The Development and Prospect of Two-way Investment between China and Korea

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Introduction

It is well known that China and Korea have a long history of close relations. However, this situation was blocked during the cold war. But economic and trade relations have recovered since the 1980s. In 1992, China and Korea established diplomatic relations. By now, a comprehensive partnership of cooperation has been built, and both have forged strong ties in all areas. In economic aspects, China is Korea's biggest export and investment market and surplus source; Korea is China's 6th ranking trade partner and 4th Foreign Direct Investment (FDI) source. In 2007, bilateral trade volume has reached US$158.9 billion.

This paper discusses the FDI between the two countries and is structured as follows: Part1 attempts to review the development and characteristics of FDI from Korea to China; Part 2 describes the basic characteristics of China's current direct investment in Korea; Part 3 and Part 4 discuss the basic conditions and challenges for the further development of FDI between the two countries; Part 5 offers several approaches to promote FDI between China and Korea. In this paper Korea refers to the Republic of Korea (South Korea).

The evolution and characteristics of FDI from Korea to China

FDI has grown fast since 1992. As a matter of fact, Korea's FDI into China was launched in 1988, and had a huge jump after diplomatic ties were established in 1992, from $264 million in 1993 to $ 933 million in 1996. But the increasing trend was interrupted during 1997 to 2001, due to the Asia financial crises. Since 2001, with Korea's economic recovery and China's entry into the WTO, the FDI in China increased in a strong momentum. Since 2002, China has been the biggest FDI destination of Korea. By 2007, the total actual use amount of FDI from Korea to China reached US$ 22.536 billion in 62988 projects (see table 1).

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Table 1 Korean Direct Investment in China, 1988－2007

year	Projects of Acceptances	Acceptance Amount (US$ million)	Projects of Investments	Investment Amount (US$ million)
1988	2	3.40	1	0.01
1989	12	9.77	7	6.36
1990	51	55.62	46	16.17
1991	135	84.72	130	42.47
1992	314	223.11	356	141.13
1993	752	631.27	747	264.02
1994	1,298	826.91	1,699	649.29
1995	1,271	1281.97	1,836	841.13
1996	1,517	1931.08	2,138	933.47
1997	1,140	915.76	1,781	753.16
1998	595	908.82	1,105	681.32
1999	852	493.86	1,276	351.66
2000	1,393	1004.99	2,144	721.51
2001	1,743	1019.53	3,209	650.12
2002	2,512	2111.40	4,430	1051.89
2003	3,102	2864.82	5,621	1746.63
2004	3,965	3717.22	8,065	2333.27
2005	4,611	3640.67	9,533	2773.50
2006	4,684	4535.29	9,782	3348.64
2007	4,549	7180.70	9,082	5231.13
Total	34,498	33440.90	62,988	22536.87

Source：http://www.koreaexim.go.kr/en/fdi/m02/s01_01.jsp, 3-11-2008

The investment field is spreading broadly. 81% of the total investment from Korea to China went to the manufacturing sectors during 1988-2007. At the early stage, the investment focused on the labor-intensive sectors, such as fiber, custom, footwear making, electronic appliance assembling, and the food industry. However, in recent years, with China's development as a global manufacturing base and its industrial structure upgrading, Korean companies are pouring investment into China in a wide array of sectors, including capital- technology intensive sectors, such as transportation, information technology, machinery components and equipment manufacturing, chemical, and petroleum etc.

The Korean investment in China is expanding to broader geographic areas. Before 1995, the early investment led by small-and medium sized Korean firms was attracted to Shandong province, and also Jilin, Liaoning, and Heilongjiang provinces on a smaller scale, the provinces where large ethic Korean communities are located. But in recent years, more and more investors are seeking opportunities in south China. For example, in the year of 2004 and 2006, the amount of FDI in Jiangsu province reached $1225 million and $2596 million respectively, ranking behind only Shandong province. Besides, investment in Shanghai, Zhejiang and Guangdong province is growing (see table 2). Also shown in table 2, the investment amount per project in these regions were much more than that in areas around the Bohai Sea and north east China. For example, in 2006, investment amount per case in Shandong and Liaoning province was US$760,000 and US$ 570,000 respectively, while in Shanghai and Zhejiang province, the number is US$1.17 million and US$1.31 million respectively.

