected by the KORUS FTA.

***The KORUS FTA will reduce South Korea's dependence on Chinese economic development.*** Since the start of China's "reform and opening up" in the late 1970s, economic cooperation between China and South Korea has increased rapidly, inducing tremendous changes to South Korea's export structure. Exports of spare parts and raw materials to China have been a vital driver in the development of the South Korean economy. As South Korea's trade dependence on the United States dropped from 24.4% in 1991 to 9.7% in 2011, its dependence on trade with China increased from 2.9% to 20.5% in the same period.<sup>1</sup> Some scholars worry that an excessive dependence on trade with China will make South Korea vulnerable to fluctuations in the Chinese economy. By establishing an FTA with the United States, South Korea can diversify its trade relations, increase its market share in the United States and reduce its economic dependence on China.

***The KORUS FTA will increase competition between China and South Korea in the U.S. market.*** China and South Korea both regard the United States as a vital export market and compete with one another for market share. Because the KORUS FTA reduces or eliminates various tariffs on South Korean products, it is expected that some South Korean goods, such as textiles, will displace comparable Chinese goods in the U.S. market. For instance, an official from the Korea Institute for Industrial Technology said that a sweater that sold for \$100 before the FTA took effect could retail for only \$70 under the new tariff scheme. Exports of Korean textile products to the United States are expected to increase by \$200 million,<sup>2</sup> which may consequently reduce U.S. imports of Chinese textile products.

***The KORUS FTA will result in a withdrawal of South Korean capital from China.*** After the establishment of diplomatic relations between China and South Korea in 1992, many South Korean companies began to invest in the Chinese manufacturing sector, seeing it as an attractive opportunity because of its low labor costs. Since then, South Korean investment in China has rapidly increased year after year, growing from \$264 million in 1993 to \$4.8 billion in 2011. China has since become the second-largest recipient of South Korean investment after the United States.<sup>3</sup> However, with the KORUS FTA, South Korea's exports to the United States will enjoy preferential tariff treatment. In order to enter the U.S. market, a number of South

Korean companies will withdraw from China and return to South Korea or increase the relative production of their South Korea-based factories. One survey, conducted by the Korea Trade-Investment Promotion Agency, queried 400 Korean firms with investments in China on whether they intended to relocate manufacturing operations back to South Korea; 27 firms answered in the affirmative. The South Korean government has promised to support these “reflow enterprises” by covering half the cost of their new industrial land in South Korea and allowing the other half to be financed with very inexpensive leases. Reflow enterprises will also receive 100% corporate and personal income tax relief for the next seven years. It has also been reported that the South Korean government is considering additional policies to support these enterprises’ return home.

***The KORUS FTA will strengthen the U.S.-ROK Alliance.*** Although the FTA itself is limited to the economic sphere, it is expected to strengthen the U.S.-ROK alliance and is also significant in the context of the Obama Administration’s “pivot to Asia”. You Hyun-Suk has argued that the United States’ intent behind the KORUS FTA is to prevent South Korea from drifting further into the Chinese economic circle and thus to counteract China’s growing economic and political dominance in East Asia.<sup>4</sup> By binding the South Korean economy more closely to the United States’ economy, the KORUS FTA will create stronger mutual interests in defending those links and thus strengthening the U.S.-ROK alliance.

***The KORUS FTA will also bring opportunities to China.*** South Korea’s preferential access to the U.S. market under the FTA, along with its convenient transportation links, makes it an attractive destination for investment by foreign companies seeking a manufacturing base, including Chinese enterprises. The South Korean government has introduced a series of policies and measures to encourage this investment, such as the 2010 “Foreign Investment Promotion Act”, which would loosen restrictions on the leasing and sale of public lands and assets to foreign investors, as well as expand foreign investors’ access to government credit. The South Korean Foreign Economic Policy Institute has predicted that after the FTA takes effect, foreign direct investment in Korea will grow annually by an average of between \$2.3 billion and \$3.2 billion.<sup>5</sup> The South Korean government also made a point of stating that China’s domestic long-term investment funds are welcome to invest in the South Korean capital market. As China’s economy continues to develop, it is expected to become one of

South Korea's largest foreign investors.

## **Assessing the Prospects of a Sino-Korean FTA**

In terms of geography, history, culture, and economic complementarities, China and South Korea are very closely connected. However, while South Korea has established FTAs with the United States, the European Union and others, negotiations for a Sino-Korean FTA have stalled. In addition to economic concerns, there are other complex political and security factors that will impinge upon the success or failure of Sino-Korean FTA negotiations.

