Economic Relation between Korea and China: Implications of Korean Economic Crisis for China

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I. Introduction

The modern history of economic interactions between Korea and China is rather short, only since the normalization of relations between the two countries in 1992. However, the speed and the extent of economic interactions have been both fast and wide. For example, China became Korea's third largest trading partner and the most important FDI (Foreign Direct Investment) destination in 1997, while Korea became China's fourth largest trading partner and sixth largest foreign investor in 1996.

* Division of International Trade, Inha University
Statistical Yearbook 1997).

The purpose of this paper is not simply to review the past economic interactions between the two. Rather, this paper will focus on the future prospect of this relationship, based on the recent experience of Korea's financial and economic crisis. Indeed, there are many similarities between Korea and China in terms of the pattern of development, the structure of trade, and the structure of development financing, etc. Korea started to industrialize its economy about 40 years ago in the early 1960s. China pursued the similar outward looking development strategy, which was based on expanding exports and encouraging foreign capital inflows about 20 years ago. This pattern of growth is not unique to Korea and China alone. Other East Asian countries have pursued the similar growth pattern. Starting from Japan, ANIEs (Asian Newly Industrializing Economies) and ASEAN (Association of South East Asian Nations) have followed. The so-called East Asian growth model tries to describe this pattern and mechanism of growth in this region, using "flying geese" hypothesis to explain the spread of industrialization and "self-circulation" hypothesis to explain a growing interdependence among East Asian economies in both trade and investment.¹)

However, as we all know Korea encountered a situation of severe shortage of foreign exchanges and had to rely on IMF's standby loans to bail it out from a near moratorium at the end of 1997. Since then, Korea has begun launching a large-scale reform and restructuring measures in a significant way. The Korean experience thus provides a deep implication for China that has emulated Korean pattern of development in many ways. Again, China

has a lot to learn not only from Korea’s success in the past but more importantly from Korean mistakes in recent years.

II. Overview of Korea-China Economic Relation before Korean Economic Crisis

1. Characteristics of Korea-China economic relation before Korean economic crisis

The official economic relation between Korea and China has a short history, only since September 1992 when the two countries normalized their official relations. Some economic interchanges had been going on unofficially (mainly through Hong Kong) in a limited extent prior to that date. As we are aware, Korea started its successful industrialization in the early 1960s, and the Chinese economic growth and industrialization date back to 1978 when the socialist country adopted the so-called “open-door” policy. The difference in the level of development between the two countries at the time China started industrialization made the bilateral relationship a “forerunner-follower” one in the so-called “East Asian growth model”. The East Asian growth model is a model in which growth is basically approached by neoclassical ideas of trade, investment, and their interdependent relationships, while government also plays an important role in the process. Interdependencies in trade and investment enable economic growth and industrialization of developing countries, by way of a provision of capital investment and export market on the part of more developed countries in the region. At the same time, industrial spurs of developing countries help more developed countries to maintain their growth momentum. The pattern of growth or the spread mechanism of growth in
this model is explained by “flying geese” and “self-circulation” hypotheses. However, it should be remembered that within a country in this model an industrialization target is often set by a close cooperation between large corporations and a group of efficient bureaucrats, and that the target is achieved by various protection and subsidy measures.

From these consideration, it is not unnatural to treat the basic character of this relationship between Korea and China in the context of East Asian growth model; i.e., Korea as a forerunner country which provides FDI and capital goods, and China as a follower which utilizes these for industrialization and export expansion. Through the process of mutual interdependence in trade and investment, both Korea and China could benefit each other and maintain their economic vitality. Economic growth of China has indeed been remarkable. The annual average rate of GDP growth for 15 years between 1981 and 1996 was 10.1%, and the figure becomes even higher to 11.6% for 1991-1996 period(China Statistical Yearbook 1997, p.25). An example of such high rate of growth for such an extended period cannot be found even in the experiences of other East Asian countries.

At this juncture, the following characteristics or limitations of East Asian growth model should be pointed out. First, East Asian growth model basically deals with an interdependent relationship between trade and investment in the real sector of the economy. FDI, an important element in this framework, is viewed mainly as a means of capital and intermediate goods supply in the real sector, which would raise productivity and push industrialization in the developing economies. That is, an interdependent relationship that also considers the financial sector is lacking in the East Asian growth model. Second, even in the real sector of the East Asian growth model, the interdependent relationship cannot be said “complete”. For the model to be a “complete” one, advanced countries provide FDI and
capital goods to developing countries, whereas developing countries should be able to export final goods to advanced countries in the region. But developing East Asian countries depend more importantly upon American and European markets for their exports. Third, an increasing interdependence in the East Asian growth model means that advanced countries' investment, capital goods supply, and provision of market enable developing countries to industrialize, and the industrialization of the latter in turn helps advanced countries to maintain their growth momentum. However, this positive effect can sometimes work in an opposite, negative direction. As we saw in the recent Asian economic crisis, the currency crisis that started from ASEAN countries affected Japan and ANIEs in a negative way - ASEAN's import demand of capital and intermediate goods from Japan and ANIEs declined. The economic slowdown in these countries in turn affected ASEAN and Chinese economies also in a negative way by reducing FDI to these countries.

Finally, non-economic characteristics peculiar to Asia or the so-called "Asiatic values" (e.g., Confucian elements of East Asia) are usually supposed to bring positive effects to growth. But these may also involve negative effects in different time and circumstances. For example, a rapid capital formation in the process of rapid industrialization was possible by a close relationship among government, firms, and banks in the Asiatic business environment. But, the environment is responsible for unsound business-politics relationship, corruptions, crony capitalism, and particularly moral hazard problem in the financial sector. Likewise, a high savings rate in the private sector functions more as an investment resource in the expansionary phase, but it could unnecessarily delay an economic recovery in the recessionary phase.
2. Trade relation between Korea and China before the Korean crisis

First of all, the total trade volume between Korea and China increased 3.71 times in just 5 years, from $6,379 million in 1992 to $23,688 million in 1997. The China's share in Korea's total trade more than doubled, from 4.03% to 8.44% during this period. The rise of Korea's trade with China is more striking in the export side of Korea, where China's share rose from 3.46% to 9.97% during this period. <Table-1>. Among various items of Korean exports to China, industrial supplies were the most prominent category (about 70% of total export value) followed by capital goods

<Table-1> Korea's exports and imports with China, by end-use category, 1992 and 1997

