

Implications of China's Economic Rise for Northeast Asian Geopolitics

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Despite the global economic crisis, China appears to have weathered the storm well; its stimulus package was robust, its economy achieved positive economic growth throughout the crisis (though it was close to zero in 2008) and its banks remain solvent. Its vast floating population of low-cost labor, high savings rates, massive foreign currency reserves and political adeptness has served China's interests well in a time of great crisis. Rather than succumb to domestic chaos from mass layoffs stemming from the collapse of export markets, China has avoided stagnation, inflation and managed its chronically high unemployment while continuing to deploy its capital at home and abroad to its own advantage.

China hopes its political-economic model -- now proven to be particularly resilient -- is appealing to developing countries seeking to replicate China's success. China's vast market lures global companies with their capital and technology, providing Beijing with considerable geopolitical leverage and in some cases, political clout abroad. Economic influence is a significant aspect of China's soft power. China's strategy of a closed political system focused on economic growth, and the maintenance of stability on its periphery is central to achieving its great power objectives. Enhancing regional economic integration is a key component of this strategy. However, security challenges in East Asia remain despite this expanding integration, just as tensions in the U.S.-China security relationship have not been ameliorated by trade and investment. Pyongyang's repeated provocations, despite North Korea's dependence on trade with China, is only one example of the limits of economic integration in addressing broader strategic and security issues.

Overview of China's economy and economic growth

Since the reform and opening period began in 1979, China has sought to maintain steady economic growth, targeting 8% growth since 1982 as adequate to create enough jobs to absorb under-employed workers, farmers and new graduates entering the labor pool, yet not so high as to drive inflation which contributes to social unrest. Their strategy is undoubtedly successful; China is currently the world's third largest economy and the country appears on track to overtake Japan as the second largest economy at some point in 2010. China's economic output was slightly less than Japan's in 2009 and its economy is currently growing faster than its neighbor. China's economy grew by 10.3% in the second quarter of 2010, a slight reduction from brisk 11.9% growth in the

first quarter of the year. Consumer inflation fell to 2.9% in June, from 3.1% in May. The government's official inflation target for 2010 is 3%.¹

With China's population of 1.3 billion people, multinational companies look to Chinese consumers for their future success. China's total consumer expenditure in 2008 was \$1.52 billion. China is now the third biggest consumer of luxury goods, after the United States and Japan, generating more than \$2 billion in luxury consumer goods sales a year. Sales in some sectors are growing 20 to 30% each year. By 2020, Chinese consumers are forecasted to have an annual disposable income of \$9.57 billion, an increase from \$2.19 billion in 2008. It is estimated that 55% of China's population will be in the middle class (defined as having an annual household income between \$8,700 and \$29,215) by 2020.² In 2009, China's per capita GDP was estimated to be \$6,600.

Though many countries are facing gloomy economic forecasts, China's government stimulus in the wake of the financial crisis has left it with relatively upbeat predictions of future growth. The IMF forecasts 9.9% economic growth for China in 2011.³ The World Bank projects GDP growth of 9.5% for 2010 as a whole and 8.5% for 2011. Growth is also expected to be less investment-driven and benefit from more favorable external trade.⁴ As in recent years, China's official target for GDP growth in 2010 is 8%.⁵

China-ROK Trade and Investment

Since Beijing's 1992 establishment of diplomatic relations with Seoul, China has balanced its market based relationship with South Korea and its socialist friendship with North Korea. The scope of China's trade and investment with South Korea overshadows its economic relationship with North Korea. In 2009, South Korea was China's fourth largest trade partner with a volume of \$156.2 billion, though this represented a decrease of 16% from 2008.⁶ South Korea was also China's fourth largest export destination in 2009 with a volume of \$53.7 billion, a 27.4% decrease over 2008.⁷ South Korea ranked second in China's top import partners in 2009 with a volume of

¹ Stephanie Ho, "China on Track to Be World's Second Largest Economy," *VOA News*, 15 July 2010. Available at: www1.voanews.com/english/news/China-on-Track-to-Be-Worlds-Second-Largest-Economy-98493224.html.