*The KORUS FTA widens the gap in expectations as to what can be achieved in Sino-Korean FTA negotiations.* With the signing of the KORUS FTA, South Korea overcame some of the greatest difficulties a country can face when conducting FTA negotiations and accumulated a wealth of experience in negotiating and bargaining skills. In the future, South Korea may take a hard-line stance during Sino-Korean FTA negotiations and force China to make concessions. Some Korean scholars believe that China is currently more anxious than South Korea to push forward FTA negotiations, which puts Seoul in an advantageous position to demand more concessions. According to LG Economic Research Institute researcher Kim Hyeong-ju's opinion, in the upcoming Sino-Korean FTA negotiations the more important issue is whether China will make concessions in their sensitive areas.<sup>6</sup> South Korea could also emulate its strategy with the United States by excluding rice and other agricultural products from FTA negotiations with China while demanding the continuation of protective tariffs for its cereals, vegetables, and fruits. It could also propose to discuss further liberalization of the Chinese financial and accounting services markets.

*There are economically sensitive areas in which Sino-Korean FTA negotiations would face challenges.* Once Sino-Korean FTA negotiations commence, it is expected that agricultural products will be a major bone of contention. South Korea may worry that around 200 kinds of agriculture and fisheries products would be affected by an FTA with China, particularly rice, which has been designated as a restricted topic for negotiations. The South Korean government has also decided to exclude pepper, garlic, and chilled and frozen fish from the tariff elimination list.<sup>7</sup> China worries that its economy will be negatively affected in areas such as petrochemicals, electronics,

steel, semiconductors, automobiles and auto parts. Therefore, once negotiations begin, both countries would certainly face intense discussions in these areas. Bark Tae-ho, the South Korean Trade Minister, stated that the Sino-Korean FTA negotiation process will be divided into two phases. The first phase would involve negotiations over sensitive areas. The second, more comprehensive phase of FTA negotiations would follow after. Thus, if negotiations over sensitive sectors were to reach an impasse, further FTA negotiations would stall.

***Political resistance could further slow Sino-Korean FTA negotiations.*** Domestic political factors could create obstacles to the formation of a Sino-Korean FTA. On January 9, 2012, South Korean President Lee Myung-bak and Chinese President Hu Jintao announced that they were ready to begin preparing for a Sino-Korean FTA. Immediately after this announcement was made, however, South Korea's largest opposition party, the Democratic United Party, asked the South Korean government to cancel its decision, arguing that a Sino-Korean FTA would seriously harm South Korea's agriculture, small and medium-sized enterprises, and light industry. It should be expected that any FTA negotiations will be subject to criticism by domestic pressure groups and the upcoming presidential elections in South Korea are likely to provide additional opportunities for such pressure groups to influence South Korea's stance on FTAs. These domestic factors will make it very difficult for the ROK government to conduct FTA negotiations effectively.

***The Sino-Korean FTA negotiations process would be arduous and lengthy.*** Even under ideal conditions, negotiations for a Sino-Korean FTA would be arduous and lengthy. The KORUS FTA negotiations process took four years and ten months, while the Korea-EU FTA negotiations process took around three and a half years. Sino-Korean FTA negotiations would likely take even longer. Second, South Korea has maintained a large number of bilateral trade surpluses with China which would diminish under an FTA. According to data recently released by the Korea International Trade Association and the Planning Ministry of Finance, Sino-Korean trade in 2011 amounted to \$220.63 billion with a \$45.26 billion South Korean surplus, suggesting that South Korea might not be particularly anxious to push through an FTA with China. Third, since the KORUS FTA has just been concluded, South Korean companies have been focused on exploring new opportunities in the U.S. market and may not perceive a pressing need to accelerate FTA negotiations with China in the near term.

***However, a Sino-Korean FTA could potentially confer enormous economic benefits on both sides.*** According to the U.S. Census Bureau, the volume of South Korea's trade with the United States in 2011 totaled \$100.14 billion in 2011. This was about 45% of the trade volume between South Korea and China in 2011. This means that the impact of a Sino-Korean FTA would likely be much greater than that of the KORUS FTA. According to a forecast by the Samsung Economic Research Institute, South Korean imports of Chinese agricultural products would increase by anywhere from 104.8% to 209.2% if a Sino-Korean FTA were implemented. Additionally, the forecast predicts that South Korea's GDP would increase by 2.72%, nearly five times the projected GDP increase resulting from the KORUS FTA (0.56%) and more than double the projected increase resulting from the Korea-EU FTA (1.02%).