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Food &amp; direct</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>consumer goods</td>
<td>(0.22)</td>
<td>(5.28)</td>
<td>(19.69)</td>
<td>(15.25)</td>
</tr>
<tr>
<td>Industrial supplies</td>
<td>2,167</td>
<td>9,497</td>
<td>2,387</td>
<td>5,823</td>
</tr>
<tr>
<td></td>
<td>(9.36)</td>
<td>(21.73)</td>
<td>(5.64)</td>
<td>(7.69)</td>
</tr>
<tr>
<td>Capital goods</td>
<td>360</td>
<td>2,867</td>
<td>148</td>
<td>1,486</td>
</tr>
<tr>
<td></td>
<td>(1.25)</td>
<td>(4.36)</td>
<td>(0.48)</td>
<td>(2.81)</td>
</tr>
<tr>
<td>Non-durable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>consumer goods</td>
<td>(0.30)</td>
<td>(5.04)</td>
<td>(9.79)</td>
<td>(27.46)</td>
</tr>
<tr>
<td>Durable</td>
<td>86</td>
<td>714</td>
<td>141</td>
<td>708</td>
</tr>
<tr>
<td>consumer goods</td>
<td>(0.80)</td>
<td>(4.21)</td>
<td>(5.26)</td>
<td>(14.23)</td>
</tr>
<tr>
<td>Total</td>
<td>2,654</td>
<td>13,572</td>
<td>3,725</td>
<td>10,116</td>
</tr>
<tr>
<td></td>
<td>[3.46]</td>
<td>[9.97]</td>
<td>[4.56]</td>
<td>[7.00]</td>
</tr>
</tbody>
</table>

Notes: (1) numbers in ( ) are weights of China in Korea's total exports and imports in that category.
(2) numbers in [ ] are weights of China in Korea's total exports and imports.
Source: Korea International Trade Association(KITA), Trend of Foreign Trade, 1998
category (about 21% of total export value). In fact, Korea's export of industrial supplies to China constituted 21.7% of total Korean exports of this category in 1997.

The major, but not dominant, Korean import category from China was also industrial supplies. Other items such as food & direct consumer goods and capital goods were also noteworthy in terms of the total amount. In terms of China's share within each category of Korean imports in 1997, non-durable consumer goods (27.5%) and food & direct consumer goods (15.3%) were also significant.

This trade structure between Korea and China confirms the basic tenet of East Asian growth model, in that a forerunner country supplies capital and intermediate goods to a follower country and imports consumer goods from the latter country.

3. Investment relation between Korea and China before the Korean economic crisis

Korean investment to China, like the case of trade, has also been initiated only since the normalization of relations in 1992. In the first year of 1992, the total amount was $0.12 billion and Korea's share out of total FDI inflows to China constituted only 1.1% of the total. The figures rose sharply for the next 4 years, reaching $1.504 billion and 3.6% of the total in 1996 (China Statistical Yearbook 1997). More specifically, when we look at figures of 1995 <Table-2>, Korean investment to China was $1.04 billion, which was about 27.7% of Korea's total investments to East Asia. This ratio was much lower than those of average East Asian ratios (51%), but higher than that of Japan (17%).
<Table-2> Intra-regional FDI matrix in East Asia, 1995

<table>
<thead>
<tr>
<th>Host investor</th>
<th>ANIEs</th>
<th>ASEAN</th>
<th>China</th>
<th>East Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Korea</td>
<td>Taiw.</td>
<td>HK</td>
<td>Sing</td>
</tr>
<tr>
<td>Japan</td>
<td>2,161</td>
<td>418</td>
<td>569</td>
<td>361</td>
</tr>
<tr>
<td>ANIEs</td>
<td>231</td>
<td>311</td>
<td>133</td>
<td>176</td>
</tr>
<tr>
<td>Korea</td>
<td>94</td>
<td>4</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Taiwan</td>
<td>104</td>
<td>10</td>
<td>10</td>
<td>n.a.</td>
</tr>
<tr>
<td>H.K.</td>
<td>26</td>
<td>157</td>
<td>58</td>
<td>99</td>
</tr>
<tr>
<td>Singapore</td>
<td>6</td>
<td>140</td>
<td>65</td>
<td>73</td>
</tr>
<tr>
<td>ASEAN</td>
<td>3</td>
<td>200</td>
<td>11</td>
<td>47</td>
</tr>
<tr>
<td>China</td>
<td>13</td>
<td>58</td>
<td>n.a.</td>
<td>47</td>
</tr>
<tr>
<td>East Asia</td>
<td>247</td>
<td>2730</td>
<td>780</td>
<td>813</td>
</tr>
</tbody>
</table>


As of the end of 1997, the total Korean investment to China was approximately $3.3 billion by actual basis in about 3,500 projects. This was about 44.5% of the total number of projects, or 20% of the total amount, out of total Korean overseas investments by then. As expected, among various sectors of Korea's investment to China, manufacturing sector captured the lion's share; 86% by number of projects and 80% by amount (in both permit and actual bases). These figures were a little higher than those for average Korean overseas investment, where manufacturing sector occupied 67% and 53% respectively. In the meantime, the share of China out of total Korean manufacturing investments abroad constituted 57% in terms of the number of project and 30% in terms of the amount.

Among various industries in the manufacturing sector, investment to fabricated metal industries was most significant (27% of the total amount by actual basis) <Table-3>. Heavy and chemical industries [petroleum & chemical(6), non-metallic mineral(7), basic metals(8), fabricated metals(9),
and machinery & equipment(10)] occupied 38% of total number of projects and 58.5% of total amount.

Up to now, I have looked at the economic relation between the two countries before the end of 1997, mainly from the perspective of trade and investment interdependencies of the East Asian growth process. However, there was a big blow in this relationship at the end of 1997 when Korean economic crisis broke out as a sequence of Asian currency crisis. The Korean economy further deteriorated into the state of economic crisis, after the initial currency crisis. I now turn to this aspect of Korean economic crisis.

*<Table-3> Korea’s direct investment to China in manufacturing, outstanding as of the end of 1997

<table>
<thead>
<tr>
<th>Industry</th>
<th>Permitted investment</th>
<th>Actual investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>projects</td>
<td>amount</td>
</tr>
<tr>
<td>1. Food &amp; Beverage</td>
<td>282</td>
<td>215.9</td>
</tr>
<tr>
<td>2. Textile &amp; Clothes</td>
<td>738</td>
<td>565.5</td>
</tr>
<tr>
<td>3. Leather &amp; Footwear</td>
<td>318</td>
<td>232.7</td>
</tr>
<tr>
<td>4. Wood &amp; Furniture</td>
<td>197</td>
<td>81.4</td>
</tr>
<tr>
<td>5. Paper &amp; Printing</td>
<td>78</td>
<td>65.2</td>
</tr>
<tr>
<td>6. Petroleum &amp; Chemical</td>
<td>307</td>
<td>401.0</td>
</tr>
<tr>
<td>7. Non-metallic Mineral</td>
<td>167</td>
<td>253.9</td>
</tr>
<tr>
<td>8. Basic metals</td>
<td>144</td>
<td>249.2</td>
</tr>
<tr>
<td>9. Fabricated metals</td>
<td>568</td>
<td>1,103.6</td>
</tr>
<tr>
<td>10. Machinery &amp; Equipment</td>
<td>203</td>
<td>356.7</td>
</tr>
<tr>
<td>11. Others</td>
<td>676</td>
<td>385.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3,678</td>
<td>3,810.7</td>
</tr>
</tbody>
</table>

III. Korean Economic Crisis in the context of East Asian Growth Process

1. East Asian model in light of Asian economic crisis

Let us look and analyze the Asian “failure” at the same level of reasoning as the Asian “success”. As it has been revealed in many studies, Asian “success”-rapid expansion of the real sector and industrialization-was possible by a high level of capital formation, a high education of workers, a successful intervention of government, etc. However, a success story of this sort is not a rare phenomenon as to be called a “miracle”, especially at an early stage of development when an industrialization is initiated with known and standard technologies and an expansion of the real sector is rather easily achieved by input expansion. ASEAN countries and China, the last layers of the “flying geese” had already been successful with this type of industrialization. In order for industrialization to proceed to a higher stage, though, a larger investment on more capital and technology intensive industries, a formation of social overhead capital as well as an acquisition of more sophisticate technology are needed. But, this is where the risk of capital investment is greater, the process takes a longer period, and the uncertainty of success is greater.

At this new and transitional stage, the East Asian economies which rely on overseas market for “goods” and “money”, are especially vulnerable in the sense that they are affected by changes in precarious external conditions in addition to usual internal problems. Thus, when external winds are blowing against (e.g., protectionism in advanced markets) and when internal conditions pose a problem because of a deterioration in export
competitiveness (e.g., a rising factor prices), the production and income rise through export expansion as well as the foreign exchange procurement for capital goods imports will be seriously hurt. When export competitiveness deteriorates the demand for foreign exchanges becomes larger, to make up for balance of payment deficits. In the case of ASEAN countries where Asian currency and financial crisis had started, the competitiveness of traditional labor-intensive manufactured exports had been declining considerably. The causes were various; an emergence of other later-coming LDCs, a shortage of social overhead capital, a rise in factor costs, a yuan depreciation in 1994, etc. The result was an accumulation of balance of payments deficits, which led to yet higher demand for capital to upgrade industrial structure and to expand social overhead capital.

It has already been pointed out earlier that countries in East Asia achieved high rates of growth by utilizing FDI inflows. But East Asian countries began expanding FPI(Foreign Portfolio Investment) in addition to the traditional FDI inflows, as their demand for capital soared <Table-4>. When these countries were trying to induce more foreign capital by opening and liberalizing financial and capital sector, the supply condition in the international money market was fortunately favorable. There had been a plenty supply of international liquidity, due to a global extension of capital liberalization, a persistent low interest rates in advanced countries, an accumulation of balance of payment deficits in the US in the 1990s. Particularly, there was an acceleration of capital inflows to emerging Asian economies since the Mexican foreign exchange crisis in 1994. However, much of this increased capital inflows turned out to be high risk, high return, short term, speculative funds, which could easily move in and out of the host country, and thus became a factor causing an instability of capital flows.
<Table-4> Movement of private capital in 5 East Asian countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>6.2</td>
<td>7.2</td>
<td>8.6</td>
<td>8.6</td>
<td>7.4</td>
<td>9.5</td>
<td>12.0</td>
<td>9.6</td>
</tr>
<tr>
<td>Stock invest.</td>
<td>1.3</td>
<td>3.3</td>
<td>6.3</td>
<td>17.9</td>
<td>10.6</td>
<td>14.4</td>
<td>20.3</td>
<td>11.8</td>
</tr>
<tr>
<td>Other invest.</td>
<td>17.4</td>
<td>18.5</td>
<td>15.4</td>
<td>6.1</td>
<td>17.1</td>
<td>39.0</td>
<td>40.6</td>
<td>-32.3</td>
</tr>
<tr>
<td>Total</td>
<td>24.9</td>
<td>29.0</td>
<td>30.3</td>
<td>32.6</td>
<td>35.1</td>
<td>62.9</td>
<td>72.9</td>
<td>-11.0</td>
</tr>
</tbody>
</table>

Note: (1) Amounts are net investments.
(2) 5 East Asian countries are Korea, Thailand, Indonesia, Malaysia and the Philippines.

In connection with the inflows of FPI, it has to be strongly pointed out that the liberalization of the financial sector was haste one, in that the conditions for liberalization were not ready for most developing countries in Asia. Even the most advanced Japan - the leader of the East Asian growth ladder - is often mentioned for its backwardness of the financial sector. As Montes sees it, the currency crisis of the Southeast Asia was brought about by two liberalization attempts - one of domestic financial system and the other of capital account: “the first liberalization had far-reaching consequences on domestic financial systems. ---credit risks were not properly priced and scant attention was paid to interest risks. The second liberalization effort consisted of opening the capital account. Because international interest rates are generally lower than domestic interest rates in developing countries, opening the capital account have given the domestic financial systems of the developing countries access to lower cost funds with which to fuel intermediation and stimulated domestic rivalry between financial groups” (Montes 1998, 56-57).

It becomes clear now that the immediate causes of East Asian crisis have to be found with the method of pursuing and managing growth policies in the afflicted economies of the region. First, they had been struggling with
BOP deficits for a long time because of the delays in the reform and upgrading of their respective industrial structures. Further, when they were dealing with this problem, there were failures and delays in exchange rate adjustment and a great dependence on short term external funds, which in turn were possible by rapid openings of the capital sector. Second, against this trend of increasing dependence on external funds, there was a defect on supervising function of the financial institutions. This backwardness in the financial system not only deteriorated the bad debt problems of firms but also those of financial institutions themselves! Short-term capitals and portfolio investments that flowed in through the hastily opened capital market resulted in an over supply of liquidity in the market, and they were absorbed, not in the long term productive investments, mostly in high risk real estate ventures or other low productive activities. All these negatively affected to already weak domestic financial system and insolvency of some domestic banks.

