



**China-Korea Relations:
Underhanded Tactics and Stolen Secrets**

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The Oct. 3 Six-Party Talks agreement on next steps in North Korea's denuclearization and the Oct. 4 inter-Korean summit declaration shaped developments in China-Korean relations in the last quarter of 2007, as China reaffirmed its peacemaking role on the Korean Peninsula. Chinese Communist Party official Liu Yunshan visited Pyongyang in late October with a message from Hu Jintao, resuming party-to-party high-level contacts with Pyongyang after a year's break. Similarly, Six-Party Talks lead negotiator Wu Dawei visited Pyongyang in mid-December to encourage North Korean counterparts to follow through on obligations to disable and declare nuclear facilities by the end of the year in accordance with the Feb. 13 and Oct. 3 agreements. South Korean telecommunications companies worked hard to gain an advantage over global competitors in the Chinese market, while Korean automobile and steel manufacturers faced new challenges as industrial espionage involving proprietary technology drew an even higher profile in both sectors. China's search for financing has not bypassed the Korean equity market, as Korea's China-focused equity funds gained while the Korean Stock Exchange attempts to attract Chinese firms to list directly on the Korean exchange.

Special worries about a "normal relationship"

Chinese descriptions of relations with North Korea as "normal" appear to be minor alterations compared to what North Korea is seeking in its relationship with Beijing. Pyongyang's desires for a strategic relationship with the U.S. appear designed, in part, to distance the North from Beijing while sowing seeds of rivalry between Beijing and Washington. North Korean leaders appear intent on doing whatever is necessary to show that China needs North Korea more than North Korea needs China. Last year's nuclear and missile tests in the face of China's public warnings were first steps. Then came Vice Foreign Minister Kim Kye-gwan's public statements during his spring 2007 trip to New York that the U.S. was over-reliant on China in its policy toward the North. Christopher Hill's sudden June visit to Pyongyang also made Chinese analysts jumpy. Kim Jong-il's inclusion of "three or four" party language in the text of the Oct. 4 inter-Korean joint statement with South Korean President Roh Moo-hyun attempted to further humiliate and play on Chinese anxieties regarding their future role on the Korean Peninsula.

The ambiguity of the inter-Korean joint statement on this point stimulated a lively debate among Korea watchers about who might be excluded in the case of a "three party"

format. South Korean interlocutors assumed that China would be the odd man out despite the North's longstanding, legally defensible position that as a non-signatory to the Korean armistice there is no role for South Korea in the great-power game of assuring peace on the Korean Peninsula. Informal South Korean explanations that the "three-party" language originated with George Bush and that Kim Jong-il was simply deferring to a U.S. formulation were neither convincing nor helpful in clarifying the issue. As the debate developed, the Chinese Foreign Ministry reasserted its right and intent to be a part of Korean talks as one of four parties and U.S. Deputy Secretary of State John Negroponte in late October reaffirmed U.S. expectations that indeed China would be a part of talks to achieve peace on the Korean Peninsula.

In the kerfluffle over the meaning of the phrase, Roh distanced himself saying, "When I signed it, I didn't pay too much attention to it." But this excuse is as lame as the assertion that the idea for "three party" talks had special meaning as the intended U.S. formulation for such a dialogue format. Roh's statement makes South Korea look naïve, but South Korean knowledge of North Korean gamesmanship would make Seoul complicit, stimulating Chinese distrust of South Korean intentions.

Peace talk formulations aside, South Korean anxieties surrounding China's increasing economic stakes in the North Korean natural resources sector provided a powerful rationale for intensified North-South economic cooperation. The Korean Chamber of Commerce and Industries reported that 70 percent of China's North Korea-bound investment targeted the natural resource sector and that Chinese imports of North Korean minerals in 2006 equaled \$274 million, five times South Korea's total of \$59 million. The strong emphasis in the inter-Korean joint statement on enhanced inter-Korean economic cooperation projects, including the promise of inter-Korean cooperation to develop natural resources, appears to have been motivated in large part by competition with China. This approach is consistent with Kim Jong-il's efforts to play off Chinese and South Korean political interests against each other by encouraging competition between them to be North Korea's main economic backer.