² "Chinese Consumers in 2020: A Look into the Future," *Euromonitor, Market Research World*, March 2009. Available at: http://www.marketresearchworld.net/index.php?option=com_content&task=view&id=2554&Itemid=77.

³ Tom Barkley, "Strong Yuan Key to Growth, IMF Says," *Wall Street Journal*, 22 April 2010. Available at: http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704133804575197822941053464.html.

⁴ "China Quarterly Update: Overview," *World Bank*, June 2010. Available at: http://siteresources.worldbank.org/CHINAEXTN/Resources/318949-1268688634523/overview_Quarterly_June_2010.pdf.

⁵ "China sets 8% target for 2010 economic growth," *Xinhua*, 5 March 2010. Available at: http://www.china.org.cn/china/NPC_CPPCC_2010/2010-03/05/content_19526619.htm.

⁶ "US-China Trade Statistics and China's World Trade Statistics," The US-China Business Council, 2009. Available at: <http://www.uschina.org/statistics/tradetable.html>.

⁷ "US-China Trade Statistics and China's World Trade Statistics," The US-China Business Council, 2009. Available at: <http://www.uschina.org/statistics/tradetable.html>.

\$102.6 billion, a decrease of 8.5% from 2008.⁸ According to data from China's Ministry of Commerce, China's trade with South Korea had a value of \$16.671 billion in 2009, a 45.9% increase compared to the same period in 2008. The export value of Chinese goods was \$5.746 billion and import value \$10.925 billion in 2009.⁹

For South Korea, China is a more important trading partner than the U.S. China overtook the United States as the biggest export market for South Korea in 2003, while South Korea is the United States' seventh largest trading partner.¹⁰

South Korea plays a significant role investing in China and is concurrently working to increase FDI flows from China. According to calculations of the actually utilized value of foreign capital from January to October 2009 in China, South Korea ranked sixth in the list of top countries investing in China with a value of \$2.261 billion.¹¹ China is one of the top targets for South Korea's overseas investment. More than 20,000 South Korean companies have invested in China in the past 20 years. South Korea's cumulative FDI in China was \$29.3 billion as of 2010, accounting for 21% of its total FDI.¹²

In May 2010, South Korea set up a new "China Desk" in KOTRA to promote increasing inflows of Chinese FDI. China invested \$55.9 billion overseas in 2008 but only 0.2% of that (\$100 million) was invested in South Korea. In comparison, South Korea attracted \$11 billion in foreign investment in 2009, a sum expected to increase to \$13 billion by the end of 2010.¹³

China-DPRK Trade and Investment

With Pyongyang's international isolation, China occupies the top position on the short list of North Korean trading partners. Beijing's assertion that normal trade is exempt from U.N. sanctions is an attempt to shield its trade with the DPRK from international pressure tied to North Korea's nuclear program. China's share of North Korea's foreign trade is expected to increase in the aftermath of the Cheonan incident and resulting halt in North-South trade. In the first five months of 2010, overall trade between China and

⁸ "US-China Trade Statistics and China's World Trade Statistics," The US-China Business Council, 2009. Available at: <http://www.uschina.org/statistics/tradetable.html>.

⁹ "Trade with Countries and Regions in Asia (2009/12)," People's Republic of China Ministry of Commerce, 4 February 2010. Available at: <http://english.mofcom.gov.cn/aarticle/statistic/AsiaAfrica/201002/20100206776301.html>.

¹⁰ "Background Note: South Korea," U.S. Department of State, Bureau of East Asian and Pacific Affairs, 28 May 2010. Available at: <http://www.state.gov/r/pa/ei/bgn/2800.htm>.

¹¹ "China's Absorption of FDI in January-October 2009," People's Republic of China Ministry of Commerce, 6 December 2009. Available at: <http://english.mofcom.gov.cn/aarticle/statistic/foreigninvestment/201001/20100106726891.html>.

¹² "South Korea Welcoming More Investment from China," *China's Foreign Trade*, 23 June 2010.

Available at: <http://www.ccpit-cft.cn/10/shownews.asp?bigclassname=%D0%C2%CE%C5%D6%D0%D0%C4&smallclassname=ENGLISH&id=474>.

¹³ "S. Korea to seek more Chinese investment," *Global Times*, 6 May 2010. Available at: <http://business.globaltimes.cn/china-economy/2010-05/529246.html>.

North Korea grew by 18%. North Korea imported \$727 million of goods from China while exporting \$256 million to China.¹⁴

In 2009, bilateral trade between China and North Korea was estimated at \$2.7 billion,¹⁵ though according to China's Ministry of Commerce, the total value of China's trade with North Korea was \$379 million in 2009, a 20.8% decrease compared to the same period in 2008, with an export value of \$315 million and an import value of \$65 million in 2009. The official figures do not account for rampant smuggling, barter trade and small scale border trade which is duty free. According to KOTRA, the value of North Korea's total foreign trade dropped to \$5.09 billion in 2009. China accounted for 53% of that total, with a value of \$2.68 billion. If shipments across the North-South border are excluded, 78.5% of North Korea's trade is commerce with China.¹⁶ In 2008, North Korean exports to China totaled \$754 million while exports to South Korea totaled \$930 million. The value of North Korean imports from China was \$2033 million in 2008 and \$888 million from South Korea.¹⁷

II. Domestic challenges associated with China's economic rise

Economic success has increased Beijing's influence and interests around the world, but this economic rise has not come without a price. Serious domestic challenges encompassing economic, environmental and political issues continue to occupy Beijing's attention and could jeopardize its future.

Domestic economic factors such as increasing competition and rising wages influence trade and investment patterns in China. Rising labor costs in China affect the calculations of companies doing business in China. The CFO of Yum Brands Inc expects "very high labor inflation" for the second half of 2010. Labor costs in China for the company rose by \$12 million in the first half of 2010 and are expected to rise by \$32 million in the second half of the year.¹⁸ According to a JP Morgan analyst, labor costs in China rose 14.9% in the second quarter of 2010. Rising wages are partly a result of labor shortages in key manufacturing regions and industrial sectors. Even in 2006, a Shenzhen labor research group estimated that turnover in some low-tech industries approached 50%. That year, Guangdong province reported 2.5 million unfilled jobs with Jiangsu, Zhejiang and Shandong provinces also reporting shortages of qualified workers. In 2010, Chinese media reports estimated a labor supply gap of 1 million people in Guangzhou and neighboring cities in the Pearl River Delta, forcing employers

¹⁴ Chris Green, "Sino-North Korean Trade Grows Again," *Daily NK*, 6 July 2010. Available at: <http://www.dailynk.com/english/read.php?cataId=nk00100&num=6567>

¹⁵ Royston Chan, "North Korea's Kim seeking lifeline in China," *Reuters*, 3 May 2010. Available at: <http://uk.reuters.com/article/idUKTRE6413DW20100503>.

¹⁶ Seonjin Cha, "North Korea 2009 Trade Shrank 9.7% on Sanctions, S. Korea Says," *Bloomberg News*, 23 May 2010. Available at: <http://www.businessweek.com/news/2010-05-23/north-korea-2009-trade-shrank-9-7-on-sanctions-s-korea-says.html>.

¹⁷ Dick K. Nanto, Mark E. Manyin and Kerry Dumbaugh, "China-North Korea Relations," *Congressional Research Service*, 22 January 2010. Available at: <http://www.fas.org/sgp/crs/row/R41043.pdf>.

¹⁸ "Executive View: The yuan and China's rising labor costs," *Reuters*, 14 July 2010. Available at: <http://www.reuters.com/article/idUSN1416478120100714>.

to raise salaries.¹⁹ Minimum wages in China's 14 provinces have risen more than 20% in 2010. The minimum wage in Shenzhen is expected to increase by 15.8% to 1100 yuan (\$161) per month beginning in July 2010.²⁰

Rising wage costs present significant challenges for Chinese economic planners. Rising wages and greater investment in social spending, while generally seen as positive contributors to social stability, also causes inflation. Inflation, however creates hardships on the large segment of the population whose incomes are not increasing. Shifting employment patterns potentially also contribute to social dislocation as companies relocate facilities further inland from China's east coast or to lower-cost countries in Asia such as Vietnam, in a bid to reduce costs. A high-profile example is Foxconn's announced plans to move its main production line from Shenzhen to Hebei province in the wake of intense scrutiny over low wages and difficult conditions following multiple suicides among workers.²¹

An appreciating currency is another issue confronting companies in China. Ahead of the G20 Summit, China announced an end to the peg of the yuan to the U.S. dollar. Instead, the People's Bank of China will maintain a 0.5% daily trading band and set daily reference rates so the renminbi rises slowly against the dollar. China faces U.S. pressure to make more dramatic changes to its currency policy. Though an appreciating currency benefits companies selling into China and allows companies to take advantage of China's growing consumer market, Chinese exporters will face disadvantages in selling abroad.

Additional market factors that present enormous economic challenges include hyper competition and local protectionism. Chinese companies have generally identified price rather than quality or innovation as their competitive advantage. In a phenomenon sometimes described as, "the China price," Chinese companies undercut one another to gain market share by slashing costs through corner cutting, taking advantage of a weak regulatory environment that enables companies to skirt regulations. Many Chinese companies disregard the 2008 labor law provisions that include generous overtime and social benefits that can reach 50% of salary. China's fiscal decentralization gives local governments a strong incentive to protect their tax base, and local governments often shelter their companies from regional competition. Locally owned SOEs are a source of political power and present an opportunity for patronage as well as a source of revenue. Industries that generate both high profits and taxes in particular benefit from policy and administrative measures.²² An example is provincial-level indigenous innovation catalogues that exclude ex-province companies from bidding on locally funded projects.

¹⁹ Shen Hong, "The Mystery of China's Labor Shortage," *Wall Street Journal*, 22 February 2010. Available at: <http://blogs.wsj.com/chinarealtime/2010/02/22/the-mystery-of-chinas-labor-shortage>.

²⁰ "China faces rising labor costs," *United Press International*, 10 June 2010. Available at: http://www.upi.com/Business_News/2010/06/10/China-faces-rising-labor-costs/UPI-65681276171700/.

²¹ Lorraine Luk, "Foxconn Relocates Production in China," *Wall Street Journal*, 30 June 2010. Available at: <http://online.wsj.com/article/SB10001424052748703426004575338201918020996.html>.

²² Chong-En Bai, Yingjuan Du, Zhigang Tao and Sarah Y. Tong, "Local Protectionism and Regional Specialization: Evidence from China's Industries." William Davidson Working Paper No. 565, May 2003. Available at: <http://deepblue.lib.umich.edu/bitstream/2027.42/39951/3/wp565.pdf>.

Environmental degradation threatens to undermine China's continued economic rise. A joint report published in 2007 by the World Bank and the Chinese government estimated the combined health and non-health cost of outdoor air and water pollution is approximately \$100 billion a year, or about 5.8% of China's GDP. Water pollution worsens China's severe water scarcity problems, with the overall cost of water scarcity estimated at 1% of GDP.²³ The report also estimated that 750,000 people die prematurely each year, primarily from air pollution in large cities and an additional 300,000 people die prematurely each year from exposure to indoor air pollution.²⁴ Cultivated land area has decreased in many areas while in others, cultivated land increased at the expense of natural ecosystems. Soil erosion is a significant problem in China's west with lost nutrients in the soil that must be replaced artificially and creeping desertification. Water consumption has skyrocketed and much of the increased consumption was satisfied by drilling, not from utilizing replenishable surface water, which can be too polluted even for industrial use. In 2007, 60% of China's cities faced water scarcity, with 110 cities facing serious water shortages.²⁵ These conditions have contributed to a growing number of Chinese outbound investment projects in Russia, Australia, Africa and Latin America that seek to acquire cropland for Chinese companies to produce food for export to China.

China's rapidly growing economy creates ever growing demand for energy. China perceives itself as having significant energy security concerns, particularly over the long term, with some predicting future conflicts between China and developed nations over access to energy. The International Energy Agency estimated in July 2010 that China was the world's largest energy consumer. China's demand challenges are exacerbated by state-controlled pricing and glaring inefficiency (China is 25% less efficient than the U.S. or Europe), though it has the potential to increase its sense of security by investing in efficiency and renewable sources. Beijing is encouraging energy efficiency and has a target of reducing energy intensity (energy consumed per unit of GDP) by 20%, based on 2005 levels, by the end of 2010.²⁶ However, despite official pronouncements by senior leaders that they are on track to meet this target, official data indicates that China is probably lagging far behind its own objectives. Unfortunately, China's stimulus efforts will likely make it even harder to reach its energy intensity targets.²⁷

²³ "Statement from World Bank China Country Director on 'Cost of Pollution in China' Report," Embassy of the People's Republic of China in the United Kingdom, 24 July 2007. Available at: <http://big5.fmprc.gov.cn/gate/big5/www.fmprc.gov.cn/ce/ceuk/eng/xnyfgk/t343995.htm>.

²⁴ Richard McGregor, "750,000 a year killed by Chinese pollution," *Financial Times*, 2 July 2007. Available at: <http://www.ft.com/cms/s/0/8f40e248-28c7-11dc-af78-000b5df10621.html>.

²⁵ Jiang Gaoming, "The terrible cost of China's growth." *China Dialogue*, 12 January 2007. Available at: <http://www.chinadialogue.net/article/show/single/en/684-The-terrible-cost-of-China-s-growth-part-one->

²⁶ Leslie Hook, "China denies IEA claim on energy use." *Financial Times*, 20 July 2010. Available at: http://www.ft.com/cms/s/0/6ca47fa2-9402-11df-83ad-00144feab49a,dwp_uuid=9c33700c-4c86-11da-89df-0000779e2340.html.

²⁷ Stephen Howes, "China's energy intensity target: On-track or off?" East Asia Forum, East Asian Bureau of Economic Research, 31 March 2010. Available at: <http://www.eastasiaforum.org/2010/03/31/chinas-energy-intensity-target-on-track-or-off/>.

Heavy government involvement in the economy may also constrain China's economic future. State-owned enterprises dominate China's trade and investment. The government controls access to capital, planning and has a strong preference for investing in infrastructure that is often underutilized or otherwise wasteful. State interference in the allocation of capital may result greater inefficiencies, high loan default rates and the lost opportunity to encourage greater market dynamism driven by private enterprise. Lastly, the slow pace of political reform and the lack of institutional checks and balances represent a drag on economic growth and a disincentive for investment. The lack of an independent court system, weak intellectual property rights protections, pervasive corruption and other regulatory issues ensure a difficult operating environment for private companies and the likelihood of re-occurring commercial problems such as food safety scares.

III. Implications of China's Economic Rise—Foreign Policy

China's large population, growing economy and rising standards of living are the chief components of China's soft power. For the first time in its modern history, China's economic rise has resulted in an expansion of economic and security interests beyond its borders. However, China's economic growth has not been matched by corresponding evolution in political reform, foreign policy or expanded military capability. Despite the dramatic expansion over the past three decades, China's military capabilities have not expanded at a similar rate. Likewise, Beijing has until now demonstrated great reluctance to assert itself militarily abroad. Of course, China contributes to U.N. peacekeeping operations and participates in anti-piracy operations in the Gulf of Aden but otherwise, its closest security allies, most notably North Korea and Pakistan, have chosen to invest in developing their own deterrent, leading to significant regional uncertainty.

Deng Xiaoping reached an accommodation with the PLA at the outset of the reform and opening period, telling them to wait until the nation had acquired wealth before expecting a greater share of national resources. However, China's global interests have expanded faster than its military capabilities and doctrine, revealing a gap that they appear to be actively trying to close. Within China, consensus exists on the need for military modernization to continue so China can close the disparity with the major powers and wield a military equal to its status as an economic great power. China's 2010 defense budget is officially \$77.9 billion; a 7.5% increase from the military expenditures budgeted for 2009, and only the second year since the military modernization program began in 1989 in which annual growth was less than 10%.²⁸ The economic crisis has likely reduced China's available resources for military modernization, though it seems unlikely that a smaller than average budget increase will have a substantially negative impact on the PLA. There is little doubt that China will eventually have the capability to reach key security benchmarks, such as overseas bases and an aircraft carrier that will enable it to project power abroad.

²⁸ "China's Defense Budget," *Global Security.org*, March 2010. Available at: <http://www.globalsecurity.org/military/world/china/budget.htm>. Note: This figure does not include large categories of expenditure and does not include all sources of income for the military.

IV. Implications of China's Economic Rise—for South Korea

Global concerns about China's rising military are balanced by the allure of the China market, making it a key aspect of China's "soft power." Undoubtedly, this is a key factor for most countries, including South Korea, that do not necessarily identify economically or politically with China's system, but instead see an economic future in which China is a major player. This is reflected in South Korean people-to-people contacts as well as bilateral investment and trade. However, recent events have raised questions for some about striking an appropriate balance between political and security interests and economic integration.

The number of students studying in China is one way to gauge China's soft power and its relationship with South Korea. In 2006, the number of South Korean students in China reached 54,000; at the time, they consisted of 38% of the total foreign students in China. South Korean students formed the largest group of foreign students in China.²⁹ Of the foreign students studying in South Korea in 2006, Chinese students consisted of 61.7% of the total. As of April 2009, South Korea had 75,850 foreign students with 70.5% of the students coming from China.³⁰ According to Korea's education ministry, 66,806 South Koreans studied in China in 2009, up from 57,504 students in 2008, while 68,124 South Korean students went to the United States to study. The number of students enrolling in universities and graduate schools in China doubled from 2006 to 2009, showing more students are seeking degrees in China instead of short term language training. China is soon expected to surpass the U.S. as the top destination for South Korean students.³¹

China is the biggest opportunity and the biggest threat for the South Korean economy. China's quick recovery and stimulus spending has lessened South Korea's impact from the global financial crisis. Likewise, China's position as the largest export market for South Korea shielded it from downturns in the U.S. economy.

South Korea, like the United States, must maintain a competitive advantage over Chinese competitors. This is a tougher task for South Korean companies. It is especially difficult to maintain a competitive advantage with rising costs on the mainland coupled with industrial policies that are unfavorable to Korean firms. Indigenous innovation, import substitution and technology transfer policies are all detrimental to China's international competitors. Weak intellectual property rights protection in China is a particular threat for South Korean industries. As South Korea shifts from labor-intensive to knowledge and technology-intensive investments, protecting intellectual property becomes even more critical.

²⁹ Li Xiaohua, "S. Korean Students in China Number 54,000," *China.org.cn*, 22 November 2006.

Available at: <http://www.china.org.cn/english/LivinginChina/189809.htm>.

³⁰ Bae Ji-sook, "Chinese account for 70% of foreign students," *Korea Times*, 20 June 2010. Available at: http://www.koreatimes.co.kr/www/news/nation/2010/06/113_67966.html.

³¹ "China to become top favorite nation of Koreans studying abroad," *Korea Times*, 21 June 2010. Available at: http://www.koreatimes.co.kr/www/news/nation/2010/06/113_67987.html.

South Korea has lost jobs and international market share to China, making it a political imperative for South Korean leaders to articulate the benefit of the South Korea-China economic relationship to Korean workers, not just Korean companies. South Korean investments in China are politically justifiable so long as products from Korean-invested companies can enter the Chinese market. Pushing back against discriminatory indigenous innovation policies and protectionist measures is vital for South Korean companies.

The Cheonan incident reveals the limits of South Korea's ability to influence Chinese strategic choices. Despite South Korea's position as a major investor and China's sixth largest trading partner, economic ties have not translated into political influence over China or its relationship with North Korea. China's almost instinctive response to shield North Korea in the aftermath of the Cheonan sinking reveals the limits of South Korea's economic leverage over China.

China's nationalistic response to South Korean investors pulling out of the country in 2007-2008 is evidence of geopolitical risks of increased investment and China's economic rise. South Korean enterprises began shutting down in China, particularly in Shandong Province, due to rising costs caused partly changes in corporate tax rates and also by an appreciation of the renminbi against the won.³² In March 2008, before the global financial crisis, the exchange rate was 130 won per yuan. A year later, the rate almost doubled to 230 won per yuan making Chinese operations on the mainland considerably more expensive for South Korean companies.³³ By one estimate, there were 20,000 South Korean investors in China in the late 1990s, only one-third of those investors remain today. In March 2008, reportedly 20 to 30% of the 6,000 South Korean companies in Qingdao were losing money.³⁴ Beginning in 2007, executives in Korean invested companies began fleeing their factories at night to avoid retaliation by workers who were owed back wages and other creditors. The Export-Import Bank of Korea reported 206 Korean business owners who left Qingdao, Shandong province from 1999 to 2007 without going through the correct procedures to shut down their business. According to one South Korean newspaper, however, only 1 percent of South Korean companies folded without following legal procedures.³⁵ Under growing public attention, the South Korean government held talks with Chinese officials and set up a team at its consulate in Qingdao to help South Korean investors undergo liquidation formalities.³⁶ However, Chinese media widely covered the South Korean exodus in negative terms (rarely explaining the causes for the corporate failures or the rise in violence directed

³² "China still a draw for S. Korean firms," *China Daily*, 21 February 2008. Available at: <http://www.china.org.cn/english/business/243379.htm>.

³³ John M. Glionna, "South Koreans in Beijing closing shop," *Los Angeles Times*, 18 June 2009. Available at: <http://articles.latimes.com/2009/jun/18/world/fg-china-koreatown18>.

³⁴ Chiang Langi "South Korean investors quit China over rising costs," *Reuters*, 23 March 2008. Available at: <http://www.reuters.com/article/idUSPEK27083320080323>.

³⁵ "중국내 비정상청산 韓기업 1% 미만," *Chosun.com*, 30 March 2009. Available at: http://news.chosun.com/site/data/html_dir/2009/03/30/2009033001861.html?Dep0=chosunmain&Dep1=news&Dep2=headline1&Dep3=h1_07.

³⁶ "S Korean investors quit China over rising costs," *The Economic Times*, 24 March 2008. Available at: <http://economictimes.indiatimes.com/articleshow/2892905.cms>.

towards expatriate managers), straining bilateral relations and souring Chinese public opinion towards South Korean investors.

Implications of China's Economic Rise—for the DPRK

Economically, North Korea is dependent on its main ally, China, for trade, aid and investment. Despite Pyongyang's dependency on China, Beijing has proven unable to shape the DPRK's strategic choices or deter it from threatening its neighbors. Though China accounts for an increasing share of North Korea's economic relationships, Beijing has been unable to curb North Korea's pattern of aggressive provocations, including nuclear tests in 2006 and 2009 and the 2010 torpedoing of the Cheonan.

China's economic engagement policy presents an opportunity for North Korea to reform its own economy, which some hope would moderate Pyongyang's belligerent posture. Chinese strategists hope economic engagement improves North Korea's sense of security and contributes to the DPRK's domestic stability. However, Chinese investments in DPRK infrastructure and in the Chinese border area have not stimulated economic reform in North Korea, nor has it moderated Pyongyang's antagonistic rhetoric or increased its social stability. China's continued economic growth may not make any difference in persuading North Korea to reform. Just as South Korea's economic ties to China appeared to have little influence regarding China's choices surrounding the Cheonan incident, it appears that China's economic relationship with North Korea has not yet provided Beijing with a reliable means of influencing the DPRK's strategic choices.

Conclusions

After the sinking of the Cheonan, President Lee Myung-bak and Kim Jong-il each traveled to Beijing to present their respective cases to the Chinese leadership. China's delayed reaction to the loss of South Korean lives and Beijing's efforts to weaken the U.N. statement on North Korea's behalf demonstrated the limits of South Korean influence over Beijing. Indecisive responses to North Korean aggressions reflect Beijing's overarching desire to preserve positive relations with both Koreas and its preference that North Korea continues to survive.

In its relations with the U.S. and South Korea, China has generally managed to separate its economic interests from the security issues stemming from North Korea. Sanctions have not targeted Chinese companies, and China's political preferences for North Korea have not visibly dampened enthusiasm for China's economic potential. China's position as North Korea's biggest trading partner would appear to give it leverage over Pyongyang's actions, though it has proven reluctant to use economic coercion, fearing that constricting aid or "normal" trade would hasten North Korea's collapse or drive North Korea to reject Chinese entreaties entirely.

Most Chinese trade and investment is not designed with the objective of accomplishing broader geostrategic goals vis-à-vis North Korea. Of course, China provides North Korea food and energy aid, as well as "friendship" projects which transfer technology to

North Korean units. All these political investments are distinct from commercial ones in that they are intended to gain Beijing influence. However, Chinese commercial investors in North Korea do not appear to have similar political goals. The Chinese government strategy regarding trade with North Korea is largely a local one, led by China's northeast provinces, particularly Jilin and Liaoning. These sub-national governments' operational objectives are economic development, not regional peace and stability. Perhaps confirming that Chinese companies are not acting as agents of the state seeking a broader geostrategic outcome, there are similarities in investment outbound patterns found for North Korea and elsewhere around the world. Increases in the numbers of investors and the ratio of investments in different sectors are consistent when comparing Chinese investments in North Korea with other states neighboring China.

Chinese investments in North Korea are not necessarily a source of leverage for Beijing over Pyongyang. As South Korea's experience in the Kaesong Industrial Complex illustrates, the DPRK is adept at using foreign investments as a means to leverage governments. Likewise, despite its dependence on foreign direct investment in the 1990s, Beijing was very adept at using American businesses as its lobby in Washington. While foreign investors in North Korea should not be considered political hostages, they do constrain Beijing to a degree. Chinese investments in North Korea amplify Beijing's reluctance to endorse broad-based sanctions and raise concerns about possible reprisals against Chinese investors should Beijing decide, however improbably, to resort to economic coercion.

Fears of North Korean collapse underpin Chinese economic commitments to the DPRK. These fears are intensified by Kim Jong-il's apparently worsening health and an opaque leadership transition in Pyongyang. An economic and political collapse in North Korea could result in instability spilling across the border, with China's northeastern provinces vulnerable to a flood of refugees and a break down of law and order. North Korean regime collapse might cause Korean unification on terms antithetical to China's interests; particularly a peninsula unified in South Korea's likeness.

Economics, as much as security, is at the heart of challenges confronting unification. Unification would likely be costly and disruptive for the South Korean economy, though a 2009 Goldman Sachs report identified upside potential in a unified peninsula that was able to realize growth from abundant human and natural resources. The report predicted that the GDP of a united Korea could exceed France and Germany in 30 to 40 years if the growth potential of North Korea was realized.³⁷ However, such a scenario might not be welcomed by China. Unification of the Korean peninsula would possibly result in a steep decline in investment from South Korea to China as Korean capital becomes concentrated in rebuilding the North. Chinese investments in mines and factories would lose their government partners in the event of a collapse of the DPRK, raising questions about the rights of Chinese investors and how China would recognize new authorities.

³⁷ Goohoon Kwon, "A United Korea: Reassessing North Korea Risks (Part 1)," Global Economics Paper No. 188, Goldman Sachs Global Economics, Commodities and Strategy Research, 21 September 2009.

Undoubtedly, Chinese investors facing the loss of their rights would actively lobby local and central authorities to intervene to protect their interests.

China's steady economic growth, rising affluence and political stability are the envy of the developing world. Its immense scale, expanding middle class and low cost labor pool has prompted uncounted multinational CEOs to declare that China is a vitally important market for them. China has eclipsed Japan to become the center of economic gravity for Asia, making it the most important market and manufacturing base for the region. While the global economic crisis has slowed the pace of growth, China appears to have emerged unscathed and newly confident in its authoritarian political-economic model. However, growing economic integration has not ameliorated festering security challenges, and mistrust is unabated by trade in northeast Asia.