What can then be said about the relationship between East Asian growth model and East Asian financial crisis? First of all, the East Asian economic crisis is not a problem facing all East Asian countries, nor is it a problem inherent in the East Asian growth model. Rather it is a problem arising from an overlook of financial sector, in a model that emphasizes a rapid expansion of real sector. But, when we analyze the transmission process of an East Asian currency crisis from one country to another, the virtuous cycle of economic growth, which has been achieved through interdependencies of trade and investment, can be turned into an opposite direction of vicious cycle. Whether the cause of East Asian economic crisis is related with East Asian growth mechanism or not, it can be said that the East Asian crisis was transmitted rapidly by the same mechanism. Fratzscher shows in his empirical study that intra-regional transmission of East Asian crisis has not been caused by the vulnerability of fundamentals of these economies.
Rather, factors that are not related with fundamentals, such as financial and trade linkage structure of the region, weaknesses of financial structure in the region, rapid and unpredicted outflows of capital, have been more responsible for it (Fratzscher 1998, 689).

2. Causes of Korean economic crisis

The real causes of Korean economic crisis have a long and deep root, dating back maybe to Korea's early industrialization. However, they are usually traced from the recent foreign exchange crisis in 1997. In the past, the symbiotic relationship between government, businesses, and financial institutions allowed the business sector to invest rather carelessly without a serious consideration of profitability. This has resulted in a series of business failures, which in turn weakened financial soundness of the monetary sector. The declining confidence of foreign investors on Asian economies first sparked the Thai currency crisis in July 1997. The contagion of this crisis eventually led to a foreign exchange crisis in Korea in Nov. 1997. The principal reasons for this foreign exchange crisis to deteriorate into the state of economic crisis were excessive bad debts of the business sector and a high interest rate policy recommended by the IMF. Many businesses which were already flooded with bad debts had to go bankrupt under heavy pressure of higher financial costs. A sharp rise of business failures further threatened financial market stability, thus generated a vicious circle of economic crisis.

Cho chronologizes the sequence of Korean currency or foreign exchange crisis into the following. Initially, there was a business crisis which was mainly caused by a lack of market discipline: "thirty years' experience of government bail-out policies created the expectation that big conglomerates would never be allowed to fail. With this expectation, therefore, Korean
conglomerates had strong incentives to keep expanding without careful consideration of the attendant risks and returns. As a result, a few conglomerates grew to command huge portions of the country's resources and thus became too big to fail." (Cho 1998, 102). That is, the structure of corporate governance was not based on market principle. Furthermore, competition against each other in the same businesses, and inflexibility of Korea's factor markets (reflected by a wage increase at an average annual rate of 15%, and by high interest rates) further squeezed their profitability. When Korean government can no longer bail out "problem" firms because of economic and non-economic considerations, these firms had to go bankrupt.

Next, there was a financial crisis as a natural outcome of the so-called "moral hazard" problem, which was nurtured by the system of government guarantees:

"In conjunction with continued bail-outs of large conglomerates, government intervention in financial markets generated a serious moral hazard problem. Because financial institutions tended to believe that there were implicit government guarantees on the liabilities of the conglomerates they had little incentive to scrutinize the financial soundness of these businesses. That is how Korean chaebol were created. Furthermore, in return for their compliance with government directions, major financial intermediaries also had been bailed out whenever they got into trouble. Consequently, under the government-led development strategy there emerged a strong symbiosis among the government, financial institutions, and the chaebol. In this environment, the chaebol made aggressive investments through profligate borrowings from financial institutions, and quite often they financed long-term investments from short-term
capital markets without worrying seriously about consequences" (Cho 1998, 103).

These two crises eventually led the country into a currency crisis, where foreign exchanges condition was worsened by an attempt to defend the currency value. Causes of the currency crisis in Korea were similar with those of other countries; some internal factors described above and other external factors such as a shortage of liquidity, (western) capitalists' plot, etc. But, as always, the most direct cause was an attempt to defend the currency value against the market.

Finally, there was a leadership crisis that failed to overcome conflict of interest. The structural problems described above have long been recognized, in that “as the economy grows and the world economy becomes more integrated, the old paradigm of government-led development will no longer work as efficiently as a free market system. However, their efforts to establish a new order inevitably confronted resistance from interest groups and Korean 'leaders' failed to lead the society to a new paradigm” (Cho 1998, 106).

The Korean economic crisis refers, in a narrower sense, only to a series of event that eventually led to the currency crisis in Nov. 1997. It is generally believed that the direct causes of this currency crisis was the shortage of liquidity, which was in turn a result from policy mistakes (e.g., over-valued exchange rate policy) and external factors (e.g., East Asian currency crisis).

However, these four crises described above are not unique to Korea, and are more or less common to all afflicted economies of Asia. Also, the first two crises (those of business and financial) are more fundamental and structural in many East Asian countries. For instance, the deterioration of currency

2) For instance, see Kim(1999).
crisis to a severe economic downturn in Korea should properly be viewed in this context. Thus, without reforms and improvements in these areas, the economic recovery of Korea and other Asian countries would only be cosmetic and temporary.

3. Korean economic crisis in the context of East Asian growth model

Studies on the causes, backgrounds, processes, etc. of Korean economic crisis are many. Instead of going through all these, I will here take a look at Korean economic crisis in terms of the East Asian growth mechanism, and ask the following questions: Has Korean economic crisis been a necessary outcome of the East Asian growth mechanism? Or, has it come about by exogenous factors that are not related with East Asian growth mechanism?

There has been an argument that economic growth of East Asian economies will, sooner or later, have to be slowed down because its growth is based mostly on input expansion, not based on the productivity or TFP (Total factor productivity) rise (e.g., Krugman 1994). Krugman further argues that structural and institutional shortcomings in the process of capital formation (which are reflected in unsound politics-business relationship, corruption, crony capitalism, etc.) and the resulting moral hazard problems in both real and financial sectors will stop the wheels of growth(Krugman 1998). By this reasoning, Korea, which has followed a similar growth path and faced similar structural problems with other East Asian countries, is expected to face a similar fate. However, there are differing views on the size and the method of calculating the TFP, which Krugman cites. Furthermore, even Krugman who claimed that moral hazard is the main cause of the Asian crisis, confesses that nobody could have predicted that the Asian economic crisis occur unpredictably and spread rapidly and
extensively at this magnitude.

Yamazawa also notes similar structural problems in East Asian economies: “This does not mean that all fundamentals were valid. There were a few major deficiencies in economic structure and performance. Their financial system has developed uncompetitively under government protection, and unsound government-business relationships have sometimes been aggravated by paternalistic industrial policies. --- Problems with the industrial structure in developing countries should also be addressed. Their production and export of labor-intensive products have relied heavily on imported parts and materials which in turn made these economies vulnerable to currency instability and frequent current account deficits. The upgrading of their industrialization in order to substitute these imports has not made significant progress. This has been due not to the lack of funds but to the lack of capacity for absorbing technology and to the insufficient availability of skilled personnel. This structural deficiency would have stopped the East Asian miracle sooner or later even in the absence of the currency crisis”(Yamazawa 1998, 340).

The arguments that East Asian economic crisis has occurred by exogenous factors which are not related with East Asian growth mechanism claim that it has occurred by a financial panic that recalled a large amount of invested funds suddenly and all at once. Among these, there is even an argument of the so-called “(western) capitalists' intrigue” aiming to tame East Asian economies. But, had not this sudden and massive recall really anything to do with the East Asian growth mechanism? It was true that the sudden and all at once recall of the investment funds caused and spread Asian financial and economic crisis. But, it was also true that there had been a problem in the ways capital is formed and allocated in the East Asian economies in the first place. For example, it is found in most afflicted economies that many long-term projects were being financed by short-term
“hot” funds.

However, it is not always clear that this unwise formation and management of capital is a necessary result from East Asian growth mechanism. Because, not all East Asian economies were hurt seriously, although most of them generally had problems of moral hazard and weak financial sector. Some economies were hurt only superficially and still maintains a sound growth momentum. In short, there are some elements in the Korean economic crisis that should be reviewed in the context of East Asian growth mechanism. It can be argued that other external causes might have been more directly responsible for igniting Korean economic crisis. But, the structural and institutional problems in the East Asian growth mechanism may have been responsible for deteriorating, deepening, and prolonging the initial Korean currency crisis.

IV. Implications of Korean Economic Crisis for China

1. How China weathered the Asian economic crisis?

Although China shares similar structural problems (e.g., governance problems of state enterprises and weakness and backwardness of financial institutions) with other East Asian economies including Korea, it has emerged relatively unscathed from the Asian crisis. This was possible by the presence of balance of payment surpluses, large foreign exchange reserves, and effective financial sector controls and supervision. Furthermore, there are some elements in Chinese economy, which can not be treated on the same level of East Asian growth mechanism. For example, China is a large economy which has its own large domestic market, unlike other small
economies in East Asia. Normally, the dependency on foreign trade or on foreign natural resources in a large economy is greatly different from that of a small economy. Also, China has experienced the socialist command economy (and even now it still retains some elements of a socialist economy), which is different from historic and institutional experiences of other East Asian countries.

Let us look at factors that enabled China to avoid a blow of the Asian currency crisis and to maintain its economic stability; namely, exchange rate devaluation in 1984, large exchange reserves and low foreign debt ratios, and strict supervision on monetary sector and foreign exchanges. The first factor was the yuan depreciation in 1994. The 45% depreciation of yuan from 1$=5.8 yuan to 1$=8.45 yuan greatly improved China's export competitiveness.\(^3\) The trade and current account deficits in 1993 turned around after the depreciation, and the accumulation of trade surpluses helped to increase China's foreign exchange reserves. This enabled China to maintain surpluses in both trade and current accounts in the 1990s, except 1993. Additionally, the inflow of FDI had jumped up drastically since 1992, whereas the inflow of portfolio investments in stocks and bonds was relatively small compared to Korea or ASEAN countries. Due to the accumulation of current account surpluses and the steady inflows of foreign funds, foreign exchange reserves rose sharply, reaching $105 billion by the end of 1996\(^4\) <Table-5>.

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\(^3\) Ironically, there has been an argument that the yuan depreciation weakened the export competitiveness of ASEAN competitors, resulted in current account deficits of these countries, and ultimately caused the Asian currency crisis(Kaplinsky 1998).

\(^4\) The foreign exchange reserve further increased to $140 billion by the end of 1997. This was greater than the sum of those in 4 ASEAN countries((Japan) White Paper on Trade 1998, 93-96).
<Table-5> Balances of payment and foreign exchange reserves of China, 1985-96

($ bill.)

<table>
<thead>
<tr>
<th>year</th>
<th>current a/c</th>
<th>trade a/c</th>
<th>for. ex. reser.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>-11.42</td>
<td>-13.12</td>
<td>2.64</td>
</tr>
<tr>
<td>1990</td>
<td>11.99</td>
<td>9.17</td>
<td>11.09</td>
</tr>
<tr>
<td>1991</td>
<td>13.27</td>
<td>8.74</td>
<td>21.71</td>
</tr>
<tr>
<td>1992</td>
<td>6.40</td>
<td>5.18</td>
<td>19.44</td>
</tr>
<tr>
<td>1993</td>
<td>-11.90</td>
<td>-10.65</td>
<td>21.20</td>
</tr>
<tr>
<td>1994</td>
<td>7.66</td>
<td>7.29</td>
<td>51.62</td>
</tr>
<tr>
<td>1995</td>
<td>1.62</td>
<td>18.05</td>
<td>73.60</td>
</tr>
<tr>
<td>1996</td>
<td>7.24</td>
<td>19.54</td>
<td>105.00</td>
</tr>
</tbody>
</table>


On the other hand, the total foreign debt was $128 billion at the end of 1996, which was about the same level as Indonesia, the largest debtor among four ASEAN countries. But the DSR(Debt Service Ratio) of China at the time was relatively low at 6.7%, compared to Korea(8.8%), Thailand(11.5%), Malaysia(8.2%), Indonesia(36.8%) and the Philippines(13.7%)(Corsetti, Pesenti, Roubini 1998). Foreign debt ratios of China out of GDP or total exports also reveal <Table-6> that these are not too worrisome.\(^5\) All these show that China would not face the shortage of liquidity, which invited a speculative attack in Korea and some ASEAN countries encountered in the second half of 1997.

Finally, there was a strict control on foreign exchanges and capital accounts by the Chinese government. As Jinping notes, it was due to the institutional and policy factors that enabled the Chinese financial sector relatively stable in spite of the Asian financial crisis: "strict controls have

---

5) For example, the DSR of 6.7% and foreign debt/export ratio of 75.6% were quite low compared to those internationally accepted critical levels, 20% and 100% respectively(Jinping 1998, 306).
been placed on foreign loans, stock investment, and foreign exchange transactions by Chinese residents. Consequently, there is little scope for buying and selling in currency and capital markets by foreign investors or speculators to affect China's financial stability" (Jinping 1998, 313). As we have seen, this was in good contrast to the experiences of Korea and ASEAN countries.

2. Implications of Asian economic crisis for China

Although China didn't experience the kind of currency, financial and other economic crises as other countries in the region, China has pursued more or less the same growth strategies, and shares similar structural and institutional problems with these countries. In that respect, Asian economic crisis has been a good lesson to China, too.

First, China is on a competitive (rather than complementary) relation
particularly with ASEAN, which pursue the same outward looking development strategy that is based on expanding exports and encouraging FDI inflows. True, the 1994 depreciation of yuan damaged the export competitiveness of the ASEAN. But, the exchange rate advantage of China has been eroded considerably since the depreciation of ASEAN currencies after the Asian currency crisis in the summer of 1997. In other words, The Chinese and ASEAN products, which are mostly labor-intensive manufactures, have again become more competitive in the major export markets of US and Japan. Furthermore, in a regional economy where the trade interdependency has been deepening and the self-circulating mechanism of growth has been strengthening, the economic recessions of Japan and other countries in the region affect China adversely. For example, declining import demand in these countries has already caused a negative impact to the expansion of Chinese exports. At the same time, Asian neighbors have become more aggressive attracting foreign capital in order to improve and reform their industrial and corporate structures. This also makes them competitive with China.6

Second, mismanagement and declining profitability (and increasing loss) of state enterprises cause a concern. The weight of state enterprises in China has been lowered, but it still commands 29% of industrial production, 64% of urban employment, 71% of fiscal revenue. However, the ratio of loss-incurring firms among State enterprises has been rising, and more and more state enterprises have gone bankrupt. Out of total 13,800 state enterprises, the ratio of loss-incurring firms rose from 23.4% in 1992 to 37.7% in 1996,

6) FDI inflow to China has been increasing on an actual utilization basis. However, it has been on a declining trend on a contract basis since reaching the peak in 1995; diminishing by 19.8% in 1996 and by 29.3% in 1997 from the each previous year. Also, as a result of the Asian economic crisis FDI investments from Korea (and to a lesser extent from ASEAN) are expected to decline on an actual utilization basis((Japan) White Paper on Trade 1998, 95).
and the total amount of loss also rose from 36.7 billion yuan to 72.7 billion yuan during the same period <Table-7>. Among various causes of this accumulation of loss, factors common to transitional economies as well as factors peculiar to China are found. But, factors common to those of East Asian countries which have suffered the economic crisis (e.g., the “triangular” relationship among government, business, and bank, the moral hazard of big firms as well as that of banks, the lack of transparency in corporate accounting) can also be found.

<Table-7> Losses of state enterprises, 1981–1996

<table>
<thead>
<tr>
<th>year</th>
<th>81</th>
<th>82</th>
<th>83</th>
<th>84</th>
<th>85</th>
<th>86</th>
<th>87</th>
<th>88</th>
</tr>
</thead>
<tbody>
<tr>
<td>units</td>
<td>22.9</td>
<td>20.8</td>
<td>12.8</td>
<td>10.2</td>
<td>9.6</td>
<td>13.1</td>
<td>13.0</td>
<td>10.9</td>
</tr>
<tr>
<td>amounts</td>
<td>46.0</td>
<td>47.6</td>
<td>32.1</td>
<td>26.6</td>
<td>32.4</td>
<td>54.5</td>
<td>61.0</td>
<td>81.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>year</th>
<th>89</th>
<th>90</th>
<th>91</th>
<th>92</th>
<th>93</th>
<th>94</th>
<th>95</th>
<th>96</th>
</tr>
</thead>
<tbody>
<tr>
<td>units</td>
<td>16.0</td>
<td>27.6</td>
<td>25.8</td>
<td>23.4</td>
<td>30.3</td>
<td>33.0</td>
<td>33.5</td>
<td>37.7</td>
</tr>
<tr>
<td>amounts</td>
<td>80.2</td>
<td>348.8</td>
<td>367.0</td>
<td>369.3</td>
<td>486.0</td>
<td>448.0</td>
<td>540.6</td>
<td>726.7</td>
</tr>
</tbody>
</table>

Source: Tian(1998, 35)

Recognizing a difficulty of maintaining stable economic growth without reforming state enterprises, the Chinese government has begun pursuing state enterprises reforms that aim for a modern corporate structure since 1993.8) However, a great amount of money is needed to reform the structure

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7) Causes of loss accumulation are the followings: (1) Moral hazard problem on the part of managers and employees, since profits belong to the State. (2) When debts or losses occur, it is usually the State which bears the cost. (3) The competitiveness of the state enterprises has weakened, as the provincial and local firms have rapidly grown. (4) State enterprises take responsibility for other areas such as housing, medical costs of the employees, education and job search for the children of the employees, etc.(Bank of Korea 1998. 4, 21~26).

8) While the reform measures have been dragging on, the People’s Congress held in Mar. 1997 adopted a principle of nurturing large state enterprises, but privatizing small state
of these enterprises and to improve profitability and efficiency. The Chinese government hopes to finance the necessary fund by listing these companies in the Hong Kong stock market, but the success of it is uncertain. Moreover, measures that deal with large additional unemployment (estimated to be 20-30 million people) that would result from mergers, bankruptcies, or streamlining of state enterprises, should be provided. If this problem of rising unemployment is not properly handled, it may even cause a social and political instability.

Third, China is no exception to a general backwardness of the financial sector, which is common to all East Asian economies including Japan, and the soundness of financial institutions in China is also questionable if not alarming. The unsoundness of financial institutions in China is basically related to the unsoundness of state enterprises. Like Korea, Chinese government also views financial institutions as instruments for industrial policy, and thus often directly intervenes in management and loan decisions of these institutions. However, the laws and regulations regarding financial practices as well as the system of supervision are quite defective. Thus, the total amount of bad debts by state owned banks constitutes about 25% of total loans or 270% of paid in capital at the end of June 1997.  

As the sense of urgency mounted, Chinese government has begun reforming the financial sector more seriously.  

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9) Furthermore, investment trust companies and other non banking financial institutions are recently expanding their businesses to high risk stock and real estate investments. Lacking proper laws and regulations, this new development adds fear to the already insecure positions of the financial institutions (Bank of Korea, 1998. 4. 21-26).

10) The Central bank of China (People's Bank of China) recently early-retired 47% of its employees (Chosun Ilbo (Daily), 1998/07/10). The Chinese government also withdrew its permit on the following four financial institutions in 1998: China Agricultural Investment
Fourth, in spite of a close watch and control on the financial sector by Chinese government, there has been a steady increase in the inflows of portfolio investments <Table-8>. Of course, the inflow of portfolio investment per se is not objectionable. Moreover, the size of portfolio inflows in China is relatively small compared to those of FDI and loans, export receipts, and foreign exchange reserves. Nevertheless, the timing and extent of inflows and outflows of these speculative funds have a great impact to the stability of growth, to warrant a more effective management, supervision and monitorship.