Having observed these latest Korean moves, Hu Jintao took the opportunity to reestablish contact with Kim Jong-il on the pretext of updating him on the latest developments from the 17th Chinese Communist Party (CCP) Party Congress by sending CCP Central Committee Political Bureau member Liu Yunshan to Pyongyang. Liu's visit to North Korea was the first high-level visit by a CCP official in over a year since Hu Jintao had sent Tang Jiaxuan to Pyongyang as a special envoy in October 2006, following the North Korean nuclear test. (Kim Jong-il also welcomed newly appointed PRC Foreign Minister Yang Jiechi in July 2007.) Although the stated purpose of Liu's visit was to describe "in detail" the situation of the 17th CCP Party Congress, the visit provided an opportunity to exchange views with Kim Jong-il about bilateral relations. Liu brought with him a verbal message from Hu, reportedly expressing a willingness to continue to follow the principles of "carry tradition forward, look to the future, be friendly neighbors, step up cooperation" and make greater contributions to regional peace and prosperity. However, the intent of Hu's message is not yet clear. Liu's visit underscored the geographic realities that necessitate continued China-North Korea relations, implying that the relationship could

not be left completely to the Foreign Ministry since it utilized the party-to-party ties that have symbolized China's "special" ties with North Korea.

Roh Moo-hyun's major international initiative following the inter-Korean summit involved efforts to promote a four-way summit meeting among the United States, China, and the two Koreas to announce negotiations to establish a permanent peace regime on the Korean Peninsula. This initiative was on the agenda for Roh's meeting with Premier Wen Jiabao on the sidelines of the ASEAN Plus Three meeting in Singapore in early November. Although Wen confirmed China's willingness to participate in such a meeting – an implicit way of affirming China's involvement in the process – it was also clear that such a proposal would be a non-starter with the Bush administration absent North Korea's clear implementation of its denuclearization commitments under the Feb. 13 agreement.

Denuclearization Update: February 13, October 3, and December 31, 2007

China's central role in the Six-Party Talks also offered grounds for confidence that China's role and interests in promoting a non-nuclear Korean Peninsula would continue to be secure. Despite a tendency by North Korea to elevate bilateral talks with the U.S. as the main vehicle for pursuing a denuclearization-for-normalization grand bargain, the Six-Party Talks remained the formal vehicle through which these agreements were announced and implemented. A series of working-level and high-level Six-Party Talks meetings in August and September produced a limited but concrete series of commitments involving North Korea's disablement of its nuclear facilities and a declaration of its nuclear facilities, materials, and programs.

This series of agreements was announced Oct. 3 in Beijing by Wu Dawei and described as "second-phase actions" to be taken under the Feb. 13 Implementing Agreement. These actions included specific measures under which North Korea would "disable" nuclear facilities at Yongbyon, and "provide a complete and correct declaration of all its nuclear programs" by Dec. 31, 2007, and reaffirmed its commitment "not to transfer nuclear materials, technology, or know-how." In return, the U.S. and Japan pledged their continued willingness to take concrete actions toward diplomatic normalization, including a U.S. willingness to terminate the application of the Trading with the Enemy Act and to remove North Korea from its State Sponsors of Terrorism List "in parallel with the DPRK's actions." In addition, North Korea would continue to receive promised economic and energy assistance.

Although the U.S. took the lead in carrying out technical implementation of North Korea's commitments to "disable" the Yongbyon facilities, the disabling was implemented as part of the Six-Party Talks process. As disablement proceeded, the main focus of the six parties was whether North Korea's declaration would include questions about North Korea's enriched uranium program, the scope of facilities and amount of materials produced by the North, and questions about suspected North Korean nuclear cooperation with Syria. (The latest allegations about North Korean proliferation to Syria and North Korean efforts to import restricted dual-use technologies via Taiwan in recent

months underscore that negotiations must be accompanied by robust export controls and other denial strategies for preventing North Korea from obtaining sensitive materials.)

Following Christopher Hill's second visit to Pyongyang in early December to discuss North Korea's declaration, during which he delivered a letter from President Bush detailing U.S. expectations regarding the declaration, Wu Dawei visited Pyongyang to assess the progress of North Korea's disablement. South Korea's chief representative to the Six-Party Talks, Chun Young-woo, also visited Beijing prior to Wu's visit to Pyongyang to prepare a coordinated message to the North on the expected contents of the declaration. Although Wu visited Yongbyon and confirmed that disablement was proceeding apace, there was no evidence of progress on the declaration, which is a critical hurdle that must be overcome in the course of moving from disablement to denuclearization. It became clear that North Korea would not meet the year-end deadline for presenting its declaration and that there remained significant differences between North Korea and the U.S. over the contents of the declaration.

Industrial Espionage Exposed

South Korea faces no more serious threat to its economic competitiveness than industrial espionage that would rapidly sacrifice the technological advantage of Korean companies over their Chinese counterparts. In this quarter alone, two serious cases have come to light, illustrating both poor Korean corporate defenses against the threat and the temptation and willingness of Chinese companies to steal a march on their competitors. Two employees of Hyundai Motor Company were accused of attempting to share proprietary information regarding Hyundai's automatic transmission technologies for sport utility vehicles such as the Tucson, Sportage, and Santa Fe, and new designs for the latest models of Hyundai's Sonata. In this case, a Swiss company brought in to commercialize the technologies tipped off Hyundai, and the employees in question were arrested.

In a second case, former employees of Korea's largest steelmaker POSCO had left the company to start their own consulting firm, taking with them USB flash drives with over 1,000 computer files and 17 books containing proprietary information regarding the entire process of steel-making. In this case, critical information that would severely erode POSCO's comparative advantage was allegedly passed on to a Chinese counterpart for over \$5 million in promised payments before the case was discovered and the individuals in question were detained. POSCO estimated that the theft could have cost as much as \$3.05 billion in lost sales and price cuts over the next five years.

Telecoms and China financial plays

Korean banks are trying to develop a customer base in China. For most Korean banks, the opportunity to service Korean customers who are already heavily invested in Chinese operations is a niche opportunity. But increasingly Korean banks are pursuing branches in China in an attempt to capture high-end Chinese retail customers who may feel more comfortable using a foreign bank than keeping their money in a local bank. Hana Bank

and Woori Bank are among the Korean banks that sought permission last quarter from Chinese authorities to expand their operations in major Chinese urban centers. These Korean banks have plans to gradually expand their services to major Chinese cities as they grow their retail customer base.

A second way in which individual Koreans have sought to take advantage of the rapidly maturing Chinese financial markets is through investments in Korean-based mutual funds that are investing in the Chinese market. These funds have rapidly grown popular among Korean investors, representing 34 percent of all Korean overseas fund investments according to the Asset Management Association of Korea. However, persistent warnings in October that the overheated Chinese stock markets may be due for a major correction and a downturn in the Shanghai equities market slowed that flow drastically. China-invested mutual funds such as Shinhan BNP Paribas Investment Trust Management's Bonjour China Fund and Mirae Asset's China Solomon Fund continue to draw hundreds of millions of dollars from Korean investors, but the level of investment dropped dramatically in late October.

Third, the Korean Stock Exchange and the KOSDAQ have actively sought to attract Chinese firms to publicly list on the Korean exchange. This is part of Korean efforts to play a more active role as a regional financial center. Although the effort to list Chinese companies has been slow, Chinese companies are beginning to list in South Korea both as an attractive financing option and as an opportunity to expand their knowledge of the Korean financial sector. China's 3NOD Digital Group, a Chinese digital audio company, was the first foreign firm to list on the Korean Stock Exchange in August, and there are predictions that up to 30 more Chinese firms may list on the Korean exchange in 2008.

Chinese institutional investors also began to actively enter Korean capital markets this quarter. