

Study Series 14-01



# **Korea's FTA Strategy and the Korean Peninsula**

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# **Korea's FTA Strategy and the Korean Peninsula**

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# INTRODUCTION



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## 1. Introduction

Free Trade Agreements (FTA) have played a leading role in the liberalization of the international economic order. It has assisted the strengthening of international partnerships with economic interests combined with political motivation. After the Cold War, the United States seized the opportunity to rise as the world's sole hegemonic power. The U.S. was able to exert a profound influence on the global economic order through the establishment of the World Trade Organization (WTO) and other multilateral trade organizations aimed at promoting global economic liberalization through enhanced regional cooperation. There has been, however, little progress in the regional integration except in the case of European nations. The Uruguay Round and the subsequent Doha developmental Agenda (DDA) failed to achieve substantial outcomes. Meanwhile, the Asian financial crisis of late 1997 raised the fundamental question of how the global economic order should be established. This led to increased attention on trade liberalization through free trade agreements in the 21st century.

Reflecting the global trend, South Korea has concluded FTAs

with 32 countries, and making it second only to Singapore in terms of the number of FTAs signed. Starting with Chile in 2003, South Korea has signed FTAs with Singapore, ASEAN, India, and the EU. Furthermore, South Korea has also begun FTA negotiations with China.

In this process, it is important for South Korea to apply greater policy consideration in establishing its FTA strategy. There is no dispute that the KORUS FTA contributes to solidifying the ties between the two states and that it incentivizes neighbouring states to also sign FTAs with Korea. At the same time, there is also the need to utilize it as an opportunity for South Korea to establish a more concrete East Asian diplomatic strategy. In addition, it can be said that as a divided state, South Korea is faced with additional disadvantages and limitations which need to be overcome, for its foreign policy decisions cannot be independent from its prospects for unification.

This study aims to analyze the effects of the KORUS and ROK-China FTA on South Korea's international relations and figure out the consequential strategic effects on the Korean Peninsula.



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# 2

## **Background of the KORUS and ROK-China FTAs**

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## 2. Background of the KORUS and ROK-China FTAs

### A. The United States and China's FTA Strategies

#### 1) The United States' FTA Strategy

##### (1) Principle of global multilateralism and pursuit of strategic exceptions

The Marshall Plan was enacted by the U.S. in 1947 as a way to help rebuild Europe after World War II. The U.S. supported Western European nations in the transformation of the European Coal and Steel Community (ECSC) into the European Economic Community (EEC) in 1957, even though the EEC failed to comply with the conditions in the regional trade agreement of the General Agreement on Tariffs and Trade (GATT) and enacted some discriminatory measures against the U.S. This decision was made in order to solidify alliances and strengthen the capitalistic bloc in Europe within the context of the Cold War against the Soviet Union. The U.S. sought a different method from that in Europe to construct 'an American-centric anti-communism post-war order' in East Asia. In

addition, they forged a ‘hub-and-spokes’ system based on its strong military alliances with Japan, South Korea, Taiwan, Singapore, and Philippines to strengthen its influence in the region.

The U.S. provided substantial financial aid to South Korea and Taiwan while its market was opened to Japan, South Korea, Taiwan, and Singapore without demanding reciprocation. As a result, those countries were able to protect their companies and markets through protective trade policies promoting the export of their own goods to the American market. Such export-oriented policy enabled those countries to achieve rapid economic growth. This foreign economic policy of East Asian nations led to the creation of the developmental state economic model. Although the developmental state economic model, first adopted by Japan followed by South Korea, Taiwan, and Singapore was in fact a threat to the free-market economic order which the U.S. aimed to achieve, it was tolerated as it enabled the U.S. to pursue its security interest in East Asia.

## (2) Promoting FTAs and the coordination of a global trade order

During the Cold War, the U.S. tolerated the discriminatory trade policies of Europe and East Asian countries due to its security needs but it pushed itself to actively promote the establishment of a non-discriminatory multilateral world trade order.

The U.S. played a leading role in trade negotiations such as the Kennedy Round (1963-1967) and Tokyo Round (1973-1979) of the

General Agreement on Trade Tariffs (GATT), endeavoring to lower tariff rates and prevent discriminatory trade practices around the world. However, U.S. policy underwent significant changes in the beginning of the 1980s as little success was made by multilateral trade negotiations under the U.S.-led GATT to accomplish trade liberalization.

The EEC's Common Agricultural Policy (CAP) was adopted in the 1950s in order to increase agricultural productivity within the European continent, when European countries were not self-sufficient in providing their food supply and therefore largely dependent on U.S. imports. This had a serious impact on the U.S. economy, and consequently caused trade conflicts between the U.S. and European countries. In such circumstances, the U.S. actively pursued FTA and regional trade agreements as a response to European protectionism, in order to force Europe to adopt a free trade system. The U.S. resolve to actively utilize FTAs can also be seen in the Asia-pacific region where it not only enthusiastically participated in the Asia-Pacific Economic Cooperation (APEC) but also utilized it as an international forum to promote neo-liberalism in trade and economy. While Australia and Japan originally intended to promote regional economic cooperation between Asian-Pacific countries through APEC, the U.S. transformed it into an instrument for trade liberalization in the Asia-Pacific region.

The FTAs and Regional Trade Agreements (RTA) signed by the

U.S. in the early 1990s indicated a shift away from its long-standing commitment to multilateral trade negotiations under the GATT system. However, it did not mean that it relinquished the establishment of the nondiscriminatory world trade order which it has been consistently pursuing. Rather, it meant that the U.S. began to recognize that FTAs and RTAs could be utilized as instruments for global trade liberalization.

### (3) Supporting anti-terrorism strategies through FTAs

With the September 11 terrorist attacks, the Bush administration began to overtly link its national security interests with FTAs when dealing with a series of bilateral trade negotiation with countries of strategic or geopolitical significance. However, this strategy of interlinking FTAs with security interests spawned the following negative results.

