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## The Economic Integration of China, Taiwan, and Hong Kong: Implications for Korea's Trade Policy

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### The Significance of the Rise of Greater China Economy

The rapid economic development and growth of the People's Republic of China has accelerated the economic partnership and integration among China, Hong Kong, and Taiwan, giving rise to a new Greater China Economy. Since signing the Closer Economic Partnership Arrangement (CEPA) with Hong Kong in 2003, the Chinese central government has been steadily expanding the scope of economic cooperation through a succession of additional

and supplementary arrangements. The bilateral economic partnership between China and Hong Kong will only continue to grow further in the coming years as the Chinese government is favorably inclined toward endowing Hong Kong with special trade privileges and status. Moreover, the growing economic partnership between China and Taiwan, spearheaded by the signing and effectuation of the Economic Cooperation Framework Agreement (ECFA) between the two countries in the June and September of 2010, respectively, will exert an increasing influence on neighboring countries in Northeast Asia.

It is thus high time that we carefully examined and analyzed the implications of the increasing attempts at economic integration in Greater China Economy, especially for the Korean government's trade policy vis-à-vis China, Taiwan and Hong Kong.

## China-Taiwan ECFA and Its Implications for the Korean Economy

First, we need to keep a cautious eye on the mid-to long-term implications that the effectuation of the China-Taiwan ECFA is likely to exert influence on the prospects of Korea's exports to China. A recent analysis of the effectuation of the ECFA and the Early Harvest Program (EHP) revealed that the short-term influence of the arrangements on Korea's exports to China is quite limited. In the mid-to-long run, however, the growing trade partnership between China and Taiwan is likely to threaten the competitiveness of Korean

exports in the Chinese market to a significant extent. Taiwan will gradually gain an upper hand in terms of exports to China, thanks to Taiwan's highly protectionist domestic industrial policy (with high tariff barriers). Whereas China continues to maintain high tariff rates to protect its domestic industry as well, its export-oriented industries still crucially rely on materials imported from Korea, which are processed in China before exports finished products overseas. The increasing trade ties between China and Taiwan, however, is likely to reduce the competitive appeal of goods imported from Korea. Korea's exports for Chinese domestic industries, with relatively low-tariff barriers, could also significantly decrease with increasing competition from Taiwan. While Korea continues to compete against Taiwan in terms of exporting to China such low-tariff and export-oriented goods as communication equipment and devices, electronic parts, and computer hardware and technology, China's increasing shift toward the domestic industry may threaten the status of Korean goods in the long run.

**Table 1. Korea and Taiwan's Shares of the Chinese Import Market**

		2010	2011	2012 (Jan.-Jul.)
Korea's exports to China	Total	10.1	9.6	9.1
	ECFA-EHP-subject goods	16.2	17.6	17.9
	Other	9.3	8.7	8.1
Taiwan's exports to China	Total	8.4	7.4	7.0
	ECFA-EHP-subject goods	12.3	11.6	11.7
	Other	7.9	6.9	6.5

Source: compiled by the authors from the Korean Foreign Trade Association's database.

## Restoring Balance to the China-Centered Trade Policy

Since Korea and China established the diplomatic ties over the last two decades, the two countries have maintained a relatively favora-

ble relationship and have complementary industrial and trade structures. It is based on this favorable trade environment that the Korean government has so far been able to emphasize cooperation as the core of its strategy for trade with China. The increasing attempts, led by

China, to form Greater China Economy today are more than likely to alter the relations of cooperation and role division not only for Korea, but for the entire region of Northeast Asia. It is thus of paramount important to devise a strategy that restores balance to the heavily China-centered economic arrangements that shape today's Greater China Economy. The Korean government can re-balance by outgrowing its exclusive reliance on China and expanding the scope of trade to include Hong Kong and Taiwan as well. At the same time, the Korean government will further need fine-tune and specialize the relations of economic cooperation with Mainland China.

