

The Impact of FDI from South Korea to China on Bilateral Trade

Liu Xiangfeng

Korea Institute for International Economic Policy

CNAEC Research Series 05-08

The Impact of FDI from South Korea to China on Bilateral Trade

Liu Xiangfeng



Korea Institute for International Economic Policy

**KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY (KIEP)**

300-4 Yomgok-Dong, Seocho-Gu, Seoul 137-747, Korea

Tel: (822) 3460-1178 Fax: (822) 3460-1144

URL: <http://www.kiep.go.kr>

Kyung Tae Lee, *President*

CNAEC Research Series 05-08

Published December 30, 2005 in Korea by KIEP

2005 KIEP

Executive Summary

The purpose of this paper is to identify the major effects of South Korean FDI to China on their bilateral trade. The paper investigates the influence of South Korean companies investing in China for processing trade. South Korean FDI has positive effects on bilateral trade, especially on exports to China. Meanwhile, processing trade plays a significant role in bilateral trade, and has been chiefly responsible for China's trade deficit with South Korea. It is notable that Korean FDI in China is closely associated with export-oriented processing and assembly industries with labor-intensive characteristics. Now confronted with overall economic internationalization, making better use of foreign capital and optimizing the export structure is an urgent task for China. China should work to develop goods that have a competitive advantage, support top export enterprises and increase the export volume of machinery, electronics, and high-tech goods. The Chinese government should enthusiastically encourage Korean companies to invest in and build a foundation for the export of high-tech goods to achieve this.

JEL Classification: F15, E22, F21

Keywords: FDI, South Korean-invested enterprises, intermediate goods import, trade structure optimization

Dr. Liu Xiangfeng is an assistant professor at the Institute of International Economy, National Development and Inform Commission, People's Republic of China. He received his Ph. D. in Economics from Asia Pacific Economy Institute in Chinese Academy of Social Sciences. His areas of interest are International Economics, East Asian Economic Cooperation, etc. His recent articles include "The Trade Relation Between China and Philippines" (The Project of China Ministry of Foreign Economic and Trade 2001), "Fiscal Policy and Income Distribution" (Chapter 6 of the project of United States University: Development and Security 2001), "The Difference of Regional Corporation Between East Asia and North America" (Chapter of Project of State Development and Inform Commission: East Asia Regional Corporation, 2002), and "Beijing Telecomm in the Open Market" (How the Company Should Do in the Open Market After China Enter WTO(企业如何应对加入WTO和开放市场), APEC Policy Research Centre, *Chinese Academy of Social Sciences*, No. 10, 2000, pp. 93-113). E-mail: Liuxf99@sina.com.

Contents

Executive Summary	3
I. Introduction	9
II. Trends and Characteristics of South Korean FDI in China.....	11
III. The Influence of South Korean FDI on Bilateral Trade	15
1. Bilateral trade between China and South Korea.....	15
2. The complementarity of Korean FDI and bilateral trade	19
IV. The Influence of South Korean Companies Investing in China	
on Processing Trade	21
1. Trade with South Korean enterprises that invested in China	21
2. Processing trade plays a significant role in bilateral trade.....	25
3. International trade through Korean FDI-processing trade	30
V. Strengthened Cooperation in Trade and Investment between	
China and South Korea.....	32
1. China should adjust the direction of investment cooperation	
and optimize its trade structure	32
2. The need for the two countries to strengthen closer economic	
cooperation to increase FDI and trade opportunities	33
VI. Conclusions.....	34
References	36

Tables

Table 1.	South Korean FDI Outflow Trends in Countries.....	11
Table 2.	South Korean FDI in China	12
Table 3.	Korean FDI in Chinese Industries by the End of 2001	13
Table 4.	South Korean FDI into the Manufacturing Sector in China in 2000	14
Table 5.	China's Import Structure from South Korea during 1995 to 2002.....	16
Table 6.	China's Export Structure to South Korea during 1995 to 2002 ...	17
Table 7.	Bilateral Trade Structure.....	18
Table 8.	Bilateral Trade Structure in Terms of Company Ownership	24
Table 9.	Bilateral Trade Structure According to Trade Type (Ordinary Trade and Processing Trade).....	27
Table 10.	Bilateral Trade Structure According to Trade Type (Ordinary Trade and Processing Trade as Percentage of Total Trade) ...	29

Figures

Figure 1.	Trends of South Korean FDI in China from 1993 to 2002	12
Figure 2.	Bilateral Trade Performance	15
Figure 3.	Contrast of Total Trade Value of KIEs and SOEs	22
Figure 4.	Comparison of Import and Export Shares for KIEs and SOEs in China	23
Figure 5.	Performance of Trade According to Company Ownership	25
Figure 6.	Share of Imports and Exports of Total Trade According to Ordinary Trade	26
Figure 7.	Share of Imports and Exports in Total Trade According to Processing Trade	26

The Impact of FDI from South Korea to China on Bilateral Trade

Liu Xiangfeng

I. Introduction

International trade and foreign direct investment (FDI) are two of the most important forces driving global economic growth. With the spread of international economic liberalization and globalization, the increasing integration of trade and investment has become clear. FDI inflows have become the most important factor in international trade, and the interaction between them has become more and more complicated. Thus, FDI theories have been closely connected to theories of international trade. These theories mainly include Mundell's substitute model, Kojima's complementary model, Vernon's international product lifestyle model, Markusen's knowledge capital model and John Dunning's eclectic paradigm of FDI.¹⁾

P. Patrie (1994) summarized FDI into three categories: 1) market-oriented FDI (FDI for producing and selling in a host country in order to occupy the local market and avoid high tariffs); 2) production-oriented FDI (FDI that invests in the host country in consideration of lower costs); and 3) trade-facilitating FDI (FDI that invests in the host country so as to expand trade volume and provide services for exports). In fact, many FDI-trade theories describe the relationship between FDI and international trade in terms of substitute relationships, complementary relationships, or as export-oriented, resource-oriented, efficiency-seeking, market-oriented, production-oriented, and trade-facilitating.

The purpose of this paper is to identify the major effects of South Korean FDI

1) Zhang Biqiong (1999, pp. 88-96)

in China on China's trade with South Korea. The structure of the paper is as follows. Section 2 describes the development of South Korean FDI in China, while section 3 analyzes the influence of South Korean FDI on bilateral trade. Section 4 investigates the influence of South Korean companies that invest in China for processing trade, and section 5 shows the deepening of cooperation in trade and investment between China and South Korea. The last section summarizes the main conclusions of the study.