The Bush administration's emphasis on bilateral trade agreements contributed to weakening the non-discriminatory world trade order which the U.S. had championed. In selecting negotiation partners for FTAs, the Bush administration linked them with the anti-terrorism alliance which inevitably limited the range of possible FTA partners. The U.S. entered into FTAs with Singapore, Australia and South Korea but rejected FTA negotiation requests from New Zealand and Taiwan. By circumscribing potential partners for FTAs, the U.S. strategic influence in the said regions gradually weakened. China, on



the other hand, benefiting from its rapid economic growth, actively repaired the once uncomfortable relationships with East Asian countries and subsequently increased its influence in the region. As a result, the Bush administration's strategy of interlinking FTAs with security became a factor which weakened the relative power of the U.S. in Asia while giving the opportunity for its potential competitor, China, to strengthen its regional power.

(4) Simultaneously promoting the resolution of the economic crisis and keeping China in check

After President Obama's inauguration, the U.S. began to pursue FTAs of great economic and political significance. In particular, with the launch of the Obama administration's first term, the U.S. actively began to pursue the Trans-Pacific Partnership (TPP). Then, in February 2013 from the beginning of the second term, the U.S. announced that it will start FTA negotiations with the EU. The Obama administration's drive for FTAs was not only aimed at revitalizing the U.S. economy, stagnant since the 2007-08 crisis, but also reflected the U.S. strategic goals to strengthen its influence in constructing the international economic order and to keep China's rise as a potential rival in check.

Although not as overtly expressed as its economic goals, geopolitical considerations are one of the main factors for the U.S. pursuit of the TPP. The United States Trade Representative (USTR)

released a statement defining the TPP as an Asian-Pacific trade agreement which reflects the priorities and values of the U.S. It signals the U.S. willingness to recover its influence in Asian-Pacific region which has been weakened compared to other regions, and to establish a U.S.-centric trade order. Simultaneously, the TPP reflects the U.S. intention to check China's increasing power in the region. If the U.S. had planned the TPP for sheer economic purposes, it would be taking various measures to encourage China's participation, but there has been no signal of such so far. In fact, the U.S. is deterring China's participation, if anything, by labeling the TPP as an agreement to pursue trade liberalization on the same level as (or higher than) the WTO. As China is not prepared to accept a high level of market-opening and trade liberalization, this has had the effect of restricting China's participation in the TPP.

In addition to the TPP, in February 2013, the U.S. announced the launch of FTA negotiations with the EU. The U.S. intentions and goals for pursuing the U.S.-EU FTA has not been made clear yet, but there seems to be two major factors behind the decision. Firstly, the U.S.-EU FTA is being pursued as a vehicle to overcome the economic difficulties of the U.S. and EU caused by the economic and financial crisis of the late 2000s. Announcing the start of FTA negotiations with the EU, the Obama administration stressed that a just and liberal trade environment created in the Atlantic region will create millions of quality jobs. Secondly, with the emergence of the

so called BRICs nations - China, India, Russia and Brazil as new economic powers, the U.S. is likely to consider an economic coalition with the EU through the FTA as a way for both sides to sustain economic leadership in building a new international economic order.

## 2) China's FTA Strategies

### (1) The purpose of FTAs

The general tendency of China's FTA strategies can be described as broadening the scope of target countries (from neighbouring to peripheral), moving from bilateral to multilateral agreements, with increasingly comprehensive terms. China's purpose of pursuing FTAs can be summarized as follows;

Firstly, China aims to develop new foreign markets and assist its companies to expand business into those markets. That is, China is concluding FTAs in order to prevent rapidly increasing trade frictions and seek to diversify export markets while encouraging its companies to enter foreign markets.

The second goal is national development. China has established the Shanghai Cooperation Organization (SCO) and expanded the energy transportation network in cooperation with Pakistan to support its developmental plans for the West and Northeast regions, with the aim of achieving continuous national economic growth and

stimulate regional development through FTAs with neighboring countries.

The third goal is the acquisition of advanced technologies. China is pursuing the so called ‘Go Out Policy’ which includes mergers and acquisitions (M&A) for the transfer of advanced technologies from abroad. Favourable conditions for M&A can be created on top of increasing the influx of advanced technologies from overseas through foreign direct investment (FDI).

The fourth goal is to improve its industrial competitiveness. Like most countries concluding FTAs, China facilitates market access and promotes sophistication of industrial structures through lowered tariffs and the lifting of other non-tariff barriers.

The fifth goal is to secure energy resources. China’s continuous rapid economic growth has led to its pursuit of FTAs to cope with burgeoning demand and rising prices for raw materials including oil, energy and rare mineral resources.

The sixth goal is the construction of overseas Chinese networks and the Chinese economic sphere. In addition to Hong Kong and Macao, which are subjects of Chinese integration, China is pursuing the FTA with Taiwan which it intends to integrate in the future. By raising mutual interdependency with those regions, China intends to integrate them into Chinese territory, as the initial step towards building a Chinese economic sphere stretching into the ASEAN region.

Lastly, China hopes to strengthen regional cooperative security

and its own leadership in it. Economic cooperation strengthened by FTAs raises mutual economic interdependency and accelerates economic integration between signatories. Furthermore, it can reinforce socio-political trust and stability, accelerating regional integration. China's economic relations were crucially dependent on bilateral trade with the other nations of the world. China's economic relations have undergone substantial changes since it has joined the WTO in 2001. This is to say that FTAs are playing an effective role in moderating the 'China threat discourse' and are conducive to creating a favorable environment for China's peaceful rise.

## (2) Strategic implications

The recent history of China's FTA with other nations has placed much emphasis on its diplomatic and security concerns. It is best presented in political concessions and compromises China made in its FTA negotiation process with other states. Such position was evident in China's negotiations with Peru, Chile, Pakistan - states of relatively lower economic stature and trade frequency; as well as with Hong Kong, Macao and Taiwan - its targets for integration. China also puts much importance on smaller scale economies over larger ones when choosing potential FTA partners. This can be seen as China's intention to prioritize states towards which China can play a leading role rather than its diplomatic-security rivals.

In particular, it is noteworthy that in choosing FTA partners,

China mostly targets countries located around its territory. This demonstrates that China hopes to create mutual interdependence with those countries leading to the stabilization of the East Asian region through FTAs. This is because FTAs are a very useful instrument for China as a great power to institutionalize cooperation with countries of relatively small size and therefore to increase mutual interdependence.

This attempt by China to use the FTA as a tool for economic integration and regional stabilization with its neighbouring countries is linked to its intention to take a leadership role in the region. More specifically, this is China's response to the U.S. China containment policy, as well as competition for regional leadership with India and Japan.

For China, the definition of its relationship with the U.S. is the most important part of its foreign and security policy. Until now, China has chosen cooperation with the U.S. rather than direct confrontation, seeking to increase its national power while increasing its regional power in response to the U.S. China containment policy. China's suggestion of 'the new type of great power relations' through cooperation can be explained from the same perspective. China is showing consistent interest in constructing an international order conducive to its own national interests, preventing the regional formation of a structure of dynamics aimed at keeping its rise in check. Thus China's FTA strategy not only contributes to its own

national interests, but also builds mutual interests and interdependence with neighboring countries, making it an effective means to weaken the power of the U.S. China's FTA strategy is a combination of its trade strategy to become a great power and foreign security goals. It has major implications for the ROK-China FTA. China's pursuit of regional security collaboration and strengthened leadership in the region has greater implications regarding China's strategic intentions in pursuing FTAs.

## **B. Strategic Impact of the KORUS and ROK-China FTAs**

### **1) The KORUS FTA**

#### **(1) Impact of the FTA on bilateral trade**

According to an analysis from the Korea International Trade Association (KITA), in the year following the signing of the KORUS FTA in March 2013, South Korea's exports to the U.S. rose 1.3% while imports fell 8.9% from the previous year. According to KITA's analysis, the data shows stability in South Korea's exports to the U.S., given 2% decline in Korea's total overseas exports, in accordance with the overall recession in trade environment. In particular, there was a 14.6% rise in the case of the FTA beneficiary items, outpacing that of its competitors, Japan (13%) and China (6.9%).

However, there is yet to be a discussion on whether the slight growth in the South Korea – U.S. trade following the FTA would have an effect on security issues, and if so, whether it would be positive or negative. Apart from the limitation that the period of observation has been too short, there has been no conclusive study in international politics conducted with regard to the causality between trade and security.

In evaluating the effect of the KORUS FTA, one should consider not only increase in trade volume (static factor) but also overall changes in trade patterns. The effect of the KORUS FTA on their security relations also should be discussed in consideration of dynamic changes. Therefore, in terms of security issues, the externalities of the FTA in the security dimension should be examined in regards to changes of the balance of interests following its implementation. In other words, if there is a serious imbalance of interests between two countries or the industrial structure of either party is exposed to the negative effects of the FTA, conflicts between the two countries will rise, in turn exerting a negative influence on security.

## (2) East Asia's security structure

The ROK-China-Japan FTA is emerging as an alternative to build a new framework for economic cooperation in East Asia which has been so far characterised by a low level of systemization in regional cooperation. It is also becoming a pressing matter of



concern regarding, whether the FTA could have positive effects on the construction of a consultative body on regional security. Of course, regional security cooperation through the FTA is a difficult goal to achieve not just due to differing economic interests but also historical, political, and security factors. But it is worthy to examine to what extent the KORUS FTA, already in effect, will inspire a response from China and Japan with regard to the trade diversion effect. Going further, it is important to examine the significance of the ROK-China-Japan FTA as a response from China and Japan to counter the KORUS FTA.

With regard to the trade diversion effect, Japan is likely to pursue the ROK-China-Japan FTA more actively than China, as competition between South Korea and Japan in U.S. market is more intense than that between China and South Korea. Also, it is more likely for the U.S.-Japan trade to be replaced by the South Korea-U.S. trade than the U.S.-China trade would be by the trade between South Korea and the U.S. However, recent territorial and political conflicts between China and Japan have led observers to cast doubt on the feasibility of the trilateral FTA. In the transformation of the East Asian region into an arena for competitive implementation of FTAs, Japan had initially appeared to be excluded from the trend. However, it has been more actively joining regional trade agreements more recently, announcing its participation in the ROK-China-Japan FTA as well as the U.S.-led TPP.

As opponents of the KORUS FTA have stated from the early stages of its negotiation, there is the criticism that the KORUS FTA constrains China by solidifying exclusive alliance ties in the Northeast Asian region, and that it undermines the logical basis for successful ROK-China-Japan FTA and the Regional Comprehensive Economic Partnership (RCEP) negotiations. Thus, it can be said that it is crucial for South Korea to consider how it should utilize the KORUS FTA as a stepping-stone for East Asian economic cooperation, rather than allowing it to stand as an obstacle. In addition, it should be of top priority to formulate policies to generate positive spillover effects from East Asian economic cooperation to lay the foundations for security cooperation in the region.

### (3) The KORUS FTA and provisions for the Kaeseong Industrial Complex

Although it has already been a year since the ratification of the KORUS FTA, there has been no discussion with regards to the launching of a committee on outward processing zones. Moreover, the Kaesong Industrial Complex revealed its vulnerability to political influence when its operations were suspended with the withdrawal of North Korean workers in April 2013.

With regard to the KORUS FTA, the Kaesong Industrial Complex is not simply an economic issue but one of security significance to both states. The U.S. has always been wary of the details of operation

in the Kaeseong Industrial Complex such as how the employees are paid. The U.S. has to make a strategic judgment as to whether allowing duty-free market access to products manufactured by North Korean workers through the FTA would contribute to the perpetuation of the North Korean regime or to its collapse.

The Kaesong Industrial Complex, as the U.S. Congressional Research Service (CRS) has pointed out, may provide an ongoing revenue stream to the regime. It can establish the foundation for capitalist modes of production to take root within North Korea and have spillover effects on other regions. The decision of the U.S. government and Congress regarding the Kaeseong Industrial Complex will depend on which perspective they choose.

Given this U.S. position and the security situation on the Korean Peninsula, it is unlikely that the KORUS FTA will play an encouraging role or put pressure on North Korea to enact reforms. Of course, the situation will change when the Kaesong Industrial Complex resumes operations and a committee is created to look into the designation of outward processing zones in the Korean Peninsula. Moreover, if the Park Geun-hye administration successfully fulfils its pledge of globalizing the Kaesong Industrial Complex, the security impact of the KORUS FTA could be maximized.

#### (4) Regional cooperation in East Asia

From the latter half of the 2000s, negotiations regarding RCEP,

TPP, and ROK-China-Japan FTA have been simultaneously ongoing. This demonstrates that bilateral FTAs are evolving into multilateral FTAs, ushering in a new era in which the KORUS FTA should not just be considered as an end but a means.

The East Asian situation in which strategic impacts rather than economic effects of FTAs are becoming the focus, there is growing need for more policy consideration regarding how to link the existing KORUS FTA to multilateral FTAs. Of course, there is no doubt that the KORUS FTA contributes to solidifying ties between the two countries and that it incentivizes neighbouring countries to sign FTAs with South Korea. At the same time, however, it is also true that there is the concern that more elaborate diplomatic strategies in the East Asian region to take advantage of the situation have not been established yet.

The changing FTA environment is a prelude not just to the reorganization of the East Asian international order, but also to political and economic changes in Korean domestic politics. Since the 2008 global financial crisis, the model of American financial capitalism based on neoliberal policy prescriptions became a subject of caution. As a result, there has been a political wave requiring new conceptualizations of capitalism such as creative economy, economic democratization, win-win growth strategy for large corporations and small and medium enterprises as well as job sharing. Those internal and external changes are demanding South Korea to establish a new

FTA strategy.

To examine the strategic effect expected from the KORUS FTA, it is important to first understand the security circumstances surrounding the agreement. Based on such understanding, favourable conditions should be created for economic cooperation to exert a positive influence on security relations, including the ROK-U.S. alliance.

Moreover, experiences from the KORUS FTA should act as a foundation for the future signing of the ROK-China FTA, ROK-China-Japan FTA, and even the RCEP. The rivalry between China and Japan for hegemony in East Asia will continue regardless of the changing FTA environment. This rivalry will require South Korea's substantial know-how gained through the past decade of success in simultaneous FTA negotiations to conduct middle power diplomacy and act as a bridge between various parties.

## **2) ROK-China FTA**

### **(1) Domestic socio-political influences**

As the ROK-China FTA refers to the institutionalization of economic cooperation between the two countries, its direct influence on Korean domestic society and politics is likely to be limited.

In the macroeconomic dimension, despite the generally expected benefits for both parties from the ROK-China FTA, it is likely that

impact on individual industries will be more varied. More specifically, South Korea is expected to benefit in the petrochemical and automobile industry, high tech industries such as information technology, finance and services where it holds a comparative advantage, but will suffer losses in agricultural and marine products, and labour-intensive manufacturing in which China is better positioned. Moreover, since China has been interested in labour export and the partial opening of this sector seems inevitable, there are growing concerns about the increased competition for jobs and resulting social conflict.

The variance in interests by industry has the propensity to lead conflicting interests in the domestic sphere and result in socio-political problems for South Korea. Of course, since South Korea's perspective and spectrum of interests vis-à-vis China are not as extensive and clear as those toward the U.S., there is little chance for socio-political problems caused by the FTA to develop into incidents like the 2008 protest against U.S. beef. Although increased economic interdependence between South Korea and China from the FTA may lead to expanded gaps between the interests of various domestic actors, it has the potential for more serious socio-political conflicts when these are combined with insular nationalism. South Korea and China have been involved in cultural, historical and territorial disputes. China's Northeast Project has the potential to provoke hostile reactions from South Korea. Also, the possibility exists for

such anti-Chinese sentiments to combine with hostility from farmers suffering damages, or certain vulnerable companies going bankrupt or a rise in unemployment as results of the FTA, and end up being interpreted as evidence for the 'China Threat' discourse to take root within Korean society. Moreover, when the dispute over how to establish and develop the relationship with China is combined with conflicting interests, this may lead to serious social conflict or act as a socio-political burden on the Korean society.

## (2) Asymmetric economic interdependence between South Korea and China

The ROK-China FTA will increase trade and investment between the two states and will, in the mid-to-long term, promote economic interdependence and even integration with increased specialization between and within industries. But the functionalists claim that economic cooperation between South Korea and China will bring about mutual interests and trigger political and security cooperation leading to eventual integration is unlikely to be realized. This is because South Korea has already entered into FTAs with many countries and regions including large economic zones, such as the U.S. and the EU. Even if the FTA with China takes effect, bilateral ties will not necessarily follow a linear mode of development going from enhanced economic cooperation to establishment of mutual trust leading to political and security cooperation and finally

integration.

However, given the fact that the ROK-China relationship has been defined by economic ties paving the way for political and diplomatic cooperation, the broadened economic relationship from the FTA is expected to enhance mutual trust necessary for political cooperation as well. In the mid-to-long term, it is expected to contribute to the strategic cooperative partnership formed in 2008 between South Korea and China. In particular, the FTA should provide conditions conducive to the reinforcement of the strategic cooperative partnership in all areas encompassing political, economic and societal, as agreed upon at the summit meeting in Beijing in June 2013.

In the mid-to-long term, close economic cooperation as well as mutual dependence resulting from the ROK-China FTA would strongly incentivize China to protect its own assets and interests by making diplomatic efforts for peace and stability on the Korean Peninsula. Thus, the ROK-China FTA and the resulting economic cooperation would not only benefit both states economically, but also have a positive impact in the socio-cultural dimensions as well as diplomacy and security. Furthermore, it will be conducive to the promotion of the discourse on the benefits of unification which champions a Korean unification led by South Korea as being beneficial for Chinese national interest as well.

However, the negative aspects cannot be ruled out either. Due to



the disparity in economic scale between the two countries, the FTA will increase South Korea's economic dependence on China, further expanding the current asymmetry in economic interdependence. This means that China would gain economic means to put diplomatic pressure on South Korea. China has already used the same manoeuvre on Japan, when it blocked exports of rare earth resources to Japan in 2010, and it is likely that China will take the same measure if South Korea poses a challenge, directly or indirectly, to its core interests.

It cannot be denied that the ROK-China FTA would strengthen economic ties between the two and contribute to their strategic cooperative partnership. However, it is clear that the impact of the ROK-China FTA would not be significant enough to strengthen their security cooperation beyond the limitations of the ROK-U.S. relations. More consideration should be given to the possibility that the FTA's negative impact on domestic economies could lead to the spread of anti-Chinese and anti-Korean sentiments in both countries coupled with growing imbalance between economic dependence (asymmetric economic interdependence) leading to a necessary adjustment in the level of cooperation. These factors could act to impede the development of ROK-China relations in general.

### (3) Regional cooperation in East Asia

The ROK-China FTA would promote cooperation in the East

Asian region by encouraging discussions and pushing forward negotiations for FTAs in the region. Already, a consensus has been formed for the negotiations of an ROK-China-Japan FTA after the ROK-China FTA inspired Japan's interest. Even though territorial disputes between China and Japan are worsening bilateral relations and consequently delaying the negotiation process for ROK-China-Japan FTA, it is expected that the second round of negotiations for the ROK-China FTA would lead to Japan expressing interest in FTAs with other East Asian Countries, as it tries to avoid isolation in the East Asian region. In addition, the ROK-China FTA, when implemented, is highly likely to determine the standards for other bilateral and multilateral FTA negotiations which are expected to spread across the East Asian region. In this regard, other East Asian states are bound to keep their eyes on the progress of the ROK-China FTA negotiations. It is also likely that when the ROK-China FTA negotiations are concluded, it will encourage discussions of FTAs among other East Asian states and even stimulate discourse regarding economic integration in the entire East Asian region.

From the functionalistic perspective that economic cooperation would lead to enhanced cooperation in the socio-cultural and diplomatic-security dimensions, the ROK-China FTA has the possibility of promoting general cooperation between East Asian countries. The signing of an FTA between South Korea and China, which has emerged as the second largest economy in the world, has

the potential to encourage economic cooperation between East Asian states as well. This would mean that the ROK-China FTA could also contribute to the vitalization of regional cooperation in economic as well as security issues. China's aim to utilize the FTA with South Korea as a tool to gain economic leadership in the region would conversely inspire the participation of the U.S. and Japan in order to keep China in check, leading to greater economic as well as political cooperation in the region.

However, the possibility of the ROK-China FTA acting to promote security cooperation between East Asian countries is highly limited. While FTA may help resolve disputes over the interpretation of history, territorial disputes and conflicts of nationalism to a certain extent, its limitations in effectuating a complete resolution are clear. Moreover, the struggle between China and Japan for leadership in East Asia coupled with U.S. efforts to keep China's rising power in check and China's response to such efforts are far from conducive for East Asian regional cooperation, not just for security but economic issues as well. Therefore, the presence and role of the U.S. in East Asia, from which it does not want to be isolated, coupled with its existing FTA with South Korea would inevitably act to restrict the influence that the ROK-China FTA could have on the promotion of regional cooperation.

South Korea, which has already signed FTAs with the EU and the U.S., could maximize its role in promoting regional cooperation by

virtue of its relative weakness in comparison to China and Japan, as the ROK-China FTA is likely to aggravate the China- Japan rivalry. Japan is currently endeavouring to contain China by participating in the U.S.-led TPP while China hopes to counter the U.S.-Japan alliance through the ROK-China-Japan FTA. South Korea as a middle power could become the only actor capable of easing conflicts and promoting regional cooperation through the FTA with China. This is because a partnership with South Korea is a relatively easier option for both China and Japan, which offers the simultaneous benefits of balancing against their respective rivals and avoiding regional isolation.





**3**

**FTA and the Korean Peninsula**

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### 3. FTA and the Korean Peninsula

#### A. Direction of South Korea's FTA Strategy

The following are the political and security objectives that South Korea would be able to pursue through FTAs. Firstly, FTAs can help maintain peace and stability on the Korean Peninsula and improve relations with North Korea by encouraging the opening and reform of its market. FTAs can act as effective means to vitalize trade between signatories and to strengthen security alliance and strategic partnerships. However, in order to utilize FTAs as useful means to maintain the stability of the Korean Peninsula, it is necessary to apply more sophisticated and strategic considerations. In addition, South Korea must use FTAs as means to encourage the reform and opening of the North Korean market. It should apply policies to designate the Kaesong Industrial Complex as an outward processing zone in its discussions with the U.S. and China. At the same time, it should formulate a range of plans allowing for FTAs with neighbouring countries to contribute to North Korea's economic development.

Secondly, South Korea has to keep in mind its role in preventing

the deterioration of the U.S.-China relations and strengthening cooperation between the two great powers as well as across the region in the establishment of the East Asian trade order. China is attempting to build a Sino-centric East Asian economic order by simultaneously seeking FTAs with South Korea and Japan as well as the RCEP on top of the existing FTA with the ASEAN as well as the Chinese economic sphere encompassing Hong Kong, Macao and Taiwan. The U.S, on the other hand, is seeking to maintain and increase its influence in East Asia by leading the TPP and building on an Asian-Pacific FTA network. Combined with the possibility of power transition and the subsequent strategic distrust, competition between the U.S. and China for leadership in the East Asian trade order is a destabilizing factor for East Asian security and economy. South Korea has undeniably strengthened its position through the global FTA hub strategy but it is also true that it has not been able to use FTAs as an effective means to achieve its strategic goals in East Asia. Thus, its strategic vision for FTAs in relation to the establishment of the East Asian economic order must contain an institutional framework for the peaceful management of conflicts and mistrust between the U.S. and China.

Lastly, South Korea's FTA strategies must be formulated to strengthen its middle power diplomacy. The Park Geun-hye administration has presented middle power diplomacy as one of South Korea's core foreign policies, with its global FTA network as



an important resource for the reinforcement of middle power diplomacy. South Korea's middle power diplomacy will act as a bridge-builder between developed and developing countries to contribute to the advancement of developing countries in both security and economic dimensions. The global FTA network built by South Korea can be used as a seminal tool for implementing South Korea's middle power diplomacy. In addition to contributing to improve traditional security relations between states, FTAs can also be linked to cooperation in non-traditional security issues, such as human rights, human security and environmental conservation. Therefore, South Korea's FTA policy direction has to work towards not only enhancing economic cooperation with developing countries but also contributing to its middle power diplomacy by fostering cooperation in traditional and non-traditional security issues.

## **B. Political Situation in Northeast Asia and Direction for South Korea's Future FTAs**

### **1) A balanced response to power transition**

The U.S. has been the global hegemonic power since the end of the Cold War but is now experiencing a relative decline with China emerging as a possible competitor. Both powers are currently seeking

separate FTAs in East Asia, showing signs of possible conflict. The U.S. is seeking a central position in the integrated economic system of Asia through the TPP and RCEP. The U.S. attempts to utilize Asian markets and resources for its economic revival and its declaration of its pivot to Asia policy has gradually clarified the dynamics of economic rivalry with China, which has been attempting to rise to leadership in a variety of fields within its own sphere of influence.

At present, it is difficult to find the debate between pro- America and pro-China which arose in the context of the U.S. decline and China's rise within the Korean society. Asian countries including South Korea, which have benefited from the rise of China while being simultaneously exposed to its strategic threat, have taken an ambivalent attitude toward China. Instead of solidifying their alliances against China or working on building up their own military capabilities, they seem to be opting for 'hedging strategies' between the declining U.S. and rising China.

Applying the hedging strategy to South Korea's FTA strategy in the present situation, it can be said that signing respective FTAs with both the U.S. and China corresponds with South Korea's national interest. Given the ensuing competition between the U.S. and China over bilateral and multilateral FTAs in East Asia, it will be an appropriate choice for South Korea to sign FTAs with both states in consideration of its economic and security interests.

In the future, South Korea should make efforts to display its strategic and security value while seeking cooperation from both states for Korean unification. That is, South Korea should engage in ‘assertive hedging’- choosing the country which will appreciate its value most, rather than a passive hedging strategy of vacillating between the two states. If South Korea participates in the different multilateral FTAs led by the U.S. and China respectively, it would be able to maximize its geographical and economic advantage of being positioned at the juncture where the two different economic blocs meet.

## **2) Simultaneous reinforcement of the ROK-U.S. alliance and national economic interests**

The U.S. has pursued and concluded FTAs with South Korea as part of a new balancing strategy formulated under the perception of China as a potential threat or a competitor. As South Korea enters into the 60th anniversary of its alliance with the U.S., it is also making efforts to transform the present security alliance relationship into that of a security and economic alliance. This policy direction has been crystallized in the ROK-U.S. joint vision for the Korean Peninsula issued in 2009. The joint vision reached a level of consensus regarding a new vision for the alliance based on permanent friendship and mutual respect with shared interests and

objectives not only in security, but also in economy, environment, energy, poverty, and human rights.

In midst of such changes, it is inevitable for South Korea to accept an increased role and burden in maintaining security. However, efforts should also be made to secure economic interest. Although economic interests can be gained through a close relationship with China, it also has to be noted that in bilateral trade relations, the party who has relatively lower degree of economic dependence has the capacity to exert influence on its partner through unilateral interruption or change in the economic relationship.

China's political intention in pursuing the ROK-China FTA includes expanding its influence over the Korean Peninsula. In other words, by building close economic cooperative relations with South Korea, China seeks to increase South Korea's economic dependency on China and use it as a means to reinforce its diplomatic influence.

Even as economic interdependence between South Korea and China rendered by an FTA strengthens the degree of bilateral cooperation, an asymmetrical interdependent relationship is likely due to the disparity in economic size and national power. In this case, even if both states pursue cooperation under the same condition for their own national interests, South Korea, expecting to benefit more from the cooperative relationship, is likely to be more committed. Also, when their respective interests come into conflict, South Korea is expected to suffer greater losses if the situation reaches a head, and

thus would have to take on a more conciliatory attitude.

That is to say, the asymmetrical interdependent relationship between China and South Korea likely to be created by the FTA would have the negative consequence of strengthening China's position while muting South Korea's voice not only in the ROK-China relations, but also in the triangular relationship between China, South Korea and North Korea.

In this case, it may be difficult to gain Chinese support when dealing with problems related to North Korea. Rather, it is more likely that China forms a trilateral cooperation between China, South Korea and North Korea as intended by China. In the long run, it will work against South Korea in advancing relations with North Korea or achieving unification, possibly even leading to the stagnation of inter-Korean relations. Thus, South Korea must pursue economic cooperation with the U.S. to prevent economic dependency on the Chinese market and its resources. Even though the ROK-U.S. alliance has been mostly defined by mutual security objectives, it should be expanded to encompass not just security but mutual prosperity as well.

### **3) Seeking security benefits from the ROK-China FTA**

An FTA with China should be developed in a way that enables South Korea to promote not only its economic interests but also its security interests. An asymmetrical economic interdependence in favour

of China is undesirable and security interests should be pursued simultaneously with economic interests through its FTA. More specifically, South Korea should devise a plan to lead North Korea to economic reform by making use of China's leverage over North Korea and their special relationship.

The designation of the Kaesong Industrial Complex as an outward processing zone is the first consideration to be made in utilizing the ROK-China FTA as an instrument of bringing changes in North Korea. Currently only South Korean companies can operate in the Kaesong Industrial Complex and most manufactured items are sold only in the South Korean market. Furthermore, methods to internationalize the Kaesong Industrial Complex are being considered. If China, which has a special relationship with North Korea, succeeds in bringing its firms to the Kaesong Industrial Complex, and items manufactured in the Kaesong Industrial Complex are granted duty-free status in both China and South Korea, it will be the Kaesong Industrial Complex's first step toward internationalization. The internationalization of the Kaesong Industrial Complex will eliminate North Korea's concerns of becoming subject to the control of any one state, at the same time, make North Korea subject to responsibility regarding diplomatic and economic costs incurred by the suspension of operations or closure of the Kaesong Industrial Complex.

South Korean and Chinese governments also need to consider designating other locations beside the Kaesong Industrial Complex

as outward processing zones. A special economic zone is being planned in the border regions between China and North Korea. For instance, if the special economic cities of Najin-Sonbong or Hwanggeumbyeong are designated as outward processing zones to be jointly developed by China and South Korea, the North Korean economy would be opened up as it makes economic gains. If Chinese companies produce goods in North Korea's special economic zones and export them to foreign countries, North Korea may attempt to go through changes, such as denuclearization, in order to access U.S. markets. This means that there is a possibility that China will induce North Korea's rapprochement with the U.S. and subsequent stabilization of the Korean Peninsula while expanding its own economic interests. Thus when its scope of coverage is broadened to encompass North Korea, the ROK-China FTA has the potential to not just benefit the economic interest of the three states but act as a turning point to improve the security environment of the Korean Peninsula.

China has been simultaneously pursuing its interests in both South and North Korea while seeking stability and expanded influence on the Korean Peninsula. Its pursuit of an FTA with South Korea is an extension of these intentions. Moreover, China is likely to play an active role in persuading the two Koreas to improve inter-Korean relations and promote stable development in order to protect their own national interest and assets, more of which can be

invested in the region as the ROK-China FTA progresses. In particular, China will seek to prevent incidents which will raise tension on the Korean Peninsula, such as a sudden change in the North Korean political system, missile launches and nuclear tests, and armed provocations while seeking to ease tensions rather than aggravating conflicts with Japan and the U.S. Thus, the ROK-China FTA has positive aspects in that it will contribute to the peace and stability of the Korean Peninsula, the peaceful resolution of the North Korean nuclear problem and South Korea's rapprochement with North Korea as well as lessening of tensions, and the creation of a peaceful climate for dialogue and negotiation between North Korea and other states. In the mid-to-long term, expanded cooperation promoted by the ROK-China FTA will increase discussions and agenda setting regarding diplomatic and security issues in the region and ultimately contribute to lasting peace on the Korean Peninsula.

#### **4) FTA as a mechanism to expedite the internationalization of the Kaesong Industrial Complex**

The internationalization of the Kaesong Industrial Complex can be a good way to induce North Korea to open up its economy without too much dependence on South Korea's economy. However, there are at least two challenges to overcome in the internationalization of the Kaesong Industrial Complex.



Firstly, the political risks discouraging the participation of the global companies should be removed. The main focus for companies investing in the Kaesong Industrial Complex is not the merit of inexpensive and high quality labour, but unstable security situation on the Korean Peninsula. As discussed, the internationalization of the Kaesong Industrial Complex can act as a shield against North Korea's provocations or also be a foundation for achieving peace on the Korean Peninsula. Ironically, the situation on the Korean Peninsula and the Kaesong Industrial Complex has to be stabilized first in order to attract more global companies into the Kaesong Industrial Complex. If China and Russia share strategic interests with North Korea could become the first participants, it would lead to the stabilization and institutionalization of the Kaesong Industrial Complex from which the internationalization of the Kaesong Industrial Complex can be expanded upon.

Secondly, markets for items manufactured in the Kaesong Industrial Complex have to be secured. Currently, the 86% of goods manufactured in the Kaesong Industrial Complex are sold in South Korea while the rest are exported to other states as 'North Korean products.' Because North Korea is not a member of the WTO, North Korean goods do not receive preferential treatment in markets such as Japan and the U.S. Thus, when signing FTAs with other states, South Korea need to introduce special conditions in country of origin specifications by which North Korean goods can be classified as

South Korean goods.

The indefinite postponement of the introduction to foreign companies intended to internationalization the Kaesong Industrial Complex due to deterioration in the inter-Korean relations is a typical example of a short-sighted approach. This incident shows how meaningless it is to discuss the internationalization of the Kaesong Industrial Complex when there is no agreement on the three major issues for the operation of an outward processing zone: traffic guidelines, communication, and customs clearance. The criticism that internationalization which should be a 'result' of institutional improvement, was instead treated as a 'means' for institutional improvement is unavoidable. This should be South Korea's cue to draw a blueprint for a more comprehensive internationalization of the Kaesong Industrial Complex through extensive institutional improvement. From this point of view, the discussion of the internationalization of the Kaesong Industrial Complex may have to be linked to the external extension of the Kaesong Industrial Complex, viewed from a long term perspective. In regards to this, preliminary discourse is ongoing under several aspects.

Firstly, the Kaesong Industrial Complex can be transformed from the current closed special economic zone to an open special economic zone. To dramatically improve South-North economic cooperation, the scope of cooperation must be extended to Pyongyang and Nampo, the heart of North Korea. From this point of view, the

Kaesong Industrial Complex can be a connecting link between the capitals of both South and North Korea and their greater metropolitan areas. In particular, since the Kaesong Industrial Complex is the southernmost point of road transport linking the Pyongyang region to the metropolitan area of Seoul, its transformation into an open special economic zone will have a great ripple effect.

Secondly, in the mid-to-long term, the internationalization of the Kaesong Industrial Complex can be progressed through the integration of separate regions. While focusing on inviting multi-national companies to the 'inside' of the Kaesong Industrial Complex, the current discussion over the internationalization of it is not handling the issue of how to connect with the Kaesong Industrial Complex with the world outside. It is important to devise a way to link the Kaesong Industrial Complex with other special economic zones in North Korea, so called 'economic clusters.' Connecting the Kaesong Industrial Complex with the other special economic zones in North Korea or other East Asian countries will require consultation and approval from relevant governments, but connecting it with South Korean special economic zones will be much easier to approach.

In this context, it is an urgent issue to forgo the cursory approach of moving a few domestic corporations set up by foreign companies into the Kaesong Industrial Complex, and instead set up more concrete mid-to-long term plans of connecting the Kaesong Industrial Complex with the two Koreas and the greater East Asian economic region.



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**Strategic Considerations**

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## 4. Strategic Considerations

As the KORUS FTA enters its second year while negotiations are ongoing for the ROK-China FTA, the following strategic approaches must be considered.

Firstly, the KORUS FTA and the ROK-China FTA must be strategically connected. South Korea can utilize China's strategic intent as it competes against the U.S. and Japan on the Korean Peninsula to gain many concessions from China during FTA negotiations. The ROK-China FTA should be advanced using the KORUS FTA as a counterweight to control the potential risk of developing an asymmetrical interdependent relationship with China. Through the KORUS FTA, South Korea should secure its own connections to the centre of the global economy as well as stable foreign exchange markets, export markets and energy resources. By doing so, South Korea should be able to decrease the degree of dependency on the Chinese economy and contribute to increasing China's compliance with international norms. Moreover, the ROK-China and KORUS FTAs should be used to induce further entry by the U.S. and China into their markets. In the long run, South

Korea should also implement measures to increase interdependence between China, South Korea, and North Korea. To do so, South Korea needs to link the issue of designation of Kaesong Industrial Complex as an outward processing zone to that of denuclearization of the Korean Peninsula and seek to develop successive projects like the Kaesong Industrial Complex to pursue balanced interdependence between China, South Korea and North Korea.

Secondly, South Korea should pursue FTAs in harmony with the Trust-building Process on the Korean Peninsula. By implementing this strategy, South Korea would be able to offset the increase in Chinese influence from the ROK-China FTA and utilize the improved ROK-China relations to South Korea's favour. If South Korea cedes too much responsibility or place too much hopes in China in the management of inter-Korean relations, it will only increase Chinese influence on the Korean Peninsula while constricting its own. As a direct party to inter-Korean relations, South Korea has to improve relations with North Korea in order to maintain its control over the situation. Only when inter-Korean relations are maintained can South Korea control the unilateral increase of Chinese influence on the Korea Peninsula and effectively utilize the Chinese influence on North Korea.

Thirdly, to allow the ROK-China FTA to contribute to the stabilization and improvement of inter-Korean relations, South Korea has to expand special conditions regarding country of origin to

classify goods produced in the Kaesong Industrial Complex as South Korean products. By expanding South Korean companies' investment in North Korea and promoting inter-Korean cooperation, South Korea can prevent the ROK-China FTA from displacing investment in North Korea to China and the resulting decrease in inter-Korean economic exchange.

There is also the possibility that as China seeks stability on the Korean Peninsula, it will show enthusiasm for the expansion of special conditions for country of origin definitions, considering its friendship with North Korea, rivalry with the U.S. and the expansion of its influence on the Korea Peninsula.

Fourthly, South Korea should seek to arrange opportunities to link the North Korean issues with the ROK-China FTA. Since the ROK-China FTA is a process of institutionalizing economic cooperation and interaction between China and South Korea, it has no binding force upon North Korea. Yet, given the unique characteristic of South-North relations, South Korea should not neglect the North Korean issue when negotiating for the ROK-China FTA.

If ROK-China cooperation enhanced by the FTA is used to induce North Korea to open its economy, South Korea needs to devise strategies to guide North Korea's opening-up process in its favor and to not orient towards the Chinese market, given that South Korea has to consider inter-Korean relations and Korean unification in the future. For example, during FTA negotiation with China,

South Korea could include provisions for South Korean cultural goods allowing for the so called ‘Korean wave’ to enter North Korea via China.

China has a profound interest in the Kaesong Industrial Complex just as South Korea is interested in the Najin-Sonbong and Hwanggeumpyeong areas. Thus South Korea also needs to leave the possibility open for Chinese participation in the Kaesong Industrial Complex project.

Fifthly, South Korea should champion the East Asian economic integration in pursuing FTAs. South Korea and China are economically integrated in East Asia’s close knit international specialization structure. Accordingly, the ROK-China FTA is not to be just confined as a bilateral trade pact between China and South Korea and should contain more comprehensive and far reaching agreements targeting future FTAs between other East Asian countries and regional economic cooperation, vitalization and integration. Also, even after an agreement has been reached, joint committees in various areas must be set up in order to take a leading role in the evolving environment of regional cooperation in East Asia and present new agendas.

Sixthly, to prevent the negative aspects of increased Chinese leverage on the Korean Peninsula after the ratification of the ROK-China FTA, it is imperative to reinforce cooperative relations with the U.S. As the KORUS FTA has already entered into effect, the



possibility of both the intensification of current asymmetrical interdependent relationship with China and the unilateral strengthening of Chinese power due to weakened ties between the U.S. and South Korea appear to be slight.

However, reinforcing the ROK-U.S. relations is still a matter of significance. This is because if the current 'abnormal' relations between the U.S. and North Korea continue, and cooperation between China, South and North Korea keeps expanding, the Chinese influence on inter-Korean relations will be increased. Therefore, ROK-U.S. relations must be strengthened in a way that is conducive to securing South Korea's control over ROK-China relations, aimed at balancing cooperative relations with China. South Korea and the U.S. should reach consensus on a South Korea-led unification and coordination in their North Korea policies as well as discuss and share comprehensive, long term strategies over a variety of issues including South Korea-China relations. To do so, the two countries need to institutionalize the 2+2 Strategic Dialogue system involving their respective foreign and defense ministers. The ROK-U.S. relations strengthened and improved by the KORUS FTA can have a positive impact on inter-Korean relations and unification. In addition, it could motivate the construction of a multilateral cooperative network in the region, which would become an effective means of drawing changes in China's policy toward North Korea and induce it to take on a more responsible stance regarding the Korean Peninsula.

Lastly, South Korea needs to motivate China to persuade and pressure North Korea into opening and reforming its economy through closer South Korea-China cooperation. In addition, as this process may increase North Korea's economic dependence or integration into China's northeast region, South Korea should explore the measures to foster trilateral cooperation between the two Koreas and China through the ROK-China FTA.

If the degree of economic cooperation between China and South Korea is taken to the next level by the ROK-China FTA, South Korea should seek to link the ROK-China economic cooperation with that between China and North Korea and plan cooperative projects among the three countries. At the same time, South Korea and China need to make joint efforts for the institutional reform of North Korean society and the elevation of living standards in North Korea. This could include plans to encourage North Korean participation in multilateral cooperative ventures within East Asia, such as cooperation between China and the two Koreas in constructing a railroad system to handle increased flow of goods, tourism projects, as well as the Greater Tumen Initiative (GTI).

## Korea's FTA Strategy and the Korean Peninsula

In line with the global trend towards FTAs, South Korea has concluded FTAs with 32 countries. South Korea has also begun FTA negotiations with China with an expressed interest in concluding an FTA among three major Northeast Asian states, China, South Korea, and Japan. In this process, it is important for South Korea to apply greater policy consideration in establishing its FTA strategy. Thus, this study investigates the impact of the ROK-U.S. and ROK-China FTA which are considered to exert a significant influence on South Korea's foreign relations, as well as other strategic considerations.