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Korea and the Dual Chinese Challenge

Françoise NICOLAS

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Executive Summary

The economic rise of China and its integration into the globalization process is undoubtedly one of the most important developments of the past decades. The resulting change in the global balance of economic activities has far-reaching implications for the world as a whole and for neighboring emerging economies in particular, with Korea as a case in point. The objective of the paper is to examine the exact nature of the Chinese challenge for Korea, and assess what may be the most appropriate response to mitigate the risks and maximize the potential benefits associated with it.

The paper starts by providing a comprehensive description of the major changes implied by the rise of China and argues that they give rise to a dual challenge for Korea. First, the paper assesses China's new role in the regional supply chain and the resulting change in the competitive game being played in the region. Based on an analysis of the trade and FDI flows in the region over the past decade, it highlights the differentiated impact on Newly Industrialized Economies, such as South Korea, and on less advanced economies such as Malaysia, Indonesia or Thailand. The paper goes on arguing that the recent changes in China's stance toward its neighbors and its apparent resolve to become a regional leader further compound the challenge raised by the new conditions prevailing on the Asian competitive scene.

The next section takes a prospective stance and examines the steps that Korea can (and should) take to face the dual challenge posed by the rise of China. It examines first the measures that can be put in place at

firms' as well as at the Government level in order to enhance Korea's competitiveness, stressing in particular the need for further structural reforms. The establishment of the Japan-Korea FTA, now in the final stage of negotiations, is shown to be a potentially powerful instrument to that end. The paper also suggests that this FTA has to be associated with other arrangements with China and ASEAN, if Korea wants to keep some leverage over the future of the East Asian integration process.

JEL Classification: F13, F14, F15
Keywords: China, Korea, regional integration, FTA

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Françoise NICOLAS**

I. Introduction

The economic rise of China and its integration into the globalization process is undoubtedly one of the most important developments of the past decades. The resulting change in the global balance of economic activities has had (and continues to have) far-reaching implications for the world as a whole and for Asia in particular. The fiercer competition from China in the trade area as well as in the FDI area has fuelled concerns in neighboring emerging economies, which tend to perceive China more as a threat than as an opportunity. Although these fears may be partly ill founded, it is worth noting that the necessary adjustments imposed by the participation of China in the regional and global production networks constitute a major challenge, which further

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compounds the difficulties already encountered in the wake of the 1997-98 financial crisis.

The objective of the paper is to determine what can be done to respond to the challenge and to defuse potential fears, focusing on Korea. To that end, it will examine the exact nature of the Chinese challenge and assess what may be the most appropriate response to mitigate the risks and maximize the potential benefits associated with it.

The first section of the paper provides a comprehensive description of the major changes implied by the rise of China as well as of the way neighboring economies have accommodated their rising neighbor so far. To that purpose, it starts by assessing China's new role in the regional supply chain and the resulting change in the competitive game being played in the region. Based on an analysis of the trade and FDI flows in the region over the past decade, it highlights the differentiated impact on Newly Industrialized Economies, such as South Korea, and on less advanced economies such as Malaysia, Indonesia or Thailand. As a next step, the section also examines the changes in China's stance toward its neighbors, focusing on its economic diplomacy moves in the region (in the form of Free Trade Agreements (FTAs) in particular), which reflect China's resolve to become a regional leader.

The following section examines the steps that Korea can take in order to respond to the two dimensions of the challenge identified earlier and to reap the full potential benefits of China's economic rise. To that end, a two-pronged approach is adopted, taking into account both firms' private strategies and governments' public policies. Moreover, when dealing with the latter, a particular emphasis is placed on Korea's regional policy. An important point is to analyze the benefits that could be reaped from the implementation of regional FTAs, as well as the feasibility of such arrangements given the changing circumstances.

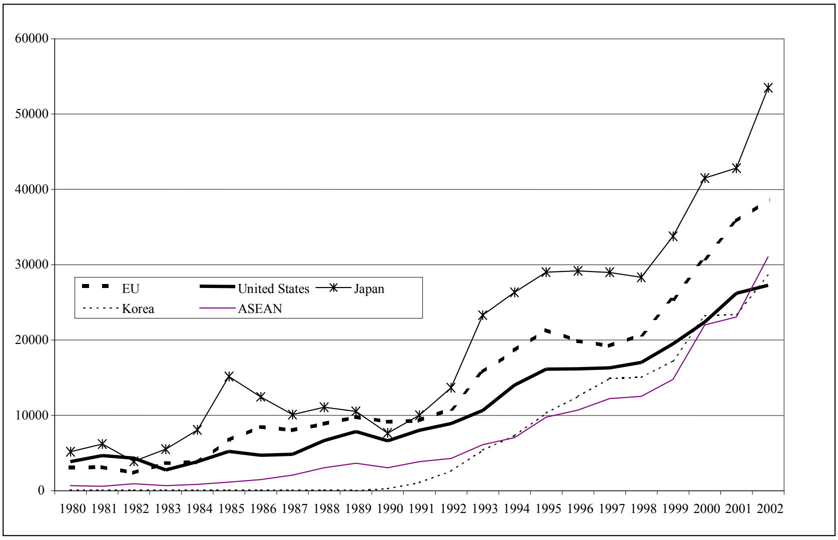
II. The Rise of China: A Dual Challenge for Korea

1. China as a major trading partner

As a result of its open-door policy, China is now clearly integrated in the world trade networks. It is now the world's fourth largest trader. The country's exports and imports have surged since the early 1990s, with the US, Japan and the EU (in that order) as major destinations, and with Japan, the EU and emerging East Asia as major suppliers of imports.

Figure 1. China's Imports, 1980-2002

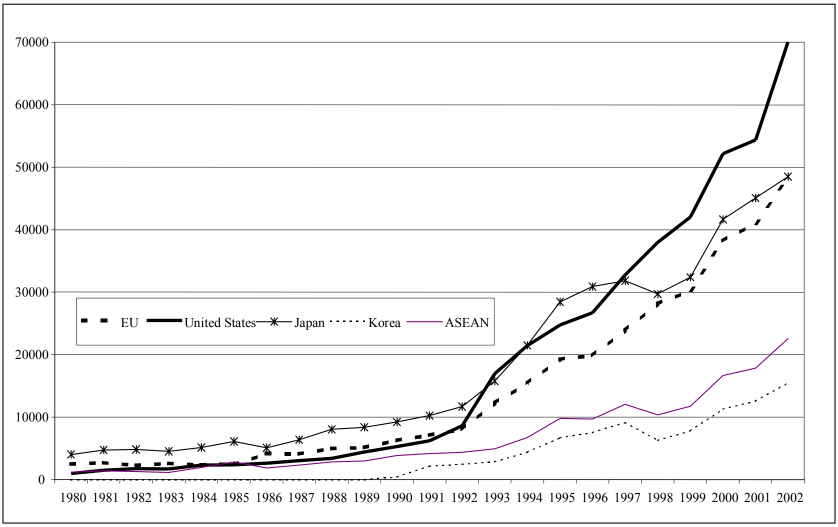
(Unit: US$ millions)



Source: IMF, *Direction of Trade.*

Figure 2. China's Exports, 1980-2002

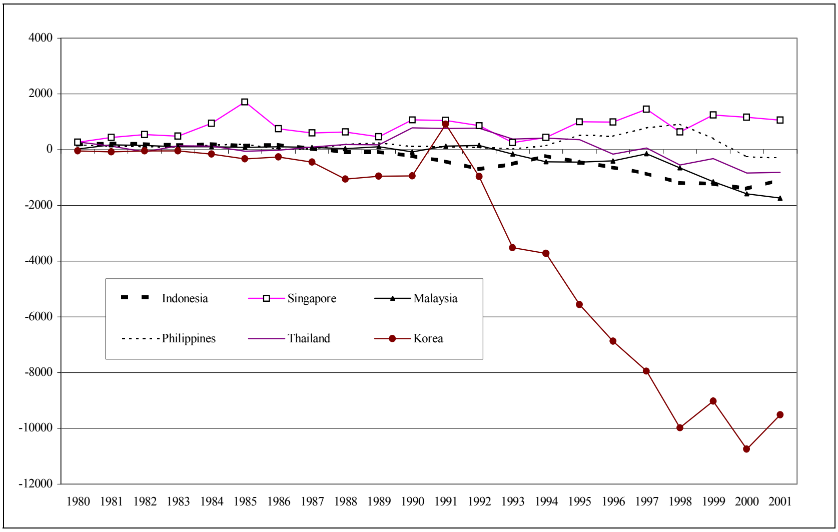
(Unit: US$ millions)



Source: IMF, *Direction of Trade.*

Figure 3. China's Trade Balance with Emerging Asia, 1980-2001

(Unit: US$ millions)

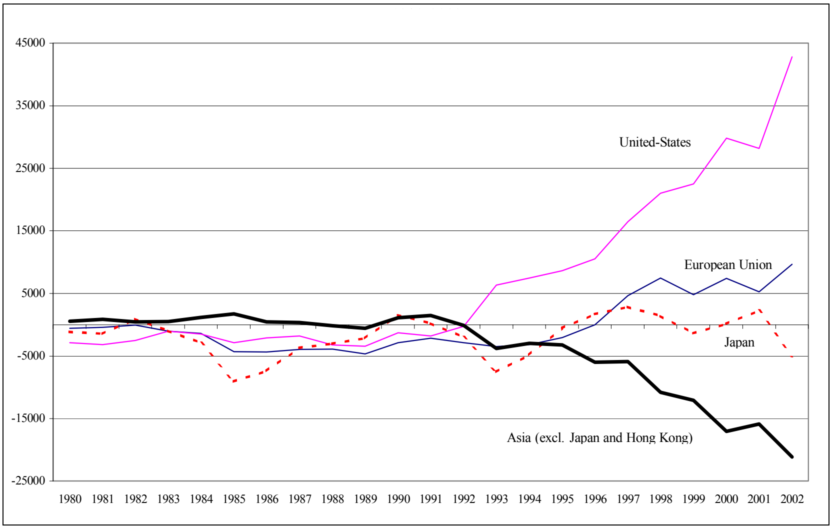


Source: IMF, *Direction of Trade.*

Emerging East Asia ranks high among China's trading partners. While China does not export much to neighboring emerging Asian economies, it imports a lot from the rest of the region, from industrial and emerging economies alike.[1)] As a result, China runs a trade deficit with the region as a whole. It runs a deficit with most neighboring emerging economies (Korea, Malaysia, Thailand, Indonesia), while its trade is basically balanced with the Philippines and Japan. The only exception is Singapore, with which China has been systematically in surplus for the past 20 plus years.