Table 2 Geographical Distribution of Korea's FDI in China

	Projects of Investments		Investment Amount (US$ million)	
	2004	2006	2004	2006
Beijing	621	1024	821	1641
Tianjin	886	1260	972	1399
Shanghai	496	806	673	944
Shandong	3 ,456	5116	2440	3881
Liaoning	1 ,517	2013	769	1138
Jiangsu	684	1114	1225	2696
Zhejiang	302	471	404	616
Guangdong	274	424	351	533
Hebei	216	300	116	202
Jilin	700	827	219	284
Helongjiang	290	340	184	208

Source: An Husen, the Current Situation, Characteristics, and problems of Korean Direct Investment to China, Academics in China, No.3, 2006; (Korean) Liu Xinyi, the Analysis of the Current Situation of Korea Direct Investment in China, Mind Line, No.1, 2007

The scale of investment per project is small. Compared to the average size of Korea's investment in other countries, which is around US$2.3 million. The scale of Korea's contracted investment into China per project, about US$ 969,000, is small. However, as more large companies, such as Hyundai, Samsung, and LG entered China, the FDI scale is becoming larger, and reached US$1.58 million per case in 2007. In addition, some R&D centers have been established in China by large companies in recent years, which will be helpful for bilateral technological cooperation.

Wholly foreign-owned enterprises or holding companies are mainly a form of Korean direct investment in China, accompanied by a closed management and marketing strategy. The average Korean investors holding share is 75.7% in order to maintain control over the companies. Moreover, lack of knowledge or inadequate information about Chinese complex socio-economic relationships, most Korean companies, especially small companies, chose the closed operation manner to avoid contact with Chinese directly. They built the factories by themselves, purchase equipments and raw material from their parent companies, and hire Korean employees.

The main motivation of investment is to take advantage of low cost and entrance to the Chinese market. In the 1980s, the main purpose of Korean companies investing in China was to combine their labor-intensive industries with cheap labor and make more profit. However, as China's economy has been growing fast since the 1990s, more Korean investors began to seek to exploit the Chinese broad market. According to a survey for 298 enterprises taken by Korea Institutional Economic Policy, the first motivation of Korean investment in China is low-cost labor (36.12%), followed by market access (25.16%) and meeting the demands of buyers (11.11%).[1]

China's direct investment into Korea

In 1997, the Chinese Communist Party (CCP)'s 15th Congress advocated the "going out" strategy, which encourages domestic enterprises to participate in international capital markets and to directly invest overseas. Since then, China's direct investment overseas increased, and also, direct investment into Korea got a jump start. China's FDI in Korea grew from US$8 million with 8 projects in 1998 to US$76 million with 1165 projects in 2000. However, since 2000, the investment growth rate has been slowing down and showing the following characteristics:

A. China's investment in Korea turned to pace up and down, except in individual years with a jumping growth. By 2007, total Chinese investment in Korea amounted to US$2.179 billion with 5589 projects, accounting for 1.59% of total foreign investment and 14.1% of projects in Korea. The average scale of China's investment was US$390,000 (see table 3). In most years after 2001, China's annual investment into Korea has remained between US$40 million and US$70million, except in the years of 2002, 2004 and 2007, which is above US$200 million. Especially in 2004, thanks to several large deals of M&A (Merger and Acquisition) projects, the investment reached US$1.166 billion.

[1] (Korean) Liu Xinyi, the Analysis of the Current Situation of Korea Direct Investment in China, Mind Line, No.1, 2007

Table 3 China's Direct Investment into Korea（US$ million）

year	Project (1)	Total projects (2)	(1)/(2) (%)	Amount (3)	Total amount (4)	(3)/(4) (%)
2000	1165	4271	27.28	76	15679	0.48
2001	812	3419	23.75	70	11292	0.62
2002	442	2441	18.11	249	9103	2.74
2003	522	2597	20.10	50	6468	0.77
2004	596	3102	19.21	1166	12785	9.12
2005	672	3668	18.32	68	11565	0.59
2006	334	3107	7.21	39	11240	0.35
2007	365	3559	10.26	385	10509	3.66
Total of 1962-2007	5589	39687	14.08	2179	137288	1.59

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B. M&A is the main form of China's investment in large projects. China's larger SOEs (State-owned enterprises) started M&A activities in Korea in recent years. For example, in 2002, Shanghai Automotive Industry Corporation (SAIC) initiated the M&A of a 10% equity investment in GW-Daewoo Motors; in 2003, Boe Technology purchased Hydis (Hynix Semiconductor's TFT-LCD division) for US$ 380 million; in 2004, SAIC completed the M&A of a 48.92% equity stake in MOU with Sangyong Motor for US$500 million. However, increasing M&A cases raised Korea's concern about the technology spillover.

C. Investments are highly centralized in manufacturing sectors. According to Korea's statistics, by June 2007, among the total 5303 projects in total $1837 million investment, investment in manufacturing sectors was 547 projects of $1474 million, accounting for 10% and 80%; investment in service sectors was 4765 projects of $353 million, accounting for 88%and 19% respectively. Furthermore, the components and intermediate goods in manufacturing sectors were the main fields for Chinese investors, and the finance, transportation, and traveling in service sectors are become new fields for Chinese investment.

The basic conditions for further development of Sino-Korea two way investments

In the long run, the investment between China and Korea will accelerate, based on the following conditions.

A. China's vast market with tremendous potential. On one hand, China has entered into the stage of accelerating development of industrialization and urbanization. With upgrading of consumption structure and expanding of urban construction, high growth industries like electronics, auto, machinery, real estate, and tourism are becoming the main drivers of China's economy. On the other hand, Korea has taken an advantaged position in the above industries, and will have more opportunities for direct investments.

B. The need for upgrading of industrial structure in both countries. China is facing the task of adjusting its industrial structure and improving its international competitiveness. Particularly, China's manufacturing and service sectors need to be improved and become new "hot hubs" for foreign investment. Both big companies and small companies will find their own place in China's huge market. On the other hand, the development of Korea's technology-intensive industries will offer more space for capital and technology-intensive industries to transfer into China. Also, FDI inflow to Korea will be helpful for solving the problem of so called "empty industry". In a word, FDI between China and Korea will have a win-win effect for the two countries.

C. The opening up policies of two countries. After joining the WTO, in compliance with the WTO principles of nondiscrimination, transparency, and trade liberalization, China has relaxed many restrictions on service FDI and capital markets, and the relevant laws have been enacted. So a more comprehensive FDI atmosphere in China is taking shape. Meanwhile, Korea has made rapid progress in reform and opening up since 1998. The international standards in the areas of corporate governance, accounting and auditing have been adopted; the market of commodities and capital have been opened thoroughly; the policies for actively encouraging FDI inflow to Korea have been formed. For example, the Policy for Promotion of FDI of 2007 has set up a series of policies for promoting FDI. These changes will help to attract more FDI to Korea.

D. The close economic and trade cooperation between the two countries. The governments are paying more attention to the bilateral relationships, and have taken many measures to promote mutual cooperation. For instance, Korea recognized China's complete market economy status at the end of 2005, bringing a fair and just environment for Chinese and Korean enterprises to launch bilateral FDI and trade; The Sino-Korea Trade Contract has been enacted; The China-Korea FTA (Free Trade Area) Government-Industry-Academic Joint Research was launched by the two governments in November, 2006, and several meetings for feasibility study have been held. If the FTA is established in the near future, it will be in favor of the long-term development of FDI between China and Korea.

The challenges facing FDI between China and Korea

A. The change of China’s strategy of FDI. By now, the goal of China’s introducing FDI has shifted from narrowing the gap between investment and saving into improving the efficiency of capital use and promoting technology development. Thus, more attention has been paid to the quality rather than quantity of FDI. Two major policies have been adopted since 2007. One is the equal tax rate on domestic and foreign enterprises, which means that the foreign companies lost the preferential tax treatment, that is, the income tax rate for foreign-funded companies was only around 17 percent, while that for domestic companies was 33 percent. Thus, foreign firms will face more fierce competition from domestic peers; the other is “the Guiding Catalogues of Foreign Investment” revised in 2007, in which high-technology industries, advanced manufacturing sectors, service, agriculture and environmental protection industries took priority to introduce FDI, while those industries with high energy consumption and environmental pollution will be restricted or even prohibited.

B. The rising prices of production factors. With the transition of China’s economic growth model and building of a harmonious society, China is undergoing a process of raising the prices of production factors. Especially, the new labor contract law has been implemented in 2008, in which the work hours and social insurance have been regulated strictly and then the labor price will raise further. This change will lead to the higher costs for enterprises, particularly the labor-intensive industries. Some small Korean companies are withdrawing from China and some began to move to Vietnam and India, and other place with lower costs.

C. The appreciation of RMB exchange rate. Based on the current account surplus and the reform of the exchange rate mechanism, the appreciation of the RMB will be a long term trend, which will certainly have an effect on the flow of FDI into China, particularly on investment into fields concerned with exports. Korean investors will be more cautious when adding investment to existing projects or launching new projects in China. In the meantime, the appreciation of RMB will stimulate Chinese direct investment abroad.

D. The concern for the industry empty and technology spillover. Since Korea is in a more advantageous stage than China in terms of technology and capital, more capital and technology-intensive industries moving to China raise Korean concerns on the risk of labor cuts and technology spillover, which will have a negative affect on their employment and economic development.

E. The lack of overseas direct investment promotion policies from China’s government. According to the experience of Japan and Korea, it is the key role for the government’s active policies towards supporting enterprises during their early years of “going out”. However, Chinese companies have yet to get such particularistic support from governments. In contrast, there exist a set of restrictions and regulations on outward investment, particularly for middle and small enterprises. For example, the “provisional regulations governing the control and the approval procedure for opening non-trade enterprise overseas" released in 1985 by the Ministry of Foreign Economic Relations and Trade (MOFERT) , which laid down the basic requirements for an overseas investment project to be approved, are still applicable today, although the ceiling of approval was raised in 1992, 2002 and 2004. Therefore, it is difficult for Chinese firms, especially the middle and small firms, to invest overseas. Furthermore, some Chinese overseas companies exhibit extreme instability due to lacking overseas investment and managerial experience.

The suggestions for promoting the FDI between the two countries

A. The proposals for FDI from Korea to China.

a) Adjusting the strategy of investment in China. With the decline of the advantage of low cost in China, it is necessary for Korean investors to change their investment structure. Firstly, increase the technological content of investment projects so as to overcome the pressure of rising cost and earn more profit; secondly, adjust the regional structure of investment in light of the regional advantage. The labor-intensive industries should be moved to the western areas in China with lower labor cost, and the technology and capital- intensive projects should be expanded to a broader region with better technology and capital conditions, such as Shanghai, Zhejiang, and Guangdong province.

b) Improve the scale structure of the investment in China. To strengthen the competitiveness of Korean companies in the Chinese market, it is an obvious trend that big companies should play a more important role in FDI. On one hand, in the process of upgrading the manufacturing structure, China needs to cooperate with big companies who have advanced technology and high quality equipment. On the other hand, Most Korean big companies have an eager willingness to enter the Chinese market. Linked investment in China with domestic corporate restructuring, big companies can improve domestic production lines with cutting-edge technologies.

c) Implementing the "localization" strategy". It's proved that localization has been an effective way to avert high cost of management and solve the problem of conflicting cultures. Localization means that Korean companies should hire more local employees, set up more local R&D centers, and take more advantage of the local investment environment. Thus, Korean companies would adapt themselves to the complex Chinese environment and improve the sustainable development ability in Chinese markets. Some Korean big companies such as Samsung and LG have set good examples for localization. By now above 90% of the employees, including middle and high level managers in these big companies are Chinese. SK seemed to go further. A Chinese national was appointed CEO in 2001, and also SK China has adopted the motto "of the Chinese, by the Chinese, for the Chinese."

B. The suggestions for FDI from China to Korea.

a) Expanding the strategic orientation of investment. China wants to combine the direct investment with the upgrading of domestic industrial structure. By now, an increasing emphasis has been placed on M&A purchase of Korean companies. Further, increasing Chinese companies would use cross-border M&A, joint venture and green-field investment to obtain accesses to advanced foreign technologies, managerial know-how, R&D establishments, and brand names in the Korean economy.

b). the key actors should be more diversified. Not only the big SOEs but also more small businesses and non state-owned enterprises could be encouraged to invest in Korea. So the strict examination and approval on non state-owned enterprises' direct investment should be relaxed.

c).Improve the public service for FDI. Some measures should be taken by the governments include: to simplify application procedures and improve the services for outward investment information in order to help investors to get more information about each others investment policy and investment environment, and help to analyze possible risks there; to finance research projects on direct investment; to train the personnel for overseas direct investment, and to set up financial service and guarantee system for FDI.

Conclusion:

The FDI between China and Korea, managed successfully, may contribute to the improvement of the welfare of the two countries' national economies and the competitiveness of their businesses in the world market. On one hand, FDI in China makes it easier for Korean companies to take away the Chinese market share and make more profit; on the other hand, it demonstrates that it is possible for Chinese companies to absorb advanced technology and improve management skills by investing in Korea.

Facing the globalization and industrial structure upgrading, Korea and China have more cooperative opportunities and the FDI between the two countries should enter into a new high quality stage. As China's strategic importance increases, companies from all over the world are intensely competing to succeed in China's market. Korean companies are no exception. More and more Korean companies alter their strategies and start viewing China as a strategic market rather than a production base. Meanwhile, the "going out" strategy of Chinese companies is largely consistent with China's persistent trade surplus and positive saving-investment gap. China's companies have strong interest to implement an internationalization strategy by way of overseas investment. In the Korean market, technology seeking is the main strategic orientation for Chinese enterprises. Despite the strong need for overseas investment, the decision for new investment in Korea must be based on detailed profitability forecasts and the sound financial structure of the company.

World economic integration is deepening, bringing with it a more severely competitive global environment. It is hard to imagine that domestic companies can maintain competitiveness and market share without the utilization of overseas direct investment under the current business environment. In this context, both Korea and China should take more measures to create a better and more sophisticated investment environment, which includes improved transparency in rules, deregulations with prudential measures, reinforced protection of investor's rights, and effective dispute settlement mechanism, is also important in promoting FDI, so that business risks of large-scale and complicated FDI can be reduced.