II. Trends and Characteristics of South Korean FDI in China

Following the expansion of the Chinese government's policy of reform and openness, the introduction of the market economy, and the establishment of diplomatic ties between South Korea and China in 1992, South Korean businesses started to invest in China in earnest in the mid-1990s. As the world's leading destination for foreign direct investment, China has also become South Korea's largest FDI market (see table 1).

Korean direct investment in China, as reported by the South Korean government, totaled \$1.72 billion in 2002. This constitutes 34 percent of South Korea's total outward foreign direct investment, meaning that China has overtaken the United States and moved into the number one spot. According to Chinese statistics, which include local reinvestment, South Korean investment in China came to an even larger \$2.7 billion in 2002 (see table 2). From figure 1, we can see that actual South Korean FDI to China reached \$2.15 billion in China in 2001, a 50 percent increase over the previous year, and marked the same levels of South Korean investment in China that had peaked at \$2.14 billion in 1997.

Table 1. South Korean FDI Outflow Trends in Countries

(Unit: \$100 million (Rate of increase: Percent))

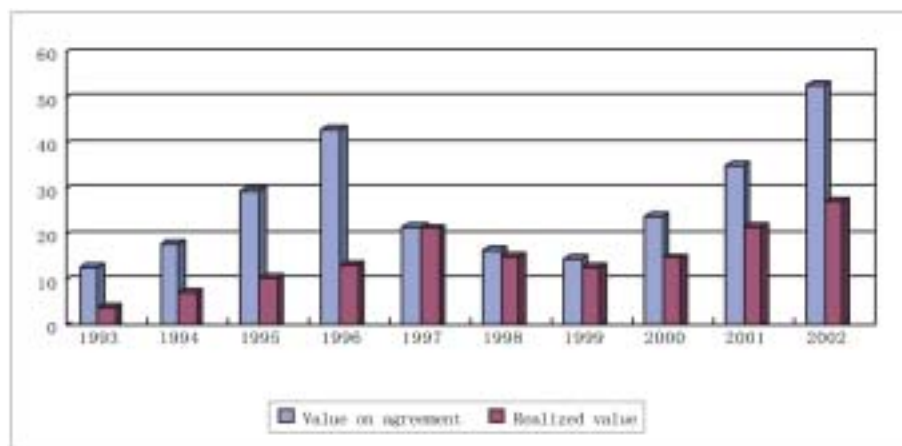
Period	Jan.–Sept. 2000	Jan.–Sept. 2001	Jan.–Sept. 2002	Jan.–Sept. 2003
China	5.1 (59.4)	7.2 (41.2)	13.8 (91.7)	13.9 (0.7)
United States	9.1 (-35.0)	15.3 (68.1)	12.2 (-20.3)	5.5 (-54.9)
Vietnam	0.5 (0)	0.6 (20.0)	3.0 (500.0)	6.7 (223.3)

Source: "FDI Outflow Trends in the Third Quarter of 2003"

[http://english.mofe.go.kr/news/n_body.php?i=515&t=eh_news_press]

Figure 1. Trends of South Korean FDI in China from 1993 to 2002

(Unit: \$100 million)



Source: Ministry of Commerce, China(2003)

Table 2. South Korean FDI in China

(Unit: \$ billion)

Year	Number on agreement	Contracted Value	Realized value
1985-1992	943	0.62	0.16
1993	1748	1.35	0.38
1994	1849	1.81	0.72
1995	1974	2.96	1.04
1996	1603	4.28	1.32
1997	1753	2.18	2.14
1998	1307	1.64	1.53
1999	1547	1.48	1.27
2000	2565	2.39	1.49
2001	2909	3.49	2.15
2002	4008	5.28	2.70
Total	22208	27.47	15.18

Source: Ministry of Commerce, China (2003).

All inward direct investment to China from South Korea is concentrated in the manufacturing sector; it reached \$4.16 billion by the end of 2001, accounting for 82.8 percent of total South Korean FDI in China (see table 3). These manufacturing sectors include electronics and telecommunications equipment manufacturing, metal products, textiles, electrical machines and mechanical appliances, transport equipment manufacturing, rubber and articles, leather, skins and feathers products, raw chemical materials and chemical products, and plastic products manufacturing, especially in textiles and electronic equipment (see table 3). This indicates that a large volume of South Korea's foreign capital invested in China has been strongly influenced by the vast size of the Chinese market and the strong competitiveness of Chinese products due to lower labor costs.

Table 3. Korean FDI in Chinese Industries by the End of 2001

(Unit: \$ million)

Industries	Number	Value	Industries	Average Value/Project
Manufacturing	5096	4160	Manufacturing	0.82
Real estate	191	220	Real estate	1.13
Restaurant and hotel	151	190	Restaurant and hotel	1.27
Construction	42	170	Construction	4.18
Wholesale and retail	187	100	Telecommunications	6.04
Telecommunications	13	80		
Total amount	5854	5020	Average Value/Project	0.86

Source: The Export-Import Bank of South Korea, South Korean Investment in China: Status and Prospects. [http://www.mofat.go.kr/en/search/e_search.mof]

In terms of investment size, small and medium-sized enterprises (SMEs) are leading South Korean FDI in China. SMEs and individual investment in China accounted for 97 percent of the total number of FDI cases and about 60 percent of the total FDI value for the period of 1999 to 2003. South Korean FDI is mainly concentrated on the export-oriented manufacturing industries, primarily focusing on Northeastern China, Shandong, Tianjin, Liaoning, Jiangsu and Shanghai. The

firms have taken advantage of the fact that China has significant global comparative advantages in labor-intensive sectors. In terms of per-project scale, the average per-project investment was \$0.86 million (see table 3), while the average per-project investment in the manufacturing industries was \$8.2 million, which is lower than the average project value.

Table 4. South Korean FDI into the Manufacturing Sector in China in 2000

(Unit: Percent)	
Manufacturing Industry	Share of Total South Korean FDI
Electronics and Telecommunications Equipment Manufacturing	19.2
Metal Products	11.6
Textile Industry	17.1
Electrical Machines and Mechanical Appliances	6.7
Transport Equipment Manufacturing	5.3
Rubber and Articles	4.0
Leather, Skins and Feathers Products	3.9
Raw Chemical Materials and Chemical Products	3.9
Plastic Products Manufacturing	2.9
Sub-Total	74.6
Total South Korean FDI	100

Source: DRC Database (2003)

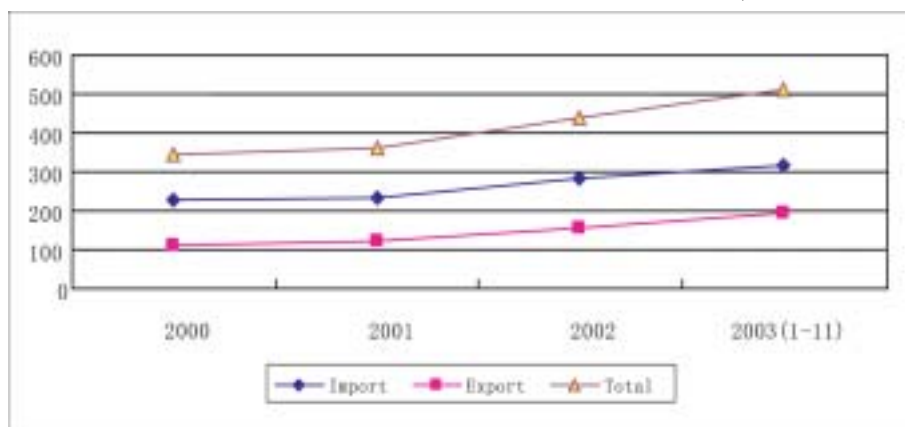
III. The Influence of South Korean FDI on Bilateral Trade

1. Bilateral trade between China and South Korea

Annual bilateral trade between China and South Korea has been constantly increasing (see figure 2), reaching \$44.1 billion in 2002 and \$51.77 billion during the first 11 months of 2003 (Ministry of Commerce of China 2003). In fact, China is currently South Korea's largest trading partner. Exports to China have grown rapidly over the past 20 years, and China is now the largest export market for South Korea, while South Korea is the third-largest export market for China. Export expansion has been associated with large inflows of FDI; on the other hand, exports by domestic enterprises have also grown strongly. South Korea is also maintaining a favorable balance of trade with China. Its trade surplus amounted to \$10.09 billion in 2001 and \$13.1 billion in 2002 (see table 7).

Figure 2. Bilateral Trade Performance

(Unit: \$100 million)



Source: Ministry of Commerce, China (2004).

Table 5. China's Import Structure from South Korea during 1995 to 2002

(Unit: \$100 million)

Products	1995		1998		2000		2001		2002	
	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value
Textiles and Products	1	24.3	2	26.4	2	31.1	3	28.4	5	26.5
Electronics, Electrical Machinery	2	22.3	1	32.6	1	70.8	1	75.4	1	120.1
Plastics, Rubber Products	3	15.2	3	26.4	3	28.0	2	28.7	3	30.7
Base Metals Products	4	10.5	4	19.5	4	27.6	4	27.3	4	28.8
Chemical Products	5	9.7	5	12.7	5	26.5	6	6.4	2	30.8
Mineral Products	6	4.0	6	11	6	20.3	5	19.6	6	13.4

Source: Customs General Administration, China (2003).

Sino-Korean bilateral trade has been driven primarily by China's increasing demand for South Korean products, and China's imports from South Korea increased greatly, including imports of textiles and products, electronics, electrical machinery, plastics, rubber products, base metals products, chemical products, and mineral products (see table 6). In fact, much of South Korea's exports to China are raw materials, parts, and materials (see table 5). South Korea's imports from China also increased, including textiles and products, base metals products, mineral products, electronics, electrical machinery, chemical products, and plant products (see table 6).

South Korea exported more than it imported from China, resulting in China's widening deficit with South Korea, especially in steel and other strategic industries. Nevertheless, China began to enjoy a surplus in its textile trade with

South Korea in 2002. China's competitiveness in fiber processing, textiles, and garments has been improving continuously and the quality of production has been enhanced, thereby altering the trade situation between the two countries in this field. China had a surplus in trade in garments, cotton textile products, silk products, and natural fiber products, while South Korea recorded a surplus in trade in chemical fiber materials, plastics, rubber products, leather, skins and feathers products, wood products, paper products, and base metals products (see table 7), especially in electronics, electrical machinery, base metals, chemical products (see table 6).

Table 6. China's Export Structure to South Korea during 1995 to 2002

(Unit: \$100 million)

Products	1995		1998		2000		2001		2002	
	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value
Textiles and Products	1	16.0	1	13.6	2	23.8	2	27.1	2	34.2
Base Metals Products	2	14.1	4	7.3	3	13.4	4	10.5	4	14.0
Mineral Products	3	8.5	3	8.6	4	11.3	3	13.7	3	40.5
Electronics, Electrical Machinery	4	6.1	2	11.4	1	25.5	1	32.1	1	40.5
Chemical Products	5	5.7	6	4.4	6	7.1	5	8.1	6	9.6
Plant Products	6	2.5	5	4.6	5	8.7	6	6.4	5	9.9

Source: Customs General Administration, China (2003).

Table 7. Bilateral Trade Structure

(Unit: \$100 million)

HS products system ²⁾	2000		2001		2002	
	Import	Export	Import	Export	Import	Export
Total	230	112	234	125	286	155
No. 1	0.74	4.44	0.51	6.25	0.44	6.62
No. 2	0.14	8.71	0.15	6.44	0.19	9.93
No. 3	0.02	0.50	0.02	0.08	0.02	0.098
No. 4	0.37	2.17	0.45	2.85	0.48	3.08
No. 5	20.3	11.3	19.6	13.7	13.4	12.7
No. 6	26.5	7.09	26.4	8.06	30.8	9.57
No. 7	28	1.19	28.7	1.28	30.7	2.15
No. 8	8.86	1.36	8.12	2.13	6.88	2.68
No. 9	0.66	1.61	0.43	1.83	0.21	2.33
No. 10	7.94	0.53	6.85	0.40	5.71	0.56
No. 11	31.1	23.3	28.4	27.1	26.5	34.2
No. 12	1.33	1.95	1.5	2.26	1.33	2.56
No. 13	1.71	1.48	2.21	2.36	2.46	4.78
No. 14	0.58	0.33	0.36	0.37	0.32	0.53
No. 15	27.6	13.4	27.3	10.5	28.8	14
No. 16	69	24.8	75.4	32.2	120	40.5
No. 17	1.24	4.53	1.81	4.22	2.89	4.04
No. 18	2.74	1.55	4.35	1.36	13	2.14
No. 19	-	.0025	-	.0019	-	0.0003
No. 20	1.26	1.73	1.18	1.86	1.33	2.54
No. 21	-	0.0024	-	0.0037	0.0030	0.0094
No. 22	0.09	0.01	0.11	0.01	0.23	0.02

Source: Ministry of Commerce, China (2003).

²⁾ Custom HS System (Harmonized Commodity Description and Coding System) includes: No. 1: Animal products. No. 2: Plant products. No. 3: Oil of animals and plants, grease for food. No. 4: Food, beverages and tobacco. No.5: Mineral products. No. 6: Chemicals and chemical products. No. 7: Plastics, rubber products. No. 8: Leather, skins and feathers products, box and packages. No. 9: Wood and products. No. 10: Paper and products. No. 11: Textiles and products. No. 12: Shoes, caps, umbrellas and feather products. No. 13: Mineral Products. No. 14: Jewellery, noble metal and products, ornaments, coins. No. 15: Base Metals Products. No. 16: Electronics, Electrical Machinery. No. 17: Vehicles and other transport equipment. No. 18: Precision instruments. No. 19: Armament and parts. No. 20: Mixed products. No. 21: Arts & antiques. No. 22: Unclassified products.

2. The complementarity of Korean FDI and bilateral trade

Professor K. Kojima introduced a complementary theory in the late 1970s in which FDI was considered complementary to trade. Where FDI expands the opportunity of exports between the home and host country, and the host country originally has labor-intensive productivity, the host should enjoy a higher comparative advantage when capital-intensive technology is imported. Likewise, there seems to be a complementary relationship between Korean FDI and bilateral trade.

First, the continuous expansion of Korean FDI inflows into China has greatly stimulated increases in the overall trade between the two countries. In the two sections above, the effects of FDI on total trade have been described in detail. FDI seems to have had a strongly positive effect on bilateral trade between China and Korea. Furthermore, FDI inflows into China complement exports to China, since South Korean companies in China import intermediate goods and parts from their home country. Thus, with the strong FDI growth, the share of FDI trade has also increased, and consequently, FDI has expanded trade opportunities for exports between the home and host country.

Second, the destination for Korean FDI is concentrated in the coastal provinces, such as the Northeastern and Shandong provinces, where bilateral trade is also concentrated. The disparity between FDI distribution in the eastern, middle and western regions has resulted in severe differences in trade volume.

Third, Korea's China-bound investments also promote international trade between China and the rest of the world, increasing China's trade volume and trade surplus with third countries such as Japan and the United States. Both FDI inflows and international trade have become the most significant driving factors behind China's strong economic growth. FDI (including Korean FDI) inflows have highly stimulated the growth of international trade, transforming China into a significant player in the world trade market.

Fourth, Korean FDI has become the major driving force of China's import and export growth. As seen in tables 3 and 4, South Korean-funded enterprises

concentrate on the manufacturing sectors such as electronics, electrical machinery, plastics, rubber products and base metals products. As seen from tables 5 and 6, trade products also focus on the manufacturing industry, including electronics and electrical machinery, chemical products, base metals products, textiles, and mineral products. Similarities between the structures for FDI, imports and exports are obvious, although this does not wholly correspond with Kojima's theory.

IV. The Influence of South Korean Companies Investing in China on Processing Trade

The imports and exports of China and South Korea are controlled by South Korean enterprises that invest in China and state owned enterprises (SOEs). In China, state-owned enterprises concentrate on the manufacturing sectors, the service sectors and the production of advantaged products. Chinese companies are generally unable to import or export without government permission. Therefore, Chinese state-owned enterprises are better able to engage in international trade than Chinese enterprises of other ownership. Conversely, South Korean enterprises that invest in China are permitted by China's government to import and export. In consequence, the total trade of South Korean companies and SOEs is almost equal to the total trade between South Korea and China. The function of South Korean companies on bilateral trade is easily seen from the proportion of the trade from South Korean companies in China to total trade.

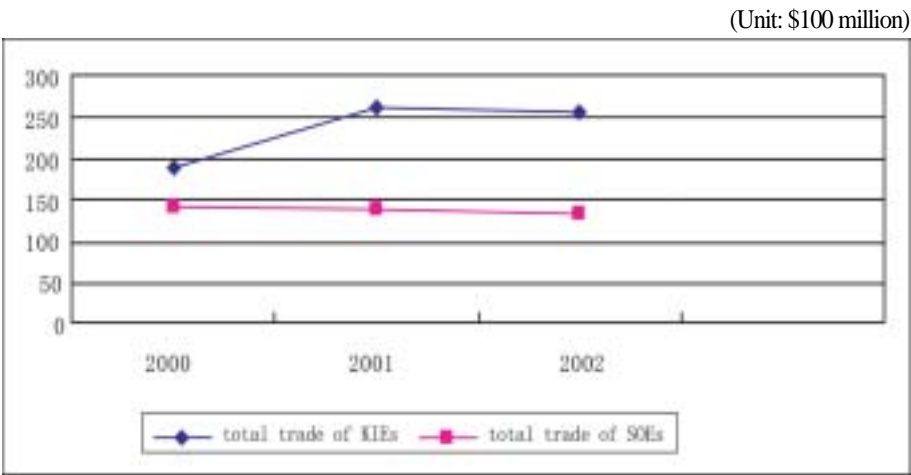
1. Trade with South Korean enterprises that invested in China

Foreign-invested enterprises (FIEs) play a very important role in the development of China's economy. There are five different forms of FDI in China: equity joint ventures (EJVs); cooperative operation enterprises or contractual joint ventures (CJVs); wholly foreign-owned enterprises (WFOs); foreign sharing-holding enterprises (SH); and joint exploration (JE) (K.C. Fung 2002). Wholly foreign-owned enterprises are important mostly for South Korean companies. In China, around 50 percent of China's exporters are either completely or partly foreign owned. The proportion of South Korean-invested enterprises (KIEs) in total exports is higher.

China's trade expansion has been accompanied by the increase of South Korean FDI and growing trade through KIEs. The total import and export volume for KIEs reached \$25.64 billion in 2002, comprising 62.84 percent of total foreign

trade (table 8). Figure 3 shows that the contribution of KIEs to total trade is higher than the contribution of SOEs. KIE trade volume has been increasing dramatically and was higher than the SOE national average. This indicates that the share of imports/exports from KIEs of total trade is dramatically higher than the share of SOEs of total trade (figure 4). The contribution of KIEs to bilateral trade is much higher than the contribution of Chinese state-owned enterprises to bilateral trade. The major reasons for this trend are: 1) KIEs mainly conduct trade with their parent companies or other affiliates; 2) KIEs have the freedom to import and export, which is not granted to Chinese SOEs; 3) SOE trade in China with the United States, the European Union and Japan is respectively higher than China's trade with South Korea. As a result, the bilateral trade volume for KIEs is much higher than SOE shares of bilateral trade.

Figure 3. Contrast of Total Trade Value of KIEs and SOEs³⁾



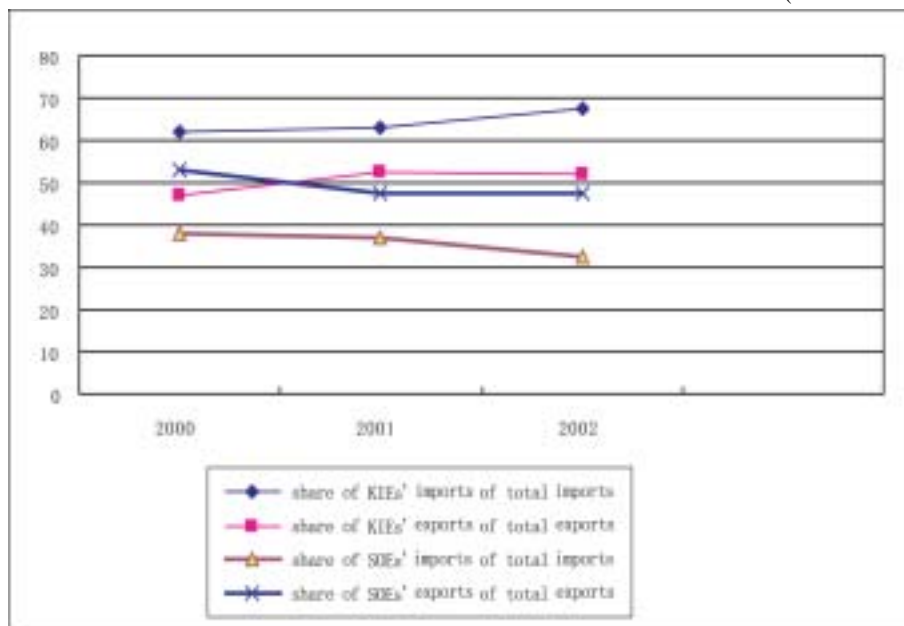
In 2000, KIE trade accounted for 61.85 percent of total imports and 47.04 percent of total exports. The shares increased to 63.01 percent and 52.47 percent in 2001, respectively. In 2002, the share of KIEs in China's total trade was 67.54

3) Figure 3, figure 4 and figure 5 are all based on data from table 8.

percent (imports) and 52.24 percent (exports) (see table 8). The rise in the share of KIEs of total trade reflects the growing contribution of KIEs to the increase in China's trade (see figure 4).

Figure 4. Comparison of Import and Export Shares for KIEs and SOEs in China

(Unit: Percent)



KIEs depend more on imports from their home country than on other import sources. Markets in the home country are the most important import markets for KIEs. South Korean enterprises also rely more on markets in third countries such as the United States, Japan and the European Union. Most of the imports are intermediate goods — parts and other factor inputs for manufactured goods, such as textiles and clothing, and electrical and electronic equipment. In fact, much of South Korea's exports to China are raw materials, parts and materials supplied to KIEs that have set up operations in China. It was mostly South Korean SMEs in labor-intensive industries that initially entered the Chinese market.

Table 8. Bilateral Trade Structure in Terms of Company Ownership

(Unit: \$100 million)

	2000				2001				2002			
	KIEs		SOEs		KIEs		SOEs		KIEs		SOEs	
	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value	Total Value
Custom HS System												
Total	137	50.1	84.5	56.4	140	61.5	82.2	55.7	181	75.4	87.3	64.3
1	0.38	1.59	0.37	2.34	0.31	2.36	0.17	2.92	0.27	2.56	0.14	2.28
2	0.07	0.75	0.068	7.81	0.11	0.88	0.04	5.31	0.13	1.23	0.06	8.35
3	0.01	0.014	0.007	0.03	0.017	0.01	0.0009	0.68	0.02	0.05	0.001	0.04
4	0.16	1.13	0.18	0.93	0.23	1.42	0.18	1.26	0.24	1.87	0.18	0.95
5	3.11	2.25	15.8	8.95	29.2	2.65	14.4	10.8	1.42	2.31	10.8	9.81
6	12.3	1.59	12.9	4.84	11.1	2.18	13.3	4.95	13.7	2.5	13	5.68
7	12.6	0.78	13.7	0.37	13.4	0.78	12.9	0.43	15.5	1.42	11.7	0.58
8	7.71	1.01	0.96	0.31	7.08	1.47	0.88	0.52	6.07	1.67	0.55	0.64
9	0.54	0.62	0.12	0.93	0.35	0.82	0.08	0.83	0.17	0.92	0.046	0.94
10	3.27	0.38	4.48	0.14	2.89	0.32	3.77	0.08	2.39	0.44	2.87	0.08
11	19.3	7.8	10.4	13.6	18.7	9.65	8.21	14.5	17.8	12.7	6.97	16.3
12	1.22	1.51	0.09	0.34	1.37	1.76	0.09	0.38	1.22	1.92	0.068	0.44
13	1.39	0.51	0.29	0.79	1.96	0.78	0.21	1.16	2.26	1.52	0.16	2.22
14	0.57	0.25	0.08	0.08	0.34	0.271	0.02	0.098	0.31	0.42	0.01	0.097
15	15.9	2.29	11	10.6	16	2.21	10.6	7.63	18.2	3.21	9.39	9.53
16	54.4	21.2	12.9	2.95	57.3	28.2	15.8	3.27	87.1	34.7	28.7	4.21
17	0.49	4.17	0.59	0.33	0.80	3.7	0.75	0.47	1.24	3.17	1.15	0.66
18	2.23	1.2	0.42	0.34	3.72	0.99	0.55	0.34	11.6	1.42	1.27	0.63
19	-	0.001	0	0.013	-	0.001	0	0.0003	-	0	-	0.0003
20	0.91	0.99	0.29	0.64	0.87	1.06	0.26	0.64	1.04	1.36	0.23	0.87
21	-	0.002	462	0.0008	0.0001	0.001	0.0008	0.002	0.0003	0.005	0.003	0.004
22	0.09	0.005	-	0.006	0.11	0.005	0	0.002	0.23	0.0099	-	0.012
Total	137	50.1	84.5	56.4	140	61.5	82.2	55.7	181	75.4	87.3	64.3

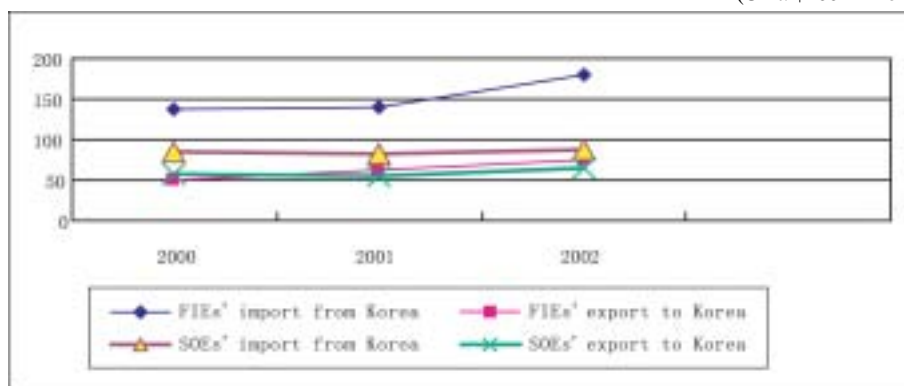
Source: Ministry of Commerce, China (2003).

Multinational firms may increase the degree of competition in host-country markets by providing training for labor and management as well as local suppliers

of intermediate products so as to meet their higher production and managerial standards. South Korean companies have held the functions of assembling, repairing and servicing from the start. Over time, the function of product development expanded, and only a few companies now hold the function of R&D.

Figure 5. Performance of Trade According to Company Ownership

(Unit: \$100 million)

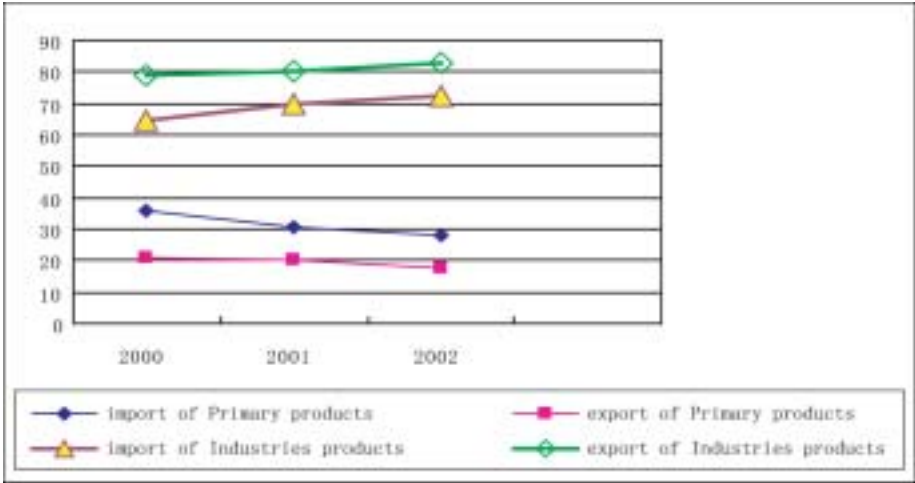


2. Processing trade plays a significant role in bilateral trade

Processing trade plays a significant role in imports and exports, and it has the highest growth rate among total trade. In 2002, the volume of processing trade reached \$32.4 billion, a 25.09 percent increase over the same period of the previous year, accounting for about 53.29 percent of the total trade volume (see table 9). It exported \$18.7 billion to South Korea, accounting for 56.5 percent of the total exports, and imported \$13.7 billion, accounting for 49.46 percent of the total imports. Furthermore, industry products accounted for an overwhelming share of processing trade (see figures 6 and 7). Intermediate goods are imported for processing trade, and then final goods are exported to the home country or a third country. Processing activities include assembling, processing and production, which are crucial for South Korean companies in China.

Figure 6. Share of Imports and Exports of Total Trade According to Ordinary Trade

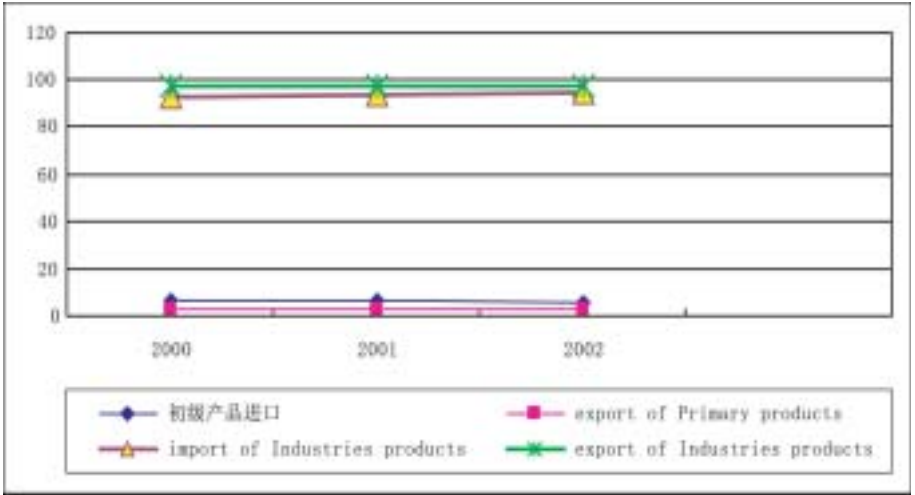
(Unit: Percent)



Source: Data from table 10.

Figure 7. Share of Imports and Exports in Total Trade According to Processing Trade

(Unit: Percent)



Source: Data based on table 10.

**Table 9. Bilateral Trade Structure According to Trade Type
(Ordinary Trade and Processing Trade)**

(Unit: \$100 million)

	Imports			Imports		
	Ordinary Trade			Processing Trade		
	2000	2001	2002	2000	2001	2002
Custom SITC System	Value	Value	Value	Value	Value	Value
Primary products	37.4	37.2	38.9	7.34	7.15	7.69
0 ³⁾	2.94	3.29	3.33	1.3	1.51	1.55
1	0.34	0.37	0.33	0.04	0.02	0.03
2	13.5	15.5	15.5	4.84	4.78	5.06
3	20.3	17.4	18.3	1.11	0.78	1.01
4	0.42	0.67	1.42	0.93	0.75	0.71
Industries products	67.9	85.2	101	97.2	99.3	129
5	17.9	20.2	23.8	14.2	14.1	17.1
6	12.4	13.8	17.3	33.8	32.5	34.8
7	33.6	45.2	54.1	40.9	44.2	64.4
8	3.66	5.7	6.01	7.44	7.68	11.8
9	0.32	0.21	0.31	0.86	0.87	0.91
Total	105	122	140	105	106	137

3) Customs SITC System includes: No. 0: Food and living animals. No. 1: Beverages and tobacco. No. 2: Raw material not for food (except fuel). No. 3: Mineral products, lube and other material. No. 4: Oil of animals and plants, grease and wax. No. 5: Chemicals and chemical products. No. 6: Products by raw material. No. 7: Machinery and transport equipment. No. 8: Mixed products. No. 9: Unclassified products.