Figure 4. China's Trade Balance with its Major Trading Partners

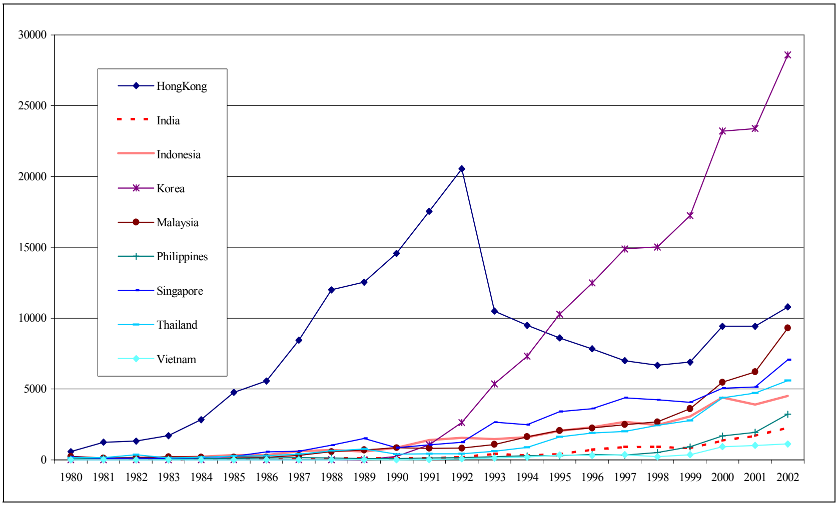
(Unit: US$ millions)



Source: IMF, *Direction of Trade.*

1) Over the period 1990-2000, the share of East Asia as a destination for Chinese exports has decreased (from 67 to 45.2 percent) while its share as a source of imports has risen (from 55.4 to 62 percent).

Figure 5. China's Imports from Asia Emerging Economies, 1980-2000



Source: IMF, *Direction of Trade Statistics*.

Following the normalization of its economic relations with a number of its Asian trading partners such as South Korea, China's trade with neighboring emerging Asian economies has intensified dramatically.[2)] Yet, the situation varies substantially across countries: the surge in China's imports from the rest of the region has not benefited all countries equally. As can be seen in figure 5, at the individual country level, Korea has undoubtedly benefited most from this development (and to a lesser extent Taiwan), and is nowadays the second source of imports for China, behind Japan but ahead of the US. China's trade with Korea has soared since the two countries resumed diplomatic relations in the early 1990s. The bilateral trade between China and Korea amounted to 45 billion US$ in 2002 (compared to 17 billion in 1995).

2) This is also reflected in the upward trend of trade intensity indices among the East Asian economies (Ando and Kimura 2003).

Korean exports to China rose to close to 30 billion US$ in 2002, while Korean imports from China reached 15 US$ billions. From the Korean perspective, China now ranks first among the country's export markets, ahead of the US. This has undoubtedly helped Korea maintain strong growth over the past few years[3] but has also made it more dependent on the fate of the Chinese economy. Moreover, China's chronic trade deficit with Korea has fuelled complaints in the former country, leading to the imposition of anti-dumping measures and festering the relations between the two countries.

At this stage, it is worth examining the composition of China's imports in more details. According to Rumbaugh and Blancher (2004) about half of China's imports are for processing and re-exporting. In this respect, the pattern of China's imports from Asia differs substantially from the country's imports from the rest of the world.[4] China's imports from the US and the EU are primarily concentrated in the aeronautics industry, in engines, auto-parts, telecommunication equipment and specialized machinery. Various electronic products (components in particular) weigh more heavily in China's imports from Japan. The pattern of China's imports varies across emerging East Asian countries and has varied over time. While China still tends to import non-edible agricultural products and crude oil from Indonesia, it primarily imports electronic goods (electronic components and computer equipment) from the rest of ASEAN. In the latter industry, there have been major changes in the structure of imports from ASEAN, with a rise in the share of

3) According to some estimations, exports to China accounted for about 40 percent of Korea's export growth over the past few years.

4) Moreover, as stressed by Yang (2003) there seems to be a long-term shift in the sourcing of China's imports from industrial countries to developing countries.

machinery and electrical goods, mainly components and parts. As far as Korea is concerned, its export pattern has substantially changed over time, with a radical shift away from textiles into electronic products, refined petroleum products and chemicals. Moreover Korean electronic exports to China have shifted from consumer electronics to electronic components, telecommunication equipment and more recently computer equipment.

More importantly, the bulk of China's imports from neighboring East Asia are made of parts, components, and raw materials. This holds particularly true for Korea. During the 1997-2002 period, parts and intermediate goods accounted for 69 to 76 percent of Korea's exports of manufactured goods to China (Lee 2004).

The rise in East Asia intra-regional trade since the early 1990s has thus been largely driven by rapidly growing trade in parts, components and intermediate products that is a reflection of greater vertical specialization and the dispersion of production processes across borders. This has been described as the "Asian integrated circuit." Emerging Asia is the major export market for intermediate goods produced in East Asia: the share of emerging Asia's exports of intermediate goods to other countries in the region has increased from about 25 percent in the late 1970s to 47 percent in 2002 (Zebregs 2004), with China playing a pivotal role in the rise in intra-regional trade in components.[5] A major result of China's participation in the regional production networks is that de facto economic integration in the region has substantially deepened, giving rise to a higher degree of interdependence.

5) As a result, China runs a trade surplus with East Asia in consumption goods and a deficit in intermediate goods.

The pattern of China's trade, with most exports directed to industrial economies and imports originating to a large extent from emerging Asia, reflects the existence of a pattern of triangular trade. China imports large quantities of parts, components and intermediate goods from other Asian countries for assembling and processing and exports finished products to industrial countries. China's exports are thus heavily import-intensive, with a substantial share of these imports originating from neighboring Asian economies, in particular from Korea.[6] As a result, China runs a trade deficit with Asia and a trade surplus with the industrial world, while overall its trade is basically balanced.

2. China as a competitor in third markets

On the basis of previous observations, overall, neighboring economies can be said to have largely benefited from sustained China's growth and from its integration in regional production networks, with Korea as a case in point. Yet, the flip side of the coin is that the boom in China's exports to third markets may constitute a threat for neighboring East Asian economies, which tend to compete in the same categories of production. The fear is that Chinese exports may crowd out ASEAN and NIE's exports to the US and the EU in particular. A number of factors suggest, however, first that the competition from China has been vastly exaggerated and second that this competition, when it exists, should not necessarily be deemed negative. There are a number of reasons for qualifying the Chinese success story and the extent of the competition it

6) According to Ng and Yeats (2003), ASEAN has played only a minor role in the expansion of intra-regional trade in East Asia.

imposes on its neighbors.

Since the US is one of the primary export destinations for all Asian economies, focusing on this market seems particularly relevant. Export similarity indices[7] suggest that countries such as Indonesia and Thailand may compete head to head with China in the US market while such is not the case for more advanced ASEAN economies such as Malaysia and Singapore, and to a lesser extent for Korea. In the former cases, the ESI exceeds 55, while the index hovers between 30 and 40 in the latter cases. In the case of Korea, the similarity index has been following a downward trend over the period 1990-98 (when it reached a low of 44) before picking up again over the past few years.[8] The absolute value of this index, however, is relatively low in the Korean case, suggesting relatively differentiated structures of exports to the US market.

As rightly stressed by Lall and Albaladejo (2003), however, similarity in specialization and export patterns only shows the potential for

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7) We refer here to the Finger-Kreinin index of similarity according to which the similarity of the export structures of two countries **a** and **b** is defined by:

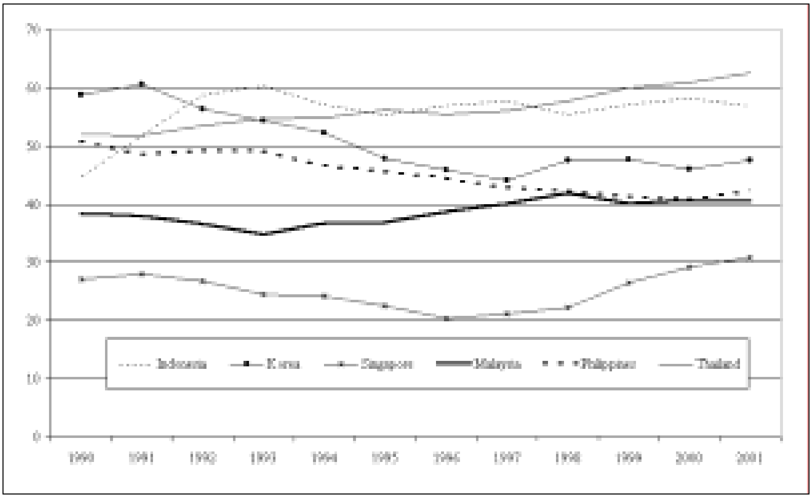
$$\mathrm{SIMFK}(\mathbf{a},\mathbf{b}) = \sum_{i=1}^{n} \{\mathrm{Minimum}\,[s_i\mathbf{a},\, s_i\mathbf{b}]\}$$

Where $s_i\mathbf{a}$ is the share of product *i* in the exports of country **a** and $s_i\mathbf{b}$ is the share of product *i* in the exports of country **b**. The index selects the lower of the two values and sums all the values obtained for each of the products. An index of 100 indicates perfect similarity between the two economies, and an index of 0 represents no overlap at all in the branch structure of the two countries. It is calculated on the basis of the CHELEM data base (71 product categories).

8) As could be expected, the similarity index between China and Korea based on the two countries' total exports is slightly higher, hovering between 51 and 55 %.

competition but it does not prove that competition actually exists. In the case of China and other Asian economies higher similarity does not necessarily imply that the latter are losing market share to China. Moreover, it is also possible that countries specialize in differentiated versions of comparable products or that they complement each other by contributing at different stages of an integrated production system.