### **CEPA-Style Negotiation for Supplementary Arrangements for the Korea–China FTA**

The key issues at stake in the Korea–China FTA negotiations include two questions of how to handle sensitive and delicate economic questions, on the one hand, and to what extent the two countries' markets and industries should be opened, on the other hand. As for the service sector, the Korean government continues to insist on a relatively greater openness, while the Chinese counterpart wants to start small, with the option of incrementally greater opening. The China–Hong Kong CEPA provides a good example of this incremental approach, as it involves the governments of both parties to conduct supplementary negotiations and arrangements each year to open up the two parties' industrial and service sectors more and more. Those involved in the Korea–China FTA negotiations may adopt this approach and gradually broaden the area or range of services to be opened up in the coming years.

The Korea–China FTA will be quite signifi-

cant for Northeast Asia for a number of reasons. First, it is likely to exert a greater influence on China's economy than any other FTAs that the Chinese government has signed so far. While the Korean government has already signed and ratified a number of FTAs with other major regions of the world, including the United States and the European Union, the impact of the FTA with China is likely to be much more direct on the Korean economy than other FTAs. In recognition of the importance and urgency of the Korea–China FTA, it may be wiser to open up relatively small parts of both countries' economies at first, gradually widening the range and scope of openness in the later years through sustained dialogues and economic cooperation.

### **Reducing the Tariffs on Intermediate goods**

Both Korea and Taiwan, along with Japan, perform the role of supplying intermediate goods for processing in China. Korea and Taiwan, in particular, are locked in a fierce competition over the intermediate goods market in China. Intermediate goods made up 75.6% and 78.4% of Korea and Taiwan's exports to China in 2011, respectively. Korea and Taiwan also account for 14.7% and 11.8% of the overall Chinese imported intermediate goods market, respectively. The elimination of tariffs, on the basis of the FTAs, on intermediate goods that China imports from these two countries is expected to exert a great economic influence on both countries. In order to counteract the threat posed by the ECFA to Korea's trade structure, and to ensure the early realization of the anticipated benefits of the FTA with China, the Korean government needs to make active efforts to reduce or eliminate tariffs on intermediate goods early on in the negotiation process.

**Table 2. Korea–China Trade Structure (Categorizing Traded Goods by Processing Stage)**

Category		Greater China		China		Taiwan		Hong Kong	
		2010	2011	2010	2011	2010	2011	2010	2011
Exports	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Commodities	0.5	0.6	0.5	0.6	1.1	1.0	0.2	0.2
	Fuels, lubricants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Intermediate goods	74.0	73.9	71.5	71.2	82.8	85.6	80.3	78.8
	Semi-processed goods	36.7	39.9	37.0	40.8	46.0	51.9	30.3	28.8
	*Fuel oils	4.9	8.2	4.8	7.5	2.6	12.7	6.3	8.3
	Parts	37.3	34.0	34.6	30.4	36.7	33.8	50.0	50.1
	Finished goods	25.4	25.5	27.9	28.1	16.1	13.3	19.5	21.0
	Capital goods	21.7	21.4	24.5	24.2	10.8	8.6	15.4	16.7
	Consumer goods	3.7	4.1	3.4	4.0	5.4	4.7	4.1	4.2
	Unclassified	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Imports	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Commodities	3.1	3.0	3.4	3.2	1.0	1.4	3.6	5.1
	Fuels, lubricants	1.4	1.2	1.7	1.4	0.0	0.0	0.0	0.0
	Intermediate goods	62.6	63.8	59.2	61.0	78.5	78.6	73.8	73.6
	Semi-processed goods	32.1	34.5	34.5	36.9	19.2	20.4	33.7	36.5
	*Fuel oils	0.9	0.9	0.9	0.9	0.9	0.9	0.1	1.3
	Parts	30.4	29.2	24.7	24.1	59.3	58.2	40.2	37.2
	Finished goods	34.4	33.2	37.3	35.7	20.5	19.9	22.6	21.3
	Capital goods	20.6	19.5	23.1	21.6	8.7	8.2	14.7	12.6
	Consumer goods	13.7	13.7	14.3	14.1	11.8	11.8	7.9	8.7
	Unclassified	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Note: The categorization of goods according to their processed status is based on the United Nation's Broad Economic Categories (BEC). For more information, please visit [unstats.un.org/unsd/cr/registry/regdnld.asp?Lg=1](http://unstats.un.org/unsd/cr/registry/regdnld.asp?Lg=1).

Source: compiled by the authors from the Korean Foreign Trade Association's database.