Table 9. Continued

	Exports			Exports		
	Ordinary Trade			Processing Trade		
	2000	2001	2002	2000	2001	2002
Custom SITC System	Value	Value	Value	Value	Value	Value
Primary products	22.5	24.2	25.5	3.98	41.3	5.01
0 ⁴⁾	10.3	10.9	12.5	2.46	2.85	3.24
1	0.39	0.697	0.91	0.64	0.62	0.66
2	4.54	4.11	4.31	0.31	0.38	0.43
3	7.23	8.38	7.7	1.09	0.79	1.22
4	0.57	0.49	0.51	0.60	0.58	0.49
Industries products	86.1	94.3	119	137	149	182
5	9.66	10.8	12.4	2.76	3.08	3.54
6	26.9	28.1	35.4	17.8	17.7	20.2
7	14.8	17.4	22.9	67.7	78.7	105
8	34.3	37.6	47.9	49	49.4	53.1
9	0.48	0.41	0.39	0.17	0.17	0.24
Total	109	118	144	141	153	187

Source: Ministry of Commerce, China (2003).

4) Customs SITC System includes: No. 0: Food and living animals. No. 1: Beverages and tobacco. No. 2: Raw material not for food (except fuel). No. 3: Mineral products, lube and other material. No. 4: Oil of animals and plants, grease and wax. No. 5: Chemicals and chemical products. No. 6: Products by raw material. No. 7: Machinery and transport equipment. No. 8: Mixed products. No. 9: Unclassified products.

Table 10. Bilateral Trade Structure According to Trade Type (Ordinary Trade and Processing Trade as Percentage of Total Trade)

(Unit: Percent)

	Imports			Imports		
	Ordinary Trade			Processing Trade		
	2000	2001	2002	2000	2001	2002
SITC System	Share	Share	Share	share	share	Share
Primary products	35.6	30.5	27.8	6.99	6.74	5.61
0	3.56	2.70	2.37	1.2	1.42	1.13
1	0.003	0.31	0.23	-	-	-
2	12.86	12.7	11.1	4.6	4.51	3.69
3	19.33	14.3	13.1	1.1	0.73	0.74
4	0.004	0.55	1.01	-	-	-
Industries product	64.4	69.5	72.2	92.57	93.2	94.16
5	17.04	16.6	17	13.52	13.3	12.48
6	11.81	11.3	12.6	32.19	30.66	25.40
7	34.86	37.1	38.6	38.95	41.7	47.0
8	3.49	4.67	4.29	7.09	7.24	8.61
9	0.31	0.17	0.22	0.82	0.82	0.67
Primary products	20.64	20.51	17.7	2.82	2.70	2.68
0	9.45	9.24	8.68	1.74	1.86	1.73
1	0.35	0.59	0.63	-	-	-
2	4.17	3.48	2.99	0.22	0.25	0.23
3	6.63	7.10	5.35	0.77	0.51	0.65
4	-	-	-	-	-	-

Source: Data from the Ministry of Commerce, China (2003).

Table 10. Continued

	Exports			Exports		
	Ordinary Trade			Processing Trade		
	2000	2001	2002	2000	2001	2002
SITC System	share	share	share	share	share	share
Industries product	78.99	79.92	82.63	97.16	97.39	97.33
5	8.86	9.15	8.61	1.96	2.01	1.89
6	24.68	23.82	24.58	12.62	11.57	10.80
7	13.58	14.75	15.90	48.01	51.44	56.15
8	31.47	31.86	33.26	34.75	32.29	28.40
9	0.44	0.34	0.27	-	0.11	0.13

Source: Data from the Ministry of Commerce, China (2003).

3. International trade through Korean FDI-processing trade

The stimulation effect of investment on trade has a direct relationship with investor motivation. In existing literature, FDI products are generally oriented toward three markets: the domestic market of the home country, the domestic market of the host country, and the international market/rest of the world.

Korean companies sell mainly to local consumers and at the same time sell their products back to their home countries or export to a third country. In addition, Korean investors are not influenced by certain local factors. First, multinational companies inclined to hold onto their market share continue to use China as the world's low-cost production platform across industrial sectors. Second, most SMEs are export-oriented. KIE trade is mainly concentrated on the processing and assembling industries that have labor-intensive characteristics, as well as ownership and comparative advantages between the home and host countries.

Co-movement between China's processing trade and South Korean FDI can be explained through a number of factors. First, the South Korean economy experienced rising domestic costs, leading companies to search for alternative production sites with lower labor costs for their exports. Northeastern China, with its favorable policy environment, as well as social and cultural proximity, became the preferred site.

Second, China's government policy is aimed at promoting exports. KIEs have the freedom to import and export on their own account, unlike Chinese state-owned enterprises. KIEs enjoy a variety of tax exemptions and are able to import raw materials and components so long as they are engaged in export production. The policies have resulted in a large portion of KIEs specializing in exports through importing and processing in the forms of processing materials and processing imports. Imports for KIEs account for a large portion of both increases in China's imports and total volume.

Third, it is likely that the determinants of Korean FDI into China are closely related to how Korean companies operate in China. They are largely engaged in processing trade.

V. Strengthened Cooperation in Trade and Investment between China and South Korea

1. China should adjust the direction of investment cooperation and optimize its trade structure

The growth of bilateral trade depends heavily on South Korean FDI, with its share of total trade over 60 percent in 2002 (see table 8). As a result, cooperation in trade and investment between China and South Korea is also concentrated on investment cooperation.

First, the investment environment should be improved. Korean FDI inflow into China was attracted by factors such as low labor-costs, geographical advantages, investment openness, and tariffs in the host country. The government should continue to encourage a favorable policy environment in order to promote bilateral trade growth and continuously absorb more Korean FDI. Not only the size, but also the quality should be stressed.

Second, investment industries should be diversified. Most FDI into China has been export-oriented and focuses on the manufacturing sectors. The scale and proportion of Korean companies in manufacturing will continue to widen, but the industries should be diversified, thus increasing the variety of investment fields. The technological-intensive or capital-intensive industries in particular have already become more important. Some professional service industries, such as finance, insurance, and telecommunications, will become important new fields of investment.

Third, the range of investment regions receiving Korean FDI in China should be increased. Korean FDI has been concentrated in areas where traditional Sino-Korean relations exist, such as the Northeastern and Shandong provinces. The disparities of distribution in the eastern, middle, western regions has resulted in severe differences in trade volumes. Along with China's new initiatives to develop

the middle and western regions, some development projects will supply many large-scale business opportunities, such as investment in huge infrastructure projects, including expressways, railways and pipelines, as well as air transport, telecom facilities, energy, water and water disposal facilities.

Based on the complementary relationship between trade and FDI, China should induce structural adjustment to achieve a more efficient division of industries, advance industrial structure and deepen technological innovation. China should optimize the export structure and reduce the trade deficits, as well as enlarge international trade.

2. The need for the two countries to strengthen closer economic cooperation to increase FDI and trade opportunities

Given the high degree of economic coexistence as well as geographical and cultural proximity that exists between the two countries, China and Korea should continue in the current direction and make joint efforts to further develop their comprehensive cooperation marked by economic complementarities. The two countries will also strengthen coordination to provide impetus for expanding trade and investment opportunities. Besides the traditional areas of cooperation, both sides can also cooperate in high-tech areas, particularly the fields of financial services, insurance, tourism, power supply, science and construction.

Considering the high complementarity of trade and investment, an export-oriented industrial structure and the geographical proximity between the two countries, the formation of a China-Korea FTA has great potential. It would not only eliminate unnecessary barriers on both sides that hinder the flow of goods and services between the two countries, but also act as a catalyst to restructuring trade and industry. Therefore, it is necessary to begin joint research on FTA promotion in South Korea and China, which is very important for deepening closer cooperation between the two countries.

VI. Conclusions

Recently, more and more Korean companies have chosen to utilize China as a production base, causing the impact of FDI from South Korea on imports, exports, total trade and the trade deficit in China to become a focus of economic research. This paper also discussed the relationship between Korean FDI and China's trade in order to identify the track of international trade of FDI in China.

In the analysis of the impacts of South Korean FDI on China's trade, FDI was found to have strongly positive effects on bilateral trade. The contribution of FDI to exports, imports and total trade is significant, especially to imports. The data analysis and theoretical analysis explain this net complementary relationship and economic coexistence.

Moreover, Korean FDI is highly responsible for China's trade deficit with South Korea. The deficit indicates that the FDI contribution to exports is less than the contribution to imports. Exports from Korean companies to the home country have significantly increased over time, and the proportion of exports from KIEs has surpassed that of the Chinese SOEs. In addition, the imports for Korean companies have maintained a higher growth rate. Most of the imports were intermediate goods – parts and other factor input for manufactured goods – and intra-firm trade was a major contributor to the China-South Korean trade deficit.

It is noticeable that Korean FDI in China is closely associated with export-oriented processing and assembling industries with labor-intensive characteristics. Processing trade plays a significant role in bilateral trade, and KIEs have a major role in the rapid growth of processing trade. However, now confronted with overall economic internationalization, making better use of foreign capital and optimizing the export structure is an urgent task for China. China should work to develop goods that have a competitive advantage, support top export enterprises and increase the export volume of machinery, electronics and high-tech goods. In the industries of electronic information, software, airlines, space and advanced materials, the Chinese government should enthusiastically support foreign companies (including Korean companies) that invest in and build a high-tech goods export basis.

China and Korea have become more important economic and trade partners to one another due to their geographical proximity and economic complementarities, and their economic cooperation is growing. The two countries should continue economic cooperation to strengthen cooperation in trade and investment.

References

- Busakorn Chantasasawat, K. C. Fung and Alan Siu. 2003. "International Competition for Foreign Direct Investment: The Case of China." Paper to be presented at the Hitotsubashi Conference on International Trade and FDI, December 12-14, 2003.
- Cabinet Office Government of Japan. 2001. "Toward Trade and Investment Liberalization Among China, Japan and Korea." (December 20)
- Cooper, Caroline G. 2000. "The Impact of China's Accession to the World Trade Organization: Implications for Korea and Japan." Korea Economic Institute.
- Ding, Jian-Ping. 2001. "Financing of Chinese SMEs: Difficulties and Further Reforms." *China and the World Economy*, 5.
- Hyun, Jung Taik. 2003. "Korea's Trade Policy, Regional Cooperation and Economic Integration: Issues and Prospects." Korea-China-Japan Forum, November 26-28, Seoul.
- Korea Online. 2002. "Report and Joint Policy Recommendations on Strengthening Economic Cooperation among China, Japan and Korea." Joint Research by the, Development Research Center of the State Council of China, National Institute of Research Advancement of Japan, and Korea Institute for International Economic Policy. (October)
- Krugman, Paul. 2000. "Strategic Trade Policy and The New International Economics." Beijing University Press, China.
- Lee, Chang-Soo. 2002a. "Korea's FDI Outflows: Choice of Locations and Effect on Trade." KIEP Working Paper 02-07.
- . 2002b. "The Linkage between the FDI and Trade of China, Japan and Korea: The Korean Perspective." Presented at the DRC/NIRA/KIEP symposium, *Strengthening Economic Cooperation in Northeast Asia: Facilitating Investment between China, Japan and Korea*, Beijing, September 29.
- Lee Chang-Soo and Chong-Kyu Lee. 2002. "Korea's FDI into China: Determinants of the Provincial Distribution." KIEP Working Paper 02-16.
- Lee, Xinzhong and Seung Rok Park. 2003. "The Effects of Foreign Direct Investment on China's International Trade." Korea Economic Research Institute.
- Li, Guanghui. 2003. "Strengthen economic cooperation to promote economic development." *Chinese Academy of International Trade and Economic Cooperation*. Ministry of Commerce, China Online.

- Pei, Chonghong. 2001. "The changing trend of FDI patterns in China." *The Chinese Economy*, 34(1).
- Sun, Haishun. 1999. "Impact of FDI on the foreign trade of China." *Journal of the Asia Pacific Economy*, 4(2).
- Sun, Haishun and Ashok Parikh. 2001. "Exports, inward foreign direct investment (FDI) and regional economic growth in China." *Regional Studies*, 35(3).
- Yang, Canying. 2000. "Theory and Practice of FDI." Nankai University Press, China.
- Yi, Xiaozhu. 2003. "Improvement the Investment Environment Enhance the Investment Cooperation." APEC, Investment Mart, Thailand.
- Yin, Xiangshuo. 1997. "Trade and Development." Shanxi Economic Press, China.
- Zhang, Biqiong. 1999. "International Capital Flow and Foreign Trade Advantage." China Development Press, China.
- Zhang, Dongming. 2002. "A Study on Industrial Policy in Korea." Economic Daily Press, China.
- Zhang, Yunling. 2003. "Is Economic Cooperation Possible in Northeast Asia." Summary was prepared by KIEP, co-organizer of the World Knowledge Forum.

The Impact of FDI from South Korea to China on Bilateral Trade

Liu Xiangfeng

The purpose of this paper is to identify the major effects of South Korean FDI in China on their bilateral trade. The paper describes the development of South Korean FDI in China and analyzes the influence of South Korean FDI on bilateral trade. We investigate the influence of South Korean companies investing in China for processing trade and show the deepening of cooperation in trade and investment between China and South Korea.



KIEP Korea Institute for International
Economic Policy

300-4 Yomgok-dong, Seocho-gu, Seoul 137-747, Korea
P.O.Box 235, Seocho, Seoul 137-602, Korea
Tel 02-3460-1001, 1114 / Fax 02-3460-1122, 1199
[Http://www.kiep.go.kr](http://www.kiep.go.kr)



ISBN 89-322-5066-9
89-322-5047-2(세트)

Price USD 2