Figure 6. Simiarity Indices with China, Export to the US



Source: CEPII, CHELEM database.

A casual look at East Asian countries' US market shares suggests, surprisingly enough, that NIEs and Japan were more severely hit by competition from China than ASEAN economies.[9] While Japan's share of US imports dropped from 18 to 10.4 percent, and Korea's share from 3.7 to 3.1 percent over the period 1990-2002, Malaysia's share for

9) This finding concurs with Lall and Albaladejo (2003).

instance rose from 1.1 to 2.1 percent. Simultaneously, China's share rose from 3.2 to 11.1 percent.

These observations require further explanation. First, the loss of US market share relative to China does not necessarily mean that exports are declining in absolute terms. Such absolute declines may be found for primary products, resource-based manufactures, textiles and garments and footwear, yet they are not observed for electronics and electric products. The loss in market share may thus simply be due to differences in exporting countries' size.

Table 1. US Imports from East Asia, 1990-2002

(Unit: percent)

	1990	1995	2002
Japan	18	16.5	10.4
China	3.2	6.3	11.1
Hong Kong	1.9	1.4	0.8
South Korea	3.7	3.2	3.1
Singapore	2.0	2.5	1.3
Indonesia	0.7	1.0	0.9
Malaysia	1.1	2.3	2.1
Philippines	0.7	1.0	1.0
Thailand	1.1	1.5	1.3
Vietnam	0.0	0.0	0.2
Total Asia	31.7	35.7	32.2

Source: IMF, *Direction of Trade Statistics.*

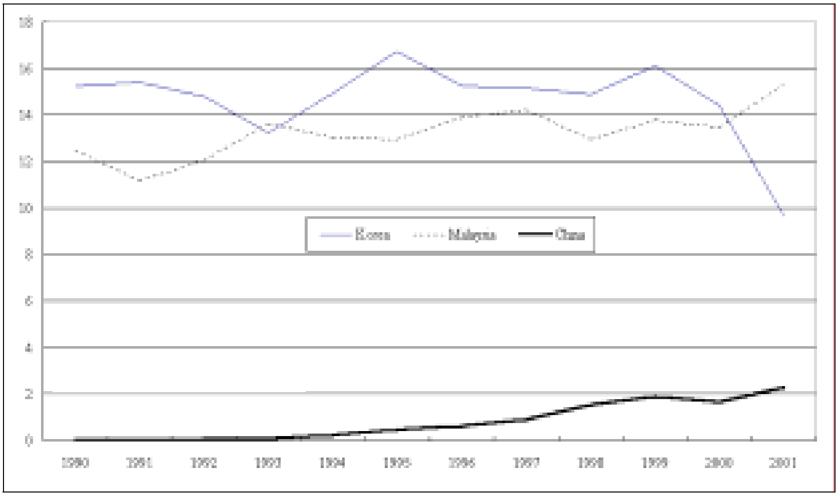
Second, the previous table merely reflects overall market shares. A look at disaggregated data gives a more precise picture. While China clearly displaced Korea (and Taiwan) as the major supplier of footwear to the US market, the competition is not as obvious in other sectors such as electronics. Moreover, while China's export performance in electronics may prima facie suggest that it is competing head to head with Korea for instance, a look at more finely disaggregated data shows that China and Korea have comparative advantages in different sub-sectors. The evolution in the US market shares shows that China has been displacing Korea in consumer electronics and to a lesser extent in computer equipment,[10] while Korea is still largely dominant in electronic components, together with Malaysia. Interestingly enough, both China and Korea have increased their market shares in the telecommunication equipment sector.

Third, as emphasized by Weiss and Shanwen (2003), China's gains of market share in the US market must be assessed in association with the previous observations about the rise in intra-regional intra-industry trade. These gains are to some extent misleading because they are due to exports of some assembled parts and components originally produced in neighboring East Asian economies. This is particularly true in the electronics sector where China's production and exports of information technology hardware (primarily computer equipment) are based on imports of high value-added parts and components originating from emerging Asia (Korea, but also Taiwan, Singapore, Malaysia or even the Philippines).[11]

10) Actually, China's US market share gains in labor-intensive products should not come as a surprise and should not necessarily be deemed to be negative. It is a simple reflection of the shift in comparative advantages as described in the flying geese pattern of economic development.

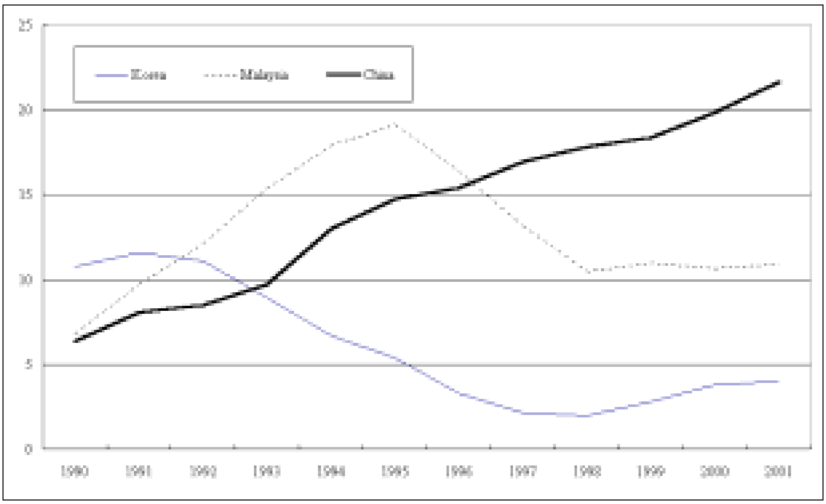
11) Electronic components account for more than 40 percent of Malaysia's and the Philippine's total exports to China, while it accounts for 32 percent of Singapore's exports to China.

Figure 7.　US Import of Electronic Components by country of origin, 1990-2001



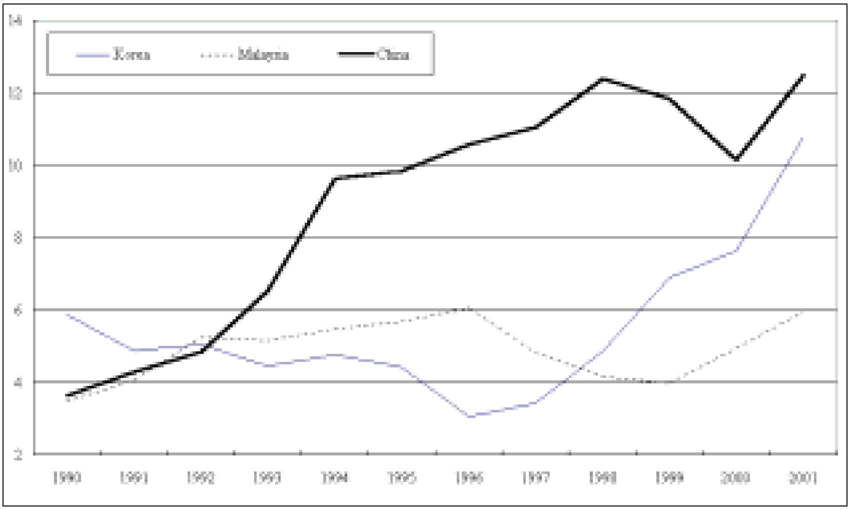
Source: CEPII, CHELEM.

Figure 8.　US Import of Consumer Electronics by country of origin, 1990-2001



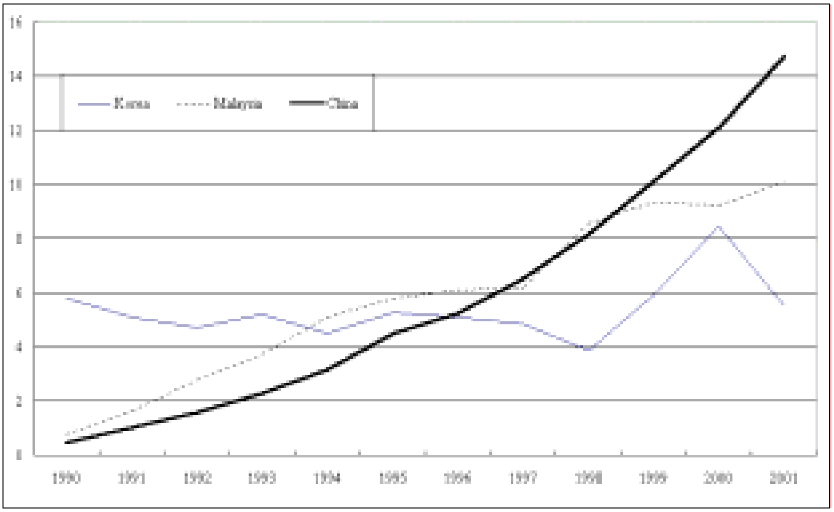
Source: CEPII, CHELEM.

Figure 9. US Import of Telecommunication Equipment by country of origin, 1990-2001



Source: CEPII, CHELEM database.

Figure 10. US Import of Computer Equipment by country of origin, 1990-2001



Source: CEPII, CHELEM database.

The high import-intensity of Chinese exports provides a good reason to be less sanguine about China's export performances. In this respect, making use of the standard classification by technology level to assess China's performances may be somewhat misleading. High-tech exports do not equate high value-added exports. As suggested by Gaulier *et al.* (2004), the high-tech content of China's exports can be explained by its high-tech imports. And an overwhelming share (70 percent) of China's high-tech imports originates from neighboring Asia in 2002. It thus remains to be seen whether China's shift away from low-tech production into hi-tech products is more than an optical delusion.

The parallel drop in East Asian economies' US market share and increase in exports of these economies to China is indicative of the fragmentation of production processes and of the new regional division of labor, with assembly activities migrating to low-wage countries, while higher wage (and better-skilled) countries specialize in the production and export of components. The close correlation between the fluctuations in Chinese exports to the US and in East Asian exports to China further supports the hypothesis that China is being used as an export-processing zone (Zebregs 2004). At the aggregate level, Chinese exports and East Asian exports appear to be quite closely correlated, suggesting that they may be subject to common shocks but also that their productive structures are complementary.[12] The complementarity

12) As a result of this complementarity, the rise in exports to China may more than offset the market share losses in third markets. See Ahearne *et al*. (2003) or Eichengreen *et al*. (2004) for further evidence on this point. While the former fail to find a statistically significant impact of Chinese exports on East Asian exports, thus concluding that there is no evidence that increases in China's exports reduce the exports of other emerging economies, the latter show, through the use of a gravity model, that the rise in China's exports – and

assumption is further supported by the observed rise in the complementarity index among Northeast Asian economies, in particular between Korea's exports and China's imports (Nam 2004).