## Implications for the Korea–China FTA

The Korean government maintains an offense in the FTA negotiations with China over the service sector. One can hardly overemphasize the importance of ensuring access for Korean service providers to the Chinese service sector, as the service sector will play a crucial role in ensuring the sustainability of Korea's trade policy vis-à-vis China by generating the de-

sired level of added values. The Korean government therefore needs to make greater efforts to persuade the Chinese counterpart to open up its service market. China's CEPA with Hong Kong and EHP (part of the ECFA) with Taiwan force the Chinese government to open the mainland service sector to the two countries to a greater extent than to other member-states of the World Trade Organization. Those working on behalf of the Korean government in the FTA negotiations with Chi-

na therefore ought to incorporate the successful elements of the CEPA and the ECFA into their strategy.

## Deciding the Pilot Regions or Sectors for the Korea–China FTA

The China–Hong Kong CEPA includes a pilot basis provision, which designates the Province of Guangdong surrounding Hong Kong as a test ground of open economic policy. The success or failure of the pilot basis will guide further negotiations and arrangements between the two parties as to whether to open up the remaining regions. This pilot-basis policy may also be tried in the Korea–China FTA, focusing on certain provinces or regions that are especially dependent on the trade between the two countries. The Chinese government is showing some interest in trying out a pilot project in Shandong by developing a special district for agricultural cooperation, as well as another pilot project in Chongqing involving a special district for industrial cooperation. Nevertheless, further research is required to identify and decide regions or markets to be given such pilot treatment. Pilot regions or markets in China ought to be decided by taking into account multiple factors, including the candidates' geographic and social proximity to Korea, their possibility of complementary relations with Korea, their prospects for offering Korea a further entry into the greater Chinese domestic market, and the sustainability of such pilot relations. Preference shall be given to markets and regions that are likely to increase Korea's advantage over and against other countries, that possess great potential for future expansion, and that can facilitate complementary relations between Korea and China. Given these considerations, Shandong and the three Dongbei provinces provide the like-

liest geographic candidates for pilot projects. As for the industrial candidates, we need to look to the medical, LED, and financial pilot projects in the China–Taiwan industrial cooperation programs in addition to the pilot service sector programs outlined in the China–Hong Kong CEPA. These sectors of the Chinese economy offer much promise for further growth, and may help Korea gain an upper hand in its relations with China compared to other rival countries.

## Growing Economic Partnership between China and Taiwan

In the long run, the ECFA will lead Chinese goods to drown out competitors in the Taiwanese market. As a result, a number of other countries have been vying for FTA deals with Taiwan since the ECFA was signed. The Korean government may benefit from strengthening economic ties with Taiwan in the future, by securing Korea's hold on the Taiwanese market and diversifying Korea's trade policy vis-à-vis Greater China. One good place to start is to promote research collaborations between the two countries' civil societies, on subjects, such as the ECFA and other FTAs that the Taiwanese government has signed and the prospects of economic arrangements and FTA between Korea and Taiwan in the future. In promoting closer ties with Taiwan, however, the Korean government needs to act with tact and pay respect to the Chinese government's insistence on the "one China" policy.

## CEPA and Popular Investments: Service Sector

Korean businesses may attempt to enhance

their access to the Chinese service sector through collaboration with Hong Kong companies that meet the CEPA requirements. Hong Kong businesses that benefit most from the CEPA are those handling logistics and retail distribution. These companies frequently interact with regions in China where many Hong Kong manufacturers have established presence. As Korean businesses are relative newcomers to international logistics and retail distribution, they may benefit much from collaboration with Hong Kong companies in accessing China, especially the regions that interact frequently with Korean manufacturers.

**K**orean entertainment companies (including film production companies and distributors)

which have competitive advantage may also expand market by collaborating with partners in Hong Kong, thereby targeting regions in China where the Korean Wave is high. Other Korean multinational corporations may also work with HKSS-qualifying Hong Kong companies in the form of joint ventures or merger-and-acquisition in order to enter the Chinese service sector and secure early advantage. Such arrangements can help Korean companies to enter such pilot-CEPA regions as Chenhai of Shenzhen, Nansha of Guangzhou, and Hengqin of Zhuhai with greater ease. These regions grant preferential treatments and privileges for different types of service providers and provide important test grounds for the opening of China's service sector. **KIEP**