**Table-8** Portfolio investments in East Asia, 1970–94

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>0</td>
<td>0</td>
<td>50</td>
<td>971</td>
<td>-48</td>
<td>677</td>
<td>1,191</td>
<td>4,516</td>
<td>6,791</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0</td>
<td>0</td>
<td>40</td>
<td>-40</td>
<td>338</td>
<td>381</td>
<td>274</td>
<td>1,845</td>
<td>4,167</td>
</tr>
<tr>
<td>Korea</td>
<td>0</td>
<td>0</td>
<td>44</td>
<td>1,271</td>
<td>687</td>
<td>3,067</td>
<td>5,606</td>
<td>9,723</td>
<td>6,682</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-30</td>
<td>-3</td>
<td>-11</td>
<td>2,253</td>
<td>80</td>
<td>143</td>
<td>11</td>
<td>3,745</td>
<td>2,296</td>
</tr>
<tr>
<td>Philippines</td>
<td>-1</td>
<td>-2</td>
<td>80</td>
<td>-71</td>
<td>395</td>
<td>124</td>
<td>282</td>
<td>1,815</td>
<td>2,333</td>
</tr>
<tr>
<td>Thailand</td>
<td>0</td>
<td>0</td>
<td>44</td>
<td>60</td>
<td>362</td>
<td>-36</td>
<td>553</td>
<td>4,889</td>
<td>3,237</td>
</tr>
<tr>
<td>Total</td>
<td>-31</td>
<td>-5</td>
<td>248</td>
<td>4,445</td>
<td>1,814</td>
<td>4,356</td>
<td>7,916</td>
<td>26,532</td>
<td>25,506</td>
</tr>
</tbody>
</table>


In sum, chances are not much that China would face a similar foreign exchange and financial crisis many Asian countries experienced, largely because of a rather abundant foreign exchange reserves, a relatively low foreign debt, and a strong governmental control and supervision on foreign exchange and capital transactions. But China has certainly been affected
adversely from economic recessions in Japan, Korea, and other East Asian countries with which Chinese trade and capital transactions have been increasingly more dependent. At the same time, China has been losing its export competitiveness vis-a-vis ASEAN rivals, since exchange rate depreciation of these countries have taken place in the late 1997. The result can be shown by a slowdown in both exports and FDI inflows (contract basis). In a longer term perspective, China needs a huge amount of foreign resources for corporate restructuring and privatization of state enterprises, and for upgrading industrial structure. If China wants a better access to external sources of fund, it has to follow the worldwide trend of liberalization in both trade and investment, where government's control on foreign exchange and capital transactions is restrained. The sequence and speed of financial liberalization will greatly affect economic future of China. In this respect, the heart-broken experiences of industrial restructuring and financial liberalization in Korea and other ASEAN countries will give a good lesson to China.

3. Implications of Korean economic crisis for China

The role of government for economic growth and industrialization is noted for almost every country in the East Asian region. However, economic structure and development strategies of China resemble those of Korea in many ways. For instance, Korean industrial structure that centers on several large conglomerates is similar with China where large state enterprises hold a dominating industrial share. China thus seemed to emulate Korean model of development more seriously than others: The economic size and industrial composition of Hong Kong or Singapore are too small and different from China; The industrial structure of Taiwan is centered more on small and medium industries; And and the level of industrial development in
Japan is too advanced for China. Moreover, the triangular relationship among government, business sector and banking sector for capital formation and investment decision is similarly present for both countries. Therefore, the recent economic crisis in Korea must have shocked and alarmed China.

Like Korea (and Japan), China is also over reliant on bank financing. Jinping again notes that “China also still relies too heavily on bank financing because of the late formation and underdevelopment of its capital market. At present, securities issues and shares provide only 1.1 percent and 0.7 percent respectively of funds for gross capital formation. With an over-reliance on indirect financing and the underdevelopment of direct financing through securities markets, China's problems of financial market structure are similar to those of Japan and some Southeast Asian countries. Improving and vitalizing the securities market, including encouraging bond and share issues, should become a major orientation for reform of China's financial system” (Jinping 1998, 314).

Not only the structure of the economy, the problems facing the two countries are also similar. As was pointed out elsewhere, the mounting bad debts and overcapacity became the main causes for business weakness as well as the sources of financial vulnerability in the monetary sector in Korea. Likewise, China also has a number of inefficient large state enterprises, which are laden with redundant labor force, over-capacity, and bad-debts. A good number of Chinese financial institutions are also suffering from non-performing loans that are mainly caused by these inefficient large state enterprises.

Since the two major internal causes of Korean economic crisis have been the poor corporate governance structure and the backwardness of financial sector, key reform measures are accordingly focused on exposing business and financial sectors to market principle and discipline. As for the reforming of corporate governance structure under chaebol, two major policy changes
are noteworthy; first, a regulation against mutual loan guarantees among subsidiary companies within chaebol, second, a requirement to release transparent consolidated balance sheets. As Cho notes, "a full-scale introduction of M&A markets could awaken chaebol to the importance of profitability and market pressure over size and political power. Regulations against mutual loan guarantees among subsidiary companies can help prevent chaebol from becoming too-big-to-fail in the first place. In addition, forcing the release of transparent balance sheets to the market can reduce the degree of financial resource concentration in chaebol"(Cho 1998, 108). To reduce the overcapacity problem, the so-called "big deal" among major chaebols has been recommended by government.

In order to restructure financial institutions, a number of ailing merchant banking corporations have been closed, and two major banks that could not satisfy the BIS standard are on sale. "Considering that no major financial institution has failed in Korea's history, the current situation may well be called a 'Big Bang'"(Cho 1998, 102). Additionally, allowing flexible employment adjustments also challenges the invulnerability of workers under labor union. This will permit firms to adjust rapidly to the world economic trends. The process of Korean economic crisis and the various reform measures to strengthen the corporate and financial structures will give a valuable lesson to China, because China faces similar problems as Korea does.

V. Conclusion and a Future Prospect for Economic Relation between Korea and China

In this paper, we first looked at Korea-China economic relationship in the general context of an East Asian growth model. We have confirmed that the
relationship between the two countries followed that of East Asian growth mechanism. That is, Korea as a forerunner country provided FDI and capital or intermediate goods to China, and provided a market for Chinese exports to a certain degree. However, these positive interactions have been affected by an unexpected occurrence of the Korean economic crisis. Thus, we have investigated the causes of Korean economic crisis, mainly within a framework of East Asian growth process. There, we have seen that an expansionist way of thinking, an unsound business-politics relationship, a triangular relationship among government, corporations and banks, backwardness as well as moral hazard problems in the financial sector were all responsible for the causes of Asian and Korean economic crises. Moreover, a deepening trade and investment interdependency in the region, which was regarded as a positive phenomenon, has paradoxically contributed for the spread of economic crisis.

The Chinese economy has emerged as relatively unscathed after the Asian currency and economic crisis and still maintains its previous vitality. Nevertheless, the Asian experience shows the necessity for foreseeing and minimizing possible risks when a country liberalizes its capital accounts. Guitian's emphasis offers a deep implication to China; “the sequence of reform is more important than the speed of reform and that capital account liberalization needs to be undertaken as an integral part of economic reforms and coordinated with appropriate macroeconomic, exchange rate, and financial sector policies” (Guitian 1998, 16). Most importantly, Guitian further argues that the liberalization of inflows through the banking system should have been supported by banking reforms, as well as by greater transparency and better information flows, to enable markets to make informed decisions and reduce the risk of subsequent reversals of market sentiment.

Does recent Asian currency and economic crisis mean the end of Asian
“miracle”, as Krugman warned? It is true that Asian economy was hurt deeply and has not fully recovered from the devastating impact of the crisis. However, Asian economic crisis may work as “bless” for Asian economy to progress for higher stages of growth by reshaping and revitalizing its economic structure, if structural reforms are successfully accomplished in both corporate and financial sectors. As Kwan argues: “Although a period of adjustment is inevitable following the crisis, if Asian governments take the appropriate steps to address the problems mentioned earlier, high economic growth can still be achieved in the longer term. This is because the basic factors contributing to the Asian miracle—high savings rates, heavy investment in human resources, and a market-friendly stance towards economic policy—are not likely to change with the latest shock (Kwan 1998, 41).

Therefore, conditions for a recovery in the afflicted economies of Korea and ASEAN are much needed. For this to happen structural reforms in both corporate and financial sectors within these economies are most important. But, external assistance would also be a big help. Among these external assistance, a continued FDI from Japan and other ANIEs, and an increased import demand from more developed countries in the region (the deficiency of which has been cited early as being the weakest point in the self-circulating mechanism of the East Asian growth model), particularly from Japan, would be good examples. This leads us to emphasize that among various functions of Japan in the region, the real sector cooperation by enlarging imports from other Asian countries would be as much important as the monetary cooperation such as establishing AMF (Asian Monetary Fund). In this respect, Fred Bergsten's warning that East Asian growth pattern would be that of “dying geese” without Japan's leadership, means a lot.
What then would be the future prospect for Korea-China economic relation?

China has maintained its economic vitality when many neighbors in Asia were suffering from the recent economic crisis. However, China also has many problems to solve such as 1) restructuring and privatizing state enterprises, 2) cleaning up of unsound financial institutions and getting rid of bad debts, 3) increasing unemployment, especially when the above reform measures are being enforced, and 4) others such as over and excess investments (arising from the rivalry among provincial governments), income and development gap between coastal areas and inland areas, etc. If China could manage wisely these problems, it would give two important implications to the East Asian growth model. First, it would certainly render a helping hand to the economic recovery of neighboring countries under crisis. Second, it would help maintain the effectiveness of the East Asian growth mechanism, and further expand this growth mechanism to Indochina and other Southwest Asian countries.

In connection with this external expansion of the growth mechanism, we can think of the internal expansion of the growth mechanism within China. That is, economic growth of China, which has been centered around coastal cities and provinces until now, could be expanded to the inland areas where growth momentum and development has been delayed. In other words, “flying geese” pattern of expansion would also be possible within China. The transmission of growth within a country as in the case of China(not like the one between countries, which has been observed in the past) would be an interesting diversion of the model: “Development of the coastal area will continue. But, the weight of highly value-added industries will go up in this area, because of a rise in wages and a rise in the prices of rent and services. This would make the development conditions of labor-intensive industries in
the central and western part of China more advantageous. There will be more of a movement of production bases of the coastal industries to midwestern area. Already industrialization is in progress in the provinces of Sichuan (四川省), Hubei (湖北省), and Hunan (湖南省). The transmission of this industrialization will be further broadened geographically. There is a possibility of a spread of (East Asian) flying geese pattern of growth in China” (Ministry of Economic Planning (Japan) 1996, 110)

The future economic relation between Korea and China will be closely related with these internal and external expansions of growth mechanism. Korea can contribute China in its effort to expand its industrialization to the inland areas, just as Korea provided FDI to the Northeast provinces or coastal areas of China in the past. Korea can also cooperate with China for industrialization of Indochina and Southwest Asia, which have begun opening and reforming their economies recently. For example, Korea can provide capital, technology and managerial skill while China offers capital, intermediate goods and raw materials in these ventures.

China in the past tried to upgrade its industrial structure by attracting FDI inflows and importing capital and intermediate goods from Japan and ANIEs including Korea. Again, it would be quite desirable for China to have advanced capital, technology and management know-how from them in the future, too. However, China should also diversify its export destinations from US and other advanced countries to other countries in the region. At the same time, Korea and Japan should be more open and receptive in their imports from China. This would strengthen the circulation of trade and investment within the region. Just as Korea complains against Japan for its trade deficits, Korea should pay more attention to its trade surpluses with China.

There are many areas in which economic cooperation between Korea and China would result in a significant structural changes of the regional
economy. For example, there has been a discussion about forming a so-called "Northeast Asian Free Trade Area" between Korea, China and Japan. Also, there is a talk about establishing a regional financial institute (e.g. AMF(Asian Monetary Fund)). The idea of these kinds of international and regional economic cooperation involving both Korea and China is not new. In fact, the idea was especially initiated by China in the late 1980s, when China was eager for trade and investment cooperation with neighboring countries. However, since the outbreak of the Asian economic crisis, Japan has been forcefully arguing for establishing formal regional institutes on both trade and investment areas. Korea has an important role in this movement as a participant and as an arbitrator between China and Japan. As an example, Korea can side with China against the dominance of economic power of Japan in an organization of this sort.

Korea's economic relation with China can finally be extended towards advanced countries outside the region such as US and EU, or other international organizations. Particularly, a trade friction of China with US, which has arisen partly by an accumulation of trade surpluses on the part of China is well known. To settle this and other matters, such as China's entry as a member of WTO(World Trade Organization) and a further opening of Chinese market to outsiders, a deepening cooperation between the two countries will be strategically important and will bear fruitful results.
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〈신문자료〉