Finally, China's gains in market share require a further qualification: the bulk of Chinese exports are due to firms relocating from neighboring economies losing market share. In other words, in addition to being import-intensive, China's exports are mainly driven by FDI, most of which originates from Asia.[13] Indeed, Asian firms rank high among the export-oriented foreign firms, while Western MNCs tend to seek to target the domestic market. This means that while a number of East Asian economies lose direct export competitiveness, their firms preserve and extend their competitive advantage and actually benefit the home country by promoting exports of intermediate products and related design and marketing activities and remitting dividends. This is certainly the case for Korean firms, whose drop in US market shares results to a large extent from the fragmentation of production and from their relocation in China. As a result, these firms now export from their Chinese production bases rather than from their home country's production bases.[14]

There is no doubt that China's export structure has undergone a dramatic change, with a shift away from agricultural products toward

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imports–positively affects the exports of its high-income neighbors but negatively affects the exports of less developed countries in the region.

13) This remark concurs with C-H Kwan's observation that we need to distinguish between "made in China" and "made by Chinese" or "what China produces" and "what Chinese produce" (Kwan 2004). For a sobering assessment of the China's miracle, see Gilboy (2004).

14) By way of illustration, Samsung now produces about 30 percent of its PCs in China.

manufactured products as well as machinery and transport equipment. Yet, as emphasized by Kim and Lee (2003), the rise in Chinese high-tech exports is almost exclusively due to foreign-owned or joint venture firms (coming primarily from Asia) that are present in China to take advantage of its low labor cost. According to China's Customs Statistics, multinational companies (or foreign affiliated firms) account for more than half of total Chinese exports and far more of its high technology exports.[15] Both imports and exports of high-tech products are mostly carried out by foreign affiliates. Moreover, China's high-tech imports from Asia tend to be even more biased towards foreign affiliates. The shift in China's comparative advantage is thus largely FDI-driven and the apparent upgrading of China appears to be almost exclusively limited to the production and export bases created in the mainland by Asian firms.[16] In this respect, the situation in China is quite comparable to that of Malaysia and differs substantially from the Korean case.[17] Yet, although China's growth can be said to be highly dependent on MNC dominated assembly activities, in contrast to other economies such as Malaysia, China is likely to be in a better position to take advantage of FDI and allow for technology transfers to throughout the economy, as will be argued below.[18]

Despite the previous qualifications, in a longer-term perspective, the rising competition from China is likely to intensify in the future for

15) Foreign firms also account for about 60 percent of China's imports (Hale and Hale 2003).

16) For more empirical evidence on this point see Gaulier *et al*. (2004).

17) See Kim and Lee (2003) for a similar point.

18) The lack of backward linkages with local component suppliers is often pinpointed as a major weakness of Malaysia's industrial development.

countries such as Korea, as China manages to engage into higher value-added production. This is already a matter of concern, and rightly so as there is already evidence of deepening of local content and even design and development activity in China. Yet again, this source of concern should not be overblown as local content may be raised thanks to foreign affiliates acting as part suppliers.

It follows from the previous remarks that the rise of China can be deemed for the time being to be more a boon than a bane for most emerging Asian economies, with Korea as a case in point. As the fastest and the most steadily growing economy in the region (and even in the world), China has been an important export market and a major contributor to sustained growth in other economies of the region, in particular Korea. Yet, these countries should try their utmost to reap the benefits from this new state of play. In the medium-term, competition from China may get increasingly fierce as China climbs the technological ladder and stops importing intermediate products and shifts away from mere assembly activities towards higher value-added activities. More than a threat, the rise of China and the competitive pressure it exerts on neighboring economies constitutes a major challenge, imposing necessary (and possibly costly) adjustments.

3. The "huge sucking sound" from China: is it for real?

Another oft-mentioned source of concern relates to the rise of China as a major magnet for FDI. As a result of this new state of play, countries may either be faced with the risk of FDI diversion or with the risk of "hollowing out" following massive relocation of labor-intensive production activities. ASEAN countries may be more likely to face the former risk, while the second applies to relatively more advanced countries such as Korea.[19)]

Table 2. FDI into China by source country, 1983-2002

(Unit: percent)

	1983-1991	1992-2002	1983-2002
Hong Kong	58.7	45.1	45.8
Taiwan	0.0	7.6	7.2
Singapore	1.2	5.0	4.8
Japan	13.4	7.8	8.1
Korea	0.0	3.6	3.4
Sub-total	73.1	69.1	69.3
United States	11.1	8.8	8.9
Virgin Islands	0.0	5.7	5.4

Note: Data for realized FDI.

Source: *China Statistical Yearbook*, various issues.

FDI into China tends to be dominated by Asian investors,[20)] while US, EU, and Japanese investors account for the bulk of FDI into ASEAN. There is no doubt that FDI inflows have soared to China, while they

19) In this respect, the Korean situation is comparable to that of Japan. The sharp contrast between the economic performances of Japan and China has led many people in Japan to perceive the rise of China as a threat (Kwan 2004).

20) The importance of (mainly Asian) FDI inflows to China may be inflated to some extent by "round tripping," that is Chinese companies moving funds out of China to Hong Kong or other tax heavens and returning to China as FDI to take advantage of preferential tax treatment (Chia 2004). On the other hand, however, FDI originating in the Virgin Islands can be expected to be to a large extent of Taiwanese origin.

tended to decline in the direction of ASEAN. Yet, as was the case with Mexico at the time of the implementation of NAFTA, the "giant sucking sound" has been widely overblown.[21]

The situation is quite different for Korea. While the country was relatively closed to FDI in the past, the outbreak of the financial crisis in 1997-98 marked a turning point and foreigners are nowadays allowed to enter in basically all sectors of economic activities.[22] Because of its status as a relatively new destination for FDI and because of the discrepancy in development levels between China and Korea, the risk that FDI may flow away from Korea to China is quite slim. Yet a persistent lack of attractiveness associated with burdensome regulations and a sluggish economic environment may not be to Korea's advantage. By contrast, Korean investors have been very active in China for a long time, and increasingly so since Korea began to recover from the financial crisis. The resurgence dates back to the year 2000 with a rise of more than 75 percent compared to the previous year. Korea may merely rank 7 among the foreign investors in China, quite far behind the US, Japan or Taiwan, yet viewed from a Korean standpoint China ranks among the top destinations for ODI. In 2003, China overtook the US as Korean investors' preferred destination for FDI. As a result of this particular situation, rather than losing FDI to China, the risk for Korea is that of industrial hollowing out.[23]

A look at investors' motivations is warranted in order to gauge the potential for hollowing out. While Korean ODI flows resumed in the

21) For more details on this point see Chantasawat *et al*. (2003) or Wu *et al*. (2002).

22) See Nicolas (2003) for a detailed account of the evolution of Korea's approach to inward direct investment.

23) The expression is being used here in a loose way, basically referring to the relocation of industrial activities abroad, leading to massive job losses.

direction of China, there was also a shift in the type of investors involved and, as a result, in their motivations. According to Lee and Kim (2004), Korean FDI to China took place in three stages.[24)]

The first stage, from the late 1980s to 1994, was dominated by SMEs' relocating labor-intensive activities in China so as to take advantage of cheap labor. It was also characterized by a sharp rise in exports of intermediate goods to China, suggesting that FDI and trade were complements rather than substitutes. Moreover, the main objective of these SMEs was to export low-cost manufactures to third markets. They thus contributed to boosting China's exports as they re-exported large amounts of their finished goods to third markets such as the US and the EU.[25)] Korean FDI in China at that time was primarily intended to help keeping afloat firms that were losing price competitiveness. The flip side, of course, is that some jobs may be lost in the process, but they were doomed to be lost as a result of declining competitiveness. This type of FDI cannot be said to be negative but simply the result of adjustment to shifting comparative advantages (Kwan 2004). To some extent, the relocation of Korean firms in China can be seen as the price to be paid first to maintain the competitiveness of some of these firms, and second for the large trade surplus with China.

The second stage from 1994 to 1998 featured chaebols' investment in capital-intensive activities targeting both the local Chinese market as well as outside markets. Such market-seeking FDI may be negative (in the sense that it may not give rise to an optimal allocation of resources) if

24) See also Shumei (2003) and Fung *et al*. (2004) for accounts of Korean direct investment in China.

25) In this respect, SMEs and large conglomerates seem to differ: while the former are motivated by China's low production costs and seek to improve their export competitiveness, the latter are mainly attracted by the huge Chinese market (Shumei 2003).

the objective is to jump over tariff barriers for instantce.[26] Such investment may indeed result in hollowing out, displacing productive activities, which should have been maintained in the country of origin. In the case of Korean chaebols' investment in China it seems that the objective was not primarily tariff jumping (even if such may be the case to some extent for carmakers' investments) but rather the desire to get a foothold in a potentially huge market and to be in a better position to penetrate this market by using the advantage of proximity to the consumers. As a result, the impact cannot be deemed to be fully negative either.

In the most recent stage, which started with the recovery in 1999, both SMEs and chaebols have been active investors in China, the former acting as sub-contractors to the latter. The SMEs thus choose to relocate to China in order to avoid being squeezed out of the market by Chinese producers. Here again, these moves cannot really qualify as hollowing out, since these firms would have for sure lost their place in the Chinese market if they had decided not to relocate. These firms are, however, encountering a number of difficulties to maintain their competitive edge over their local rivals. As a result, the number of bankruptcies has been on the rise lately.

Despite the difficulties encountered by some firms, Korean FDI into China still contributes substantially to increasing Korean exports to China because China-based Korean firms (mainly SMEs, but not only) import intermediate goods and components in large amounts from their

26) As pointed out by Kwan (2004), this is the case in the automobile sector where foreign producers are faced with import restrictions hampering their exports to China. With the recent rise in Korean auto-makers' involvement in China, the risk of a similar misallocation of resources is also quite large.

home country. According to a study commissioned by the Korea EXIM Bank, an investment of $1 promoted exports of goods worth $1.55 and offset the trade deficit by $1.11 (Ha 2004).

There are further reasons not to deem the expansion of Korean FDI to China as a negative development. In particular, a number of surveys suggest that Korean firms tend to keep producing at home the most sophisticated intermediate goods and export them to their affiliates located abroad. Until now, the share of procurement of intermediate goods from the home country is sufficiently high for the risk of hollowing out to remain limited. Korean producers tend to merely relocate those segments of production in which they have definitely lost competitiveness while maintaining higher value-added activities at home. This relocation process is a natural phenomenon, which is perfectly in line with the exploitation of comparative advantages, and should thus not be deemed to be negative, provided it is compensated with the emergence of more high value-added production (Nam 2004). In this respect, there seems to be less risk of hollowing out for Korea than for Taiwan for instance. In the latter case, the goods produced in China by Taiwanese affiliates are in direct competition with Taiwanese exports, while such does not seem to be the case in the former.

Yet, as in the case of trade competition, the current situation cannot be expected to last forever. There are already signs of China's upgrading, despite all the caveats mentioned earlier, and it is certainly time for Korea to prepare for fiercer competition from China. In a longer-term perspective, it is worth stressing that China may be in a particularly good position to take advantage of FDI,[27] in addition to

27) At least in a better position than countries such as Malaysia, which is also quite heavily dependent on FDI. By contrast to Malaysia, the quality of

being able to attract large inflows, thus allowing China to further raise its competitiveness. There is thus a risk that FDI can be used by China as a means of upgrading or moving up the technological ladder. Ironically enough, foreign firms can be held responsible both for China's export boom as well as for upgrading its exports. By so doing, they may have created a new Frankenstein's monster, which may be gradually getting out of control.

The sustainability of former development strategy is being challenged. Even if the imposed adjustment should be welcome by Korea as a good incentive to upgrade its industrial basis and to shape up its economy, what may be problematic is the speed at which restructuring has to take place. In particular, an excessively abrupt restructuring process may turn out to be socially extremely costly.

4. China's rise as a regional leader

In addition to being at the center of regional production networks (thus contributing to the growth of intra-regional trade and FDI links and to the overall economic growth of the region), China has also risen as an active promoter of regionalism, particularly since the Asian financial crisis. Thanks to its stellar economic performances, China has been seeking lately to increasingly play the role of a regional leader, thus

China's human capital is often believed to provide an environment that may be particularly favorable for the development of positive spillovers from FDI. At the same time, however, the poor quality of the financial sector (particularly its fragile banking system) may work in the opposite direction. It remains to be seen whether China will be able to make the transition from a MNC dominated economy to a technological powerhouse.

leading to a shift in the balance of economic power in the region. This has a number of implications, first a potential rise in the Sino-Japanese rivalry, and secondly a new pattern of possible economic coalitions in the region. The more assertive stance taken by Chinese authorities in the region cannot be ignored by its neighbors, which now have to account with this new partner.

Various initiatives taken by China reflect this change and probably the country's resolve to become a regional leader instead (or ahead) of Japan.[28] The first initiatives date back to the 1997-98 financial crisis, when China actively publicized its refusal to devalue the renminbi, allegedly in order to protect its neighbors from a new round of contagious devaluations. At the same time, Beijing also provided some financial assistance to ailing economies such as Thailand and Indonesia, as a way of showing its rising sense of solidarity.[29] China also contributed to initiate the ASEAN+3 mechanism (involving the 10 ASEAN countries, as well as China, Japan, and Korea) and gave its support to the so-called Chiang Mai initiative (CMI), which provides a general framework for financial cooperation in the East Asian region.[30] More recently, Chinese officials kept trumpeting that their refusal to let the renminbi appreciate was motivated by their concern about the possible negative impact this may have on neighboring economies. This move was again meant to be interpreted as being not only in China's

28) See Hale and Hale (2003).

29) Although the amount may have been symbolic, the gesture was meant to be perceived as amicable. See Vatikiotis (2003) for more details on this point.

30) Interestingly enough, China did not support Japan's proposal for the creation of an Asian Monetary Fund in 1998. The shift in China's stance may be explained by its desire to act either as a leader or collectively, rather than simply as a follower behind Japan.

interest but also in its partners' interest, since a revaluation could be expected to lead to a drop in exports and thus to have a negative impact on the rest of the region as well, given the tight economic relations now in existence in the region. These moves all point in the same direction and are clearly aimed at proving China's amicable stance towards its neighbors.

The China-ASEAN FTA (CAFTA) is probably the latest and most dramatic example of China's new regional policy. Zhu Rongji first proposed the possibility of a CAFTA at the ASEAN+3 leaders meeting in Singapore in 2000, and official negotiations started in November 2001.[31] The framework agreement on Comprehensive Economic Cooperation was signed a year later, formally launching the process of establishing a CAFTA by 2010 for the most advanced ASEAN member countries and by 2015 for the others (Cambodia, Myanmar, Laos, and Vietnam).

Under the agreement, the first phase of a free market comprising a quarter of the world's population – 1.7 billion people – and an overall nominal GDP of 2 trillion dollars will be completed within eight years. Yet, under the so-called "early harvest provisions" (EHP), tariff reductions on a broad range of goods[32] are set to begin sooner. The far-reaching commitments made by China to open domestic sectors (such as agriculture and financial services) that are important to neighboring trading partners should allow them to gain from China's sustained

31) There is disagreement among researchers about the reason for this Chinese initiative. Some authors see it as a defensive move in response to Japan's proposed FTA with Singapore, while others consider that China acted on its own (See the debate between Tsugami and Lincoln, *RIETI policy debate*, 2003).

32) These include meat, fish, dairy products, fruits, and fresh vegetables.

growth. Yet overall, China can be expected to gain most, be it only because of the imbalance in the partnership.

The official motivation of the agreement is to take advantage of complementarities and build on existing strengths in order to make the region collectively more efficient and competitive, and to attract investment.[33] Yet, additional considerations certainly motivated the initiation of the scheme.[34] Through this agreement China is trying to quiet its weakest (and most vulnerable) neighbors' concerns that it is swooping up the lion's share of regional foreign investment by allowing them to export their goods to the expanding Chinese market. At the same time, it may also be seeking to defuse criticisms by industrial countries (and thus potential trade conflicts). The agreement may also be considered as a necessary strategy to preserve outlets for its production. Through this agreement China is also pushing its strategic and political interests in the region. Chinese officials have actually made quite clear their desire to extend cooperation with ASEAN into the security sphere.

Besides the strategic move to signal China's interest in Southeast Asia, the implications of such an agreement may be far-reaching. For both sides, there should be net trade gains: trade creation would offset trade diversion with ASEAN getting a slight trade diversion while the same trade diversion would not be obvious for China. With China's strong growth, it seems that China would require more input imports and ASEAN could provide an alternative source of inputs for natural-resource based and intermediate inputs in an FTA. Both ASEAN and

33) Political (or strategic) motivations may actually dominate economic con siderations (Sheng 2003).

34) China's entry into WTO clearly makes this strategy less costly.

China's hope to prosper will be intricately linked to their outward orientation and the role of developed countries to open up more opportunities, thus providing a firmer foundation for growth and stability.

From a Korean perspective, China's attempt to impose a China-centered form of regionalism has major implications. The country is getting increasingly isolated as well as more evidently squeezed between two major rivals, China and Japan. This new state of play cannot be ignored by Korea in the definition of its regional policy.

To sum up, for Korea, the rise of China and the resulting changes in the competitive regional game means first more trade flows and a deeper integration in regional production networks. It also means more investment opportunities (rather than a risk of investment diversion, unlike what Malaysia or Thailand may experience) despite a slight risk of hollowing out.[35] At the same time, China's more assertive diplomatic stance in the region raises a further challenge for Korea, which has to face the rise of a new Sino-Japanese rivalry, and the emergence of new economic coalitions. While the former effects tend to point to China as a stabilizing force, the latter suggests that some form of tension cannot be excluded. Moreover, the relatively positive impact of China's rise in terms of trade and investment opportunities is unlikely to be long lasting as China moves up the technological ladder. As a result, Korea

35) At the same time, the rise of China and the resulting intensification of intra-regional trade and investment also mean that US-Korea economic relations have weakened since the early 1990s. Although the US may still be the number one trading partner for Korea as a whole, it is no longer its top supplier or its top export destination. This necessarily has implications on the US-Korea relationship, but this question is beside the scope of the present paper.

has to take advantage of the relatively propitious current situation to pave the way for change and adjustment in order to be in the best possible position to face rising competition from China when it materializes. At the same time avoiding an excessive dependence on China is another challenge in the short term as well as in the long-term.

III. Responding to the Dual Chinese Challenge

By definition, a country, whatever its size, cannot have a comparative advantage in all industries. Despite the economic rise of China, neighboring East Asian economies will maintain comparative advantages in some areas. Of course, the problem is that the resulting specialization may not square with their objectives and lead to what may be perceived as a "downgrading" of their industrial base. In Korea, a widely shared concern is that there may be no supporting activities to fill the gap opened by activities leaving the country. The real challenge is thus to encourage the necessary adjustments that will help avoid such a development. As is always the case under such circumstances, the resulting adjustment costs will be more or less difficult to absorb or mitigate depending on the country's flexibility and assets.

The other aspect of the challenge is the speed at which adjustment is imposed on these economies.[36] One cannot deny that the rise of China imposes a much quicker transition than would have been the case otherwise. The real challenge for China's neighbors is to manage to find niche markets and to be flexible enough to face swift changes in comparative advantages imposed by the rapid intensification of competition from China. A particularly strong pressure can be expected in labor-intensive sectors such as textiles and clothing, footwear, toys, and plastic products.

36) But it must again be emphasized that the adjustment would have had to take place anyway.

The situation is particularly tricky for Korea, since the country has done relatively well so far and has even resisted better than any other country in the region to changing conditions imposed by the emergence of China on the regional scene. The risk is thus quite high that this result may lead to some complacency and reduce the sense of emergency. The rapid drop in the commitment to reform observed in the post-crisis period as soon as growth picked up again, suggests that this concern is not ill-founded. While panic is certainly not warranted, complacency should also be avoided.

In order to respond to the challenge, a number of options are open, which involves taking steps at the national as well as at the regional level. Moreover, the response will have to come from the government as well as from the firms. These various levels will be analyzed, in turn. Finally, with China now trying to take the lead in the regional integration process, Korea has to redefine its regional policy taking this new factor into account. This other dimension of the challenge is examined last.

1. Re-orienting Korean Firms' Strategies

A. Integrating China in the global value chain

Now that China has started to get integrated in the regional production networks, the challenge for neighboring countries' firms is to reposition themselves in the value chain, with China as their new partner. Korean firms have done it to some extent in the 1980s with the relocation of some activities in China by a number of SMEs. As emphasized by Rajan (2003), "seen through the lens of production sharing, the cost effectiveness of the PRC ought to benefit all countries that are part of the production network." Yet this requires maximizing the complementarities that may exist between China and its neighbors. As explained earlier, even if the real challenge is still to come, the positions held by Korean firms are likely to be challenged sooner rather than later by Chinese competitors. The only option left to the former is to anticipate the possible changes in the competitive setting and prepare for it.

The experience of most of the Korean SMEs, which moved first to China is quite revealing. These firms initially relocated in China looking for cheaper labor, and they were successful at first, managing to preserve their competitiveness through the use of cheaper inputs. Yet, this strategy seems to have reached its limits as the trend for localization (that is increasing the local content of production) has been gathering pace in China, as a result first of government pressures, and second of the emergence of competitive local producers. There is definitely a need for Korean SMEs firms to shift to a new strategy. Using China in order to extend the life of some of their activities by preserving cost-competitiveness should actually be giving them some breathing space and time to switch to a different production strategy. It is worth emphasizing at this stage that the strategy of pursuing low cost labor cannot be a viable approach in anything other than in the short term. As a next step, enhancing competitiveness is key, as a way of reaching more sophisticated and higher value added sectors of activities, and of maximizing the opportunities offered by the regional fragmentation of production processes. Korean firms should attempt to push vertical integration further, with Chinese partners as suppliers of cheap components. Production sharing arrangements are to some extent already in place, but they can certainly be further deepened and/or restructured.

In concrete terms, this means that Korean SMEs should invest in design and R&D in particular to be able to be more than mere sub-contractors to large foreign firms. In particular, the growth of low-cost contract manufacturing in China is forcing Korean firms to increase their ability to add value through manufacturing of leading-edge products or advanced product design capabilities. In other words, the challenge for Korean SMEs is to try to shift from working as contract manufacturers under OEM (original equipment manufacturer) arrangements to an ODM (original design manufacturer) strategy. Of course, the shift from contract manufacturing to ODM is a long-term transition that requires significant upgrading of engineering talent and related design and materials technology. Yet Korean firms are definitely in a better position to make that jump than firms in countries such as Thailand or Malaysia, which may find it difficult to upgrade their production capacities. In this respect, the experience of some Taiwanese firms may also be interesting to examine in more details. The key is to simultaneously develop further technological capabilities at home and make the best possible use of low cost facilities in China.

A further step still for some Korean SMEs could be to shift to an OBM (own brand manufacturer) strategy. This is the path successfully taken by Aurora World Co., the only Korean toy producer exporting under its own brand. As explained by Lee and Kim (2004), large investments in design and development capabilities as well as persistent efforts to establish a brand name account for the success of Aurora World.[37] The headquarters in Korea are still in charge of R&D and

37) Other successful examples of brand name development is Malaysia's Supermax rubber glove producer, who succeeded in creating a global brand and sells its

marketing, while they run factories in cheap labor abundant countries such as China. The core of Aurora's strategy was thus to maximize complementarities between the two economies, and even to create new complementarities.

Another interesting success story is Reigncom, one of Korea's MP3 device manufacturer. Struggling as an OEM in early 2002, with one of its major contractors in deep financial problem, Reigncom realized that being an OEM was a dead end. Moreover, the drop in prices of components and the emergence of cheap Chinese knock-offs had made MP3 basically a commodity. Reigncom thus decided to launch its own brand of flash-memory-based players under the name of i-River. The strategy is based on the idea that MP3 are not mere gadgets but fashion accessories, which implies substantial investments in design and marketing. Reigncom develops its innovative MP3 technologies in Korea, outsources the exterior product design to the U.S. (to the California-based industrial designer - Innodesign) and manufactures its products in China. I-River players now account for about a fifth of all flash-memory players sold in the US. This highly innovative company provides another good example of Korean firms' ability to move up the production and technology chain as China takes over more electronics manufacturing.[38)]

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rubber examination gloves in more than 85 countries, including the US (see FEER September 9, 2004). By contrast, Hyundai had to stop marketing its own brand computers in the US because people were puzzled as to why a car maker would want to sell computers (ADB 2003).

38) As result of this success story, other Korean groups such as LG Electronics or Samsung, which had missed the MP3 boat at the time, are trying to catch up and investing aggressively in innovative designs.

Rather than simply moving labor-intensive activities to China (and thereby triggering job losses in Korea), Korean firms should aim at making the best of China's strengths (primarily in labor-intensive activities)[39] while developing their own strengths based on an improvement of their technological capabilities. As a result, they can hope to become lead firms in their own right. There is, however, no point for them to try competing with Chinese firms in labor-intensive activities.

There are a variety of ways in which Korean firms can respond to the Chinese challenge. There are also different ways for them to participate in the regional division of labor and to interact with Chinese partners. They can concentrate on R&D or design activities without intervening in the labor-intensive part of manufacturing, they can take advantage of production conditions in China and retain control over the final product through a brand name strategy, or they can act as suppliers for local firms operating in the Chinese market. Another route still is to specialize in process-specific technologies that enable them to provide high quality, low-priced manufacturing and manufacturing-related services. Moreover, Korean firms can seize the opportunity offered by the Chinese challenge to regenerate once traditional competitive sectors, such as the textile industry. In this sector, there is definitely scope to capitalize on existing technological capabilities to venture into high-tech products for instance.

39) It must be stressed that China's competitiveness in labor-intensive activities can be expected to last due to the large excess labor in rural areas, which hold down wage increases in the industrial sector (Kwan 2004). Yet, according to some authors, the trend may be reversed sooner rather than later as a result of recent policies aimed at reducing large regional income disparities in China.

There is more than one upgrading path. The best approach will vary from one industry to the other and even within the same industry, different firms may opt for a different path, depending on their own capacities and assets. What should be clear, however, is that remaining at the same level of competence and technological development cannot be a viable option. Whatever the strategy, it remains key for Korean SMEs to maintain their price competitiveness and enhance their technological capabilities. In particular even if they continue to make products that will be sold under another label, they have to develop internal capabilities sufficient to invest these products with design and functional features allowing them either to command higher prices and/or to keep an edge on their competitors. The complementary pattern between Chinese and Korean firms is in constant flux, making it necessary for the latter to keep investing in knowledge, R&D and technological capabilities if they want to make the best of these complementarities. The process of upgrading is an open-ended one, which makes it a particularly daunting challenge.

B. Making the best of the Chinese market

Another avenue is to take better advantage of the Chinese market. Most Korean firms have so far primarily used China as a production base rather than as a market place. In these circumstances, the most promising strategy for them is to take the appropriate steps to be in a better position to penetrate the Chinese market. This involves investment in R&D as well as in marketing so as to adapt products to Chinese consumers' tastes. Due to the sizeable investments involved, this may be more appropriate a strategy for large groups than for SMEs though.

Although all the large groups operating in China seem to have been quite successful so far, this does not mean that no change should be envisaged. A number of authors point to some emerging difficulties having to do in particular with the type of management of Korean firms in China. Shumei (2003) stresses the need for changes to Korean chaebols' management systems in China so as to avoid recurring conflicts between Korean managers and Chinese employees. This involves such measures as the appointment of local supervisors. In this respect, Japanese and Korean affiliates are quite similar, and differ from Western affiliates, where Chinese account for a much larger share of the senior managers. According to a survey of Japanese subsidiaries operating in China, establishing a system of management by local Chinese employees is one of the most important strategies for success in the Chinese market. Korean firms may be well advised to follow the same path if they want to expand their local sales. Indeed, in addition to improving labor relations, localization of management can also be expected to improve speedy decision-making as well as facilitate the increase in local procurement thanks to a better knowledge of local market conditions and business practices.

It is worth emphasizing at this stage that accessing the Chinese market does not necessarily imply moving all stages of production into China. Korean firms can perfectly cater to the Chinese market through exports rather than through FDI. The choice between these two strategies should be based on cost conditions. Of course, other barriers may bias the choice in favor of local production, leading to a sub-optimal resource allocation. This is one of the reasons why the implementation of a FTA with China, which would go beyond tariff elimination, would be a welcome step contributing to a better allocation of resources.[40] In particular, it is not at all obvious that Korean carmakers made an optimal decision by setting up large production facilities in China. While this may be appropriate for low range goods, which can definitely be produced at better-cost conditions in China, such may not be the case for higher-end products, which may be produced more efficiently in Korea. Depending on the type of products, exports will have to be preferred over FDI.

Of course, in order to avoid being overly dependent on the Chinese market, the objective of Korean large groups should still be to maintain their global competitiveness so as to maintain and even increase their market shares in other countries, such as the US and the EU.

Finally, competitive Korean firms may also reap other opportunities offered by the Chinese market, such as in the energy sector.

2. Addressing Domestic Economic Weaknesses[41]

What concrete steps can the government take to help strengthen the capacity of both SMEs and large groups to participate successfully in the new regional division of labor and to be in the best possible position to respond to the Chinese challenge? The most important policies are those whose outcomes benefit all sectors of the economy: macroeconomic stability, a transparent and efficient financial system, confidence in public institutions, a pacified social climate, and a strong foundation of

40) This idea is taken up again and developed further in section III.3.

41) The following recommendations may appear very general and remotely related to the "China threat." Yet, it must be acknowledged that is the existence of the rising competition from China (or the threat of such a competition), which makes these weaknesses more problematic.

education and training. Beyond these general far-reaching measures, however, additional steps can be taken to address the specific capabilities of the supply-base but they should be kept to a minimum and be very precisely focused.

First, the Korean Government should definitely refrain from providing support to declining industries. As emphasized earlier, there is no point in trying to keep afloat labor-intensive activities in which Korea has definitely lost its comparative advantage to China. Moreover, the cultivation of vertically integrated national champions can no longer serve as a primary goal of industrial development policies.

As explained by UNCTAD (2003), key drivers of technological development are interrelated; for instance, advanced human capital and skills training are integral to R&D efforts and to absorbing technologies embodied in FDI, while the latter themselves introduce and develop new skills. The government when formulating policies for competitiveness must take the feedback effects between the drivers of technological development into account. This suggests in particular that the government has to consider a set of several interrelated policies rather than isolated and disjointed measures and try to maximize the possible feedback effects.

The major goal of public policies should be to create a favorable environment for the expansion of more high value-added activities. In Korea, at present, given the depressed domestic economic context, the real challenge is to design the policies that will help create the appropriate environment to catalyze the private sector. Among the priorities is the need to develop a knowledge-based economy. This involves investment in education, human capital development, R&D, and so on. These measures should first help Korea to be better able to attract FDI for instance, and secondly, be in a better position to make the best of such investments. Also, a sound macroeconomic environment is key for attracting foreign investors. Moreover, it is important to make sure that the financial needs of SMEs can be met adequately. This means that the functioning of the financial system should be further improved, with the development of local financial markets in particular. This is the only way that long-term finance for investment can be provided.

Another priority lies in the social sector. The government should take the necessary steps to avoid the widening of the rift between domestically oriented ailing SMEs and export-oriented prosperous conglomerates. There is a definite risk of increased dualism of the Korean economy, leading to social instability as well as a reduction in the potential to adjust to changes. To that end, a number of reforms related in particular to the pension scheme system, and to the social safety net in its entirety are needed. At the same time, social safety nets are also needed to help absorb or mitigate the adjustment costs imposed by the relocation of some production facilities in China, or by the elimination of sunset industries. All government policies that may ease adjustment are to be welcome.

A brief assessment of the Korean Government's "hub strategy" is in order at this stage. Over the past few years, turning Korea into a "hub" in East Asia has become the new national economic mantra. The objective is to make Korea a financial, business and logistical hub for the rest of East Asia. While, setting such an ambitious goal is nice and dandy, everything cannot be decided from the top, however. For this strategy to be successful, a thorough overhaul of the Korean economy is needed. Again, this boils down to shaping up the domestic economy. In the absence of accompanying measures (including sound macroeconomic policies, structural reforms, pursuit of the reforms of the financial sector, etc) this strategy is unlikely to succeed. This initiative can be compared to the EU strategy of turning Europe into the most competitive knowledge-based economy in the world (as described in the Lisbon agenda 2000), which was not followed by any concrete steps and has remained a dead letter so far. Despite a number of assets, Korea is plagued with problems, which may undermine the feasibility of the whole scheme. The rigid labor market and militant unions, less than transparent markets and corporate operations are often quoted as major stumbling blocks on the road to global competitiveness. Moreover, while the financial hub project was very much in the headlines some time ago, it seems to have been removed from the Government's list of priorities with little visible progress.

As recalled earlier, targeted measures may also help enhance the country's competitiveness. In this respect, the Government-initiated "Next ten generation growth engines" scheme[42] probably goes in the right direction. These industries are expected to propel the country's economic growth in the future. Under the five-year project, the Government and private organizations will invest a total of 3.5 trillion won ($3 billion) into research and development projects for the 10 industries. Yet an important concern should be to ensure that the scheme is consistent with Korea's commitments in various international institutions such as the OECD or the WTO. In other words, the program should not lead to

42) The ten industries are intelligent robots, future automobiles, non-memory semiconductors, digital televisions and broadcasting, next-generation mobile telecommunications, display devices, smart home networks, digital content and software, next-generation rechargeable batteries and biomedical products.

eavy public subsidization but ensure that private companies undertake the bulk of the R&D effort.

The positive aspect of increasing competition from China is that it gives a new momentum to technological upgrading and provides a strong incentive to implement badly needed (and overdue) reform. Yet it is important to avoid blaming it all on China. Actually the reason for the lack of attractiveness of Korea compared to China and for its present weak economic performances has more to do with domestic characteristics than with anything else. Of course, the impact of rising competition from China is all the more detrimental since the capacity to respond is weak, but it is key to acknowledge that the solution to the problem has to come from the domestic side.

3. Korea's regional strategy

A. A Japan-Korea FTA, an obvious response to China

Korea's economic security and independence appear to be somewhat threatened by the industrial rise of China as well as by the launch of the CAFTA. The aim of a free trade area is to reduce mutual trade barriers among member states and to remove other non-tariff barriers step by step, while protectionist policies against non-member countries are still retained. In essence, any forms of free trade scheme involve agreeing and implementing a set of measures to ensure economic exclusivity. As a result, those excluded from the agreement will by definition be discriminated against. This is the main fear of Korea with the emergence of a CAFTA.

The negotiation of the CAFTA has basically left Japan and Korea with no other choice than to team up. Due to the proliferation of FTAs all over the world, not being part of any arrangement is necessarily costly because of the resulting discriminatory treatment. Indeed, the major explanation for the RTA dynamics in East Asia lies in what Soogil Young calls "the extended Vinerian motive to avoid trade and FDI diversion resulting from exclusion from RTAs."[43)]

It is often believed that unless Japan and Korea enhance their competitiveness through a bilateral FTA, they could easily be overwhelmed by China. For these two countries, the natural response to the rise of China is thus to team up against their big neighbor. Japan itself apparently considers an FTA as a possible response to the rise of China (Cho 2004).

Prima facie, however, it may appear paradoxical to advocate a Japan-Korea FTA since such an agreement can be expected to have relatively negative effects on Korea, at least in the short-term and would thus compound further the difficulties already raised by the rise of China.[44)] All estimations concur that the lifting of trade barriers between Korea and Japan would lead to a surge in Japanese exports to Korea in a number of sensitive sectors such as the automobile, machinery and

43) Quoted in Kim and Lee (2003).

44) As a result, Japan has shown much more enthusiasm toward the JKFTA than Korea has. The main concern in Korea is that the elimination of tariffs would increase its structural trade deficit with Japan. There may also be the fear of China's reaction. Given the increasing dependence of Korea on China, it certainly cannot ignore its position. The experience of the post-crisis IMF-imposed termination of the import diversification program (the objective of which was to discourage imports from Japan) and the resulting surge in Japanese exports to the Korean market provides a good reason for the public to be worried. As a result, the deal may be difficult to sell politically to the public.

electrical products. By contrast, Korea can be expected to gain in apparel, leather products, agricultural (fishery) products, steel and petrochemicals. This is because Korean tariffs are still about 7.9% on average against Japan while Japan's tariffs are a mere 2.9%.

Korea has a systemic trade deficit with Japan because it is still heavily dependent on Japan for a whole array of high tech components. The immediate result of the JKFTA is likely to be a further widening of this deficit. This is why the scheme is facing resistance from a large fraction of the business sector,[45] especially consumer goods manufacturers, and small and medium-sized parts manufacturers. Smaller industries and consumer products manufacturers will naturally experience erosion in their market share at home as a result of rising imports of Japanese goods of better quality.

Yet in a longer-term perspective, the agreement can be expected to yield positive results. In particular, the rising competition from Japanese products will inevitably compel Korean producers to focus their efforts on enhancing the quality of their goods.

It is worth stressing at this stage that for the Japan-Korea FTA (JKFTA) to be beneficial for both countries (particularly for Korea) it has to encompass a broad spectrum of issues, otherwise, the only result will be a deepening of Korea's trade deficit with Japan (Ahn 2004). The implementation of a comprehensive agreement would indeed involve other important benefits, in the form in particular of a rise in service trade and dynamic effects through a new division of labor and industrial cooperation. The JKFTA should thus not be only aimed at tariff reduction. Competition may indeed be increased but so will be

45) In contrast to what is usually observed with FTAs projects, the main resistance will not come from the agricultural sector but from the industrial sector.

intra-industry trade. Strategic alliances for a more sophisticated division of labor may also be possible, as well as restructuring of over-capacities. To some extent, this is what the European economies sought to do with the creation of the Single Market in 1992. At the time, the major objective was no longer to abolish tariff barriers but to create a genuine single market that would allow firms to reap the benefits from economies of scale, thus easing the necessary restructuring of a number of industrial sectors, which had lost competitiveness to foreign, in particular Japanese, rivals.[46]

A good reason for Korea to go ahead with a JKFTA is that it may provide an external pressure to push with reforms, restructuring, and so on. The major positive impact of the JKFTA would be to help ease reform, impose adjustments, in other words, external pressure can be used as leverage. Korea is still far too protectionist and change is badly needed. Trade liberalization will expose low-productivity sectors to external competition and force them to change. Increased competitive pressure will be brought to bear on consumer goods manufacturers and SME parts manufacturers, compelling them to focus efforts on enhancing quality, efficiency, and so on. The JKFTA can thus be seen as an instrument to drive economic reform.

In this respect, Japan and Korea are in similar positions: both countries tend to be plagued with inertia in their economic systems, hampering the progress of deregulation. They thus need the type of external pressure that is brought about by the dynamic cross-border movement of management resources such as people, goods and money

46) In the late 1980s, Europe was going through a period of sluggish economic activity, which has come to be known as "eurosclerosis." The Single Market scheme, which came into existence in 1992 was a response.

under an economic cooperation agreement (Fukagawa 2003).

The major difficulty facing the Korean Government is how to sell the agreement to the public and how to mitigate the short-term (primarily social) impacts. This obviously provides a further rationale for a swift and thorough reform of the social safety net mentioned earlier.

B. Beyond the JKFTA

While going ahead with a Japan-Korea FTA may be a rational and advisable strategy for the reasons highlighted above, the strategy has to be assessed taking into account the regional context and the possible implications it may have on the two countries' neighboring economies.

A purely defensive type of regionalism should definitely be avoided, be it only because it would necessarily be associated with the lack of a clear vision. The JKFTA may have started on this basis, but it is important to turn it into a more positive agreement. In particular, the objective should definitely not be to use any kind of regional scheme against China. As a result, it is important for Japan and Korea to design their FTA with a view to its extension to other countries in the region.

Even if the possibility of an East Asian FTA has been actively discussed at various ASEAN+3 meetings, concrete steps are still to be taken in this direction. For the time being, the two most advanced projects are the CAFTA and the JKFTA.[47] A major issue is to determine how these two groupings may relate with one another and how they interact. In this respect, the European experience may hold interesting lessons in store. It suggests that the coexistence of different (and to some

47) A Japan-Singapore FTA is already in existence, and a Korea-Singapore FTA is currently under negotiations, yet because of their size these agreements cannot be compared to the two other arrangements.

extent rival) regional groupings in the same region is unlikely to be long lasting. In Europe, two regional groupings were formed in the late 1950s, the European Communities[48] and the European Free Trade Association (EFTA). Very soon the success of the former over the latter led a number of EFTA member countries to seek accession into the EC, while the remaining EFTA member countries eventually established a FTA with the EEC. After a decade and a half, the two groups had collapsed into one, with the most complete and well-structured group prevailing over the other looser grouping. This experience suggests that the modalities of regional arrangements matter.

In East Asia, the nature of the two competing FTAs differs widely. Because Japan and Korea are both members of the OECD, the JKFTA will have to be consistent with the WTO.[49] By contrast, the CAFTA was negotiated under the enabling clause provision rather than Article 24 of the GATT. As a result, the JKFTA is more likely to provide an appropriate starting point for an East Asian FTA than the CAFTA. Yet, for this to be the case, it is important for Japan and Korea to provide a benchmark framework for a Northeast Asian FTA (encompassing China, Japan, and Korea) and eventually an East Asian FTA (including ASEAN+3 countries).

Two important objectives should be kept in mind. First, Japan and Korea should design their agreement with the objective of a future

48) In its initial form, it encompassed six member countries: the three Benelux countries, France, Germany, and Italy, while the EFTA was made up of seven countries: Austria, the UK, Denmark, Ireland, Norway, Sweden, and Switzerland.

49) In the context of WTO rules, FTAs must cover “substantially all trade,” and zero duties should apply across the board to all sector. In other words, there should be no a priori exclusion of any sector or sensitive product.

enlargement in mind. This would be a good way of not antagonizing China, and the two countries would be eventually in a better position to attract the other countries in the region. Second, the agreement should be designed to be exemplary.

Beyond pushing for an "open" JKFTA, Korea should also enter in parallel negotiations with China and/or ASEAN,[50] but these two negotiations may have to proceed along different lines.

It is unlikely that Japan and Korea can engage jointly in negotiations with China in the near future, as a result, it is certainly in Korea's interest to go ahead with bilateral negotiations with China. Actually, for Korea's reform strategy, as described above, to be fully successful, the implementation of a Korea-China FTA would certainly be a further asset. Removing trade barriers with China would obviously contribute to a better exploitation of the market as well as to a better allocation of resources, helping in particular to maintain more sophisticated activities in Korea rather than relocating them systematically in China in order to circumvent trade barriers. Pushing for free trade with China is certainly a promising strategy since it should help enhance production-sharing arrangement. A number of voices indeed advocate the establishment of some sort of PTA with China in order to exploit the growing and potentially huge Chinese market and turn China from an export-processing zone to a large market place. In this respect, the snag is that Korea obviously does not constitute a priority for China. China has launched a partnership with ASEAN and is about to launch a number of other initiatives with a number of resource-rich countries such as the Gulf Cooperation Council economies or Central Asian economies

50) Both a Japan-ASEAN FTA and a Korea-ASEAN FTA are at the joint study level but are expected to enter the negotiation phase in 2005.

(under the so-called Shanghai Cooperation Organization–SCO).[51] China may have launched a dialogue with Korea as well as suggested to further examine the implications of a CJKFTA, one can reasonably argue that these various moves aim primarily at holding the JKFTA in check. According to a number of authors, China is relatively hostile to the JKFTA and it is concerned about the potential negative effects on the Chinese economy (Cho 2004).

Moreover, for Korea, the negotiation of a China-Korea FTA would automatically meet a strong opposition from the agricultural lobby. Opening up the Korean agricultural sector to competition from China would certainly prove to be extremely costly for Korean agriculture.

Theoretically, the rise of China and the resulting intensification of the Sino-Japanese rivalry should have given Korea an edge. The leadership problem that it entails may constitute a major obstacle on the road to deeper integration as well as add a need for collective action. It is this paradox that may give Korea a key role in the regional integration process. Yet the margin of maneuver seems to be extremely narrow. Korea is often considered to be like a shrimp between two whales. It should certainly try not to play one against the other at the risk of getting crushed. Ideally Korea should be able to act as a go-between but it may not be given the opportunity to do so. A NEAFTA or a partnership would probably be the most appropriate solution for Korea, but it seems unlikely to materialize soon.

By contrast, pushing for a Japan-Korea-ASEAN FTA may be a more realistic strategy. At a minimum, if Japan and Korea cannot negotiate

51) While the organization was initially aimed at addressing territorial and military issues, it has recently shifted to a wider range of issues, including regional trade.

jointly with AFTA, they should coordinate their FTA policies with other East Asian countries. Yet, rather than planning separate FTAs with ASEAN, Japan and Korea should probably first finalize the JKFTA and then seek to jointly enter in bilateral negotiations with ASEAN, or with individual ASEAN member countries.

There are other areas in which Japan and Korea can seek to engage their neighbors so as to deepen cooperation beyond existing de facto interdependence. In particular, an important move for Japan and Korea would be to get China to partake in a trilateral investment agreement, encompassing investment protection and liberalization, as well as transparency, national treatment, and so on.

A final remark provides a further incentive for Korea to push for a broad East Asian integration, rather than small competing groups. As shown earlier, the increasing participation of China in regional production networks has created a complex web of economic linkages and given rise to tighter interdependence within the region. This new state of play provides a renewed incentive to push for exchange rate coordination, but also to push for the deepening of economic policy monitoring as envisaged in the surveillance mechanisms of the CMI. This is particularly important since the risks of instability[52] are far from negligible in China. This form of cooperation may actually be more urgent than any kind of FTA. From Korea's point of view, the priority should be to strengthen existing cooperative mechanisms in East Asia. Incidentally, this may pave the way for a broader East Asian FTA, if cooperation is conducted more systematically in other areas.

52) There are indeed quite a few factors of risk such as the rise in unemployment, which may fuel social instability, the sorry state of the financial system, or the widening regional income disparities.

IV. Summary and Conclusions

The rise of China has had two major impacts on the East Asian region, first it has substantially changed the competitive setting in the region, and second, it has given rise to the emergence of a potential leader additional to Japan. These two changes necessarily impose adjustments in other countries' policies, particularly for Korea.

As a result of China's active participation in the regional production networks, the degree of de facto economic integration has been rising dramatically over the past ten to fifteen years, making the fates of all the economies in the region much more closely intertwined. So far, Korea has managed to take advantage of this new state of play, first by acting as a major supplier (which incidentally has helped the country to continue recording decent export-based growth performances while domestic demand was stagnating), and second, by relocating part of its activities in the mainland, thus preserving the competitiveness of declining sectors. This may have contributed to some extent to the drop in domestic investment in Korea, yet, as emphasized earlier, other factors have certainly been at play.

From this perspective, the rise of China has been, for the time being, more an opportunity than a threat for Korea. Of course, this is a picture of the past and it is quite unlikely that this propitious situation will last forever. Even if Korea has resisted better than most other economies such as Taiwan or Singapore, complacency should be avoided. The game is far from being over and Korea needs to remain focused. Korea's challenge is to take the appropriate steps to enhance firms' competitiveness and help them make the best of the potentially huge Chinese market. The next step is managing to design an appropriate strategy that maintains a competitive edge. Beyond specific micro strategies, such as brand name promotion, or niche market strategy, Korean firms also need some public support in the form of a more investment-friendly environment, as well as more comprehensive measures addressing the development of human capital, and the promotion of venture capital,. In this respect, the establishment of a Japan-Korea FTA may help in the adjustment process by providing a strong impetus for change.

The challenge posed by the rise of China can be used as a means of enhancing mobilization for structural adjustment. Yet, this first dimension of the Chinese challenge should not be overdone for a number of reasons. First, exaggerating the magnitude of the challenge may be counterproductive since apocalyptic predictions cannot be expected to materialize, thus reducing the motivation to implement reform ad and leading to complacency. Moreover, overselling China's threat may also simply be discouraging, again reducing the willingness to address the challenge. It is extremely important that a fair assessment of the situation should be made and publicized.

It must be stressed at this stage that a number of the recent economic difficulties encountered by Korea should not be attributed to the rising competition from China but rather to domestic weaknesses. Blaming it all on China is the wrong strategy since it tends to shift attention away from the real problems. In other words, China bashing gets you nowhere.

The second challenge for Korea is to remain involved in the regional integration movement currently at work. This involves first to go ahead with the JKFTA in order to avoid being isolated and discriminated against. Yet, it is important to design the JKFTA first as a possible benchmark agreement but also as an open agreement. In parallel, it is in Korea's interest to maintain a dialogue with both China and ASEAN, as well as strengthen existing cooperative schemes at the East Asian level as a whole.

China's rise and the associated changes in the game being played in the region enhance the awareness of the need to adjust Korea's economic structure to tougher competition. At the end of the day, the rise of China may turn out to be a blessing in disguise if it helps in designing and implementing the reform, which has been long overdue (while the impetus given by the financial crisis of 1997-98 has been petering out). Similarly, while the highly publicized CAFTA may prove to be much ado about nothing, it may however be instrumental in inducing Japan and Korea to join efforts and pave the way to formal economic integration in East Asia.

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Korea and the Dual Chinese Challenge

Françoise NICOLAS

The objective of the paper is to examine the exact nature of the Chinese challenge for Korea and assess what may be the most appropriate response to mitigate the risks and maximize the potential benefits associated with it. The paper also suggests that this FTA has to be associated with other arrangements with China and ASEAN, if Korea wants to keep some leverage over the future of the East Asian integration process.

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