For China, a Sino-Korean FTA would significantly reduce transaction costs between the two countries, stimulate trade growth, and help to modernize the industrial sector by promoting foreign enterprise investment in the Chinese market, introducing more foreign management experience to China, and hastening the upgrading of industrial infrastructure. China's comparatively advantaged products would enjoy a broader market alongside a simultaneous reduction in the costs of imports.

***A Sino-Korean FTA would greatly enhance South Korea's position in international trade.*** In 2011, 24.2% of South Korea's exports went to China, more than its exports to the United States and the European Union combined. Were a Sino-Korean FTA agreement to be established, South Korea would be the only country to have signed FTAs with the world's three major economies – the European Union, the United States and China, potentially making it into a global trade hub and a dynamo for Northeast Asian regional integration.

## **Conclusions and Policy Implications**

By strengthening the trade relationship between the United States and South Korea, potentially increasing the U.S. market share of South Korean goods relative to Chinese goods, and making South Korea a more attractive destination as a global manufacturing hub, the KORUS FTA has become an important factor in stimulating Chinese interest in an FTA with South Korea. Moreover, both China and South Korea stand to gain a great deal in investment and trade gains should an FTA come to fruition.

Although the process of forming a Sino-Korean FTA would be difficult, the long-term prospects for further development in economic relations between South Korea and China are optimistic. China's current efforts to promote the formation of a Sino-Korean FTA are part of a general trend in Chinese foreign policy. In April 2007, as KORUS FTA negotiators reached an agreement, China proposed bilateral FTA talks with South Korea. Due to opposition from the agricultural sector as well as small and medium enterprises, South Korea did not respond to China's proposal. Nevertheless, in October 2007, the 17<sup>th</sup> National Congress of the Communist Party of China agreed to pursue an FTA strategy, leading ultimately to Lee Myung-bak and Hu Jintao's January 2012 decision to commence FTA negotiations. However, in order to make progress in future Sino-Korean FTA negotiations, both sides should take the following points into consideration:

First, both governments will have to acknowledge that there will be winners and losers and that they will need to make trade-offs between advantaged and disadvantaged industries. In order to reduce pressure from domestic opposition, both governments will need to consider providing subsidies and preferential tax policies to disadvantaged industries. It will also be necessary to promote the further upgrading of industrial infrastructure.

Second, both countries should avoid linking the Sino-ROK FTA with the security issues of the Korean Peninsula. Although maintaining stability on the Korean Peninsula is of vital importance for both China and South Korea, the unpredictability of events in North Korea would serve as a poor foundation for trade relations. The recent ascension of Kim Jong-Un to North Korea's top leadership post has also generated heightened uncertainty about the peninsula's future. Making trade relations dependent on relations with North Korea would grant Pyongyang a form of unwanted leverage over both countries. The more insulated China and South Korea's trade relations are from events in North Korea, the more stable those relations will be.

Third, both China and South Korea should continue to improve overall cooperation so as to create a harmonious and friendly atmosphere for trade negotiations. During this process, China and South Korea will need to work assiduously to avoid impasses over sensitive products, try to reach agreement on non-sensitive products, and overcome those specific difficulties through negotiations on an incremental basis.

The year 2012 marks the twentieth anniversary of the establishment of diplomatic relations between China and South Korea. Today, China and South Korea are facing severe challenges of the global economic slowdown. A Sino-Korean FTA would, on balance, mutually benefit both countries' development and contribute to greater regional and global prosperity.

1. Dependence on foreign trade refers to the proportion of a country's total import and export trade in its gross domestic product.
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\* The above is the author's personal opinion and does not necessarily represent the opinion of any organization.



**Qun Liu** is a Visiting Research Fellow in the Foreign Policy Studies Department at the Asan Institute for Policy Studies in Seoul, Korea. His research interests include national defense industry, industrial economics, national security, and crisis management in China. Dr. Liu currently serves the Navy unit of China's People's Liberation Army (PLA) and was a United Nations Military Observer for the United Nations Mission for the Referendum in Western Sahara (2005-2006). He was previously an associate professor of the Research Center for National Defense Economics at PLA National Defense University (1993-2011). Dr. Liu is the author of *Defense Industry Regulation* (Financial Economics Publishing House China, 2008) and the translator of Maurice Isserman's book, *America at War: World War II* (Contemporary China Publishing House, 2005). He received his Ph.D and M.A. in economics from PLA National Defense University and his B.A. in philosophy from East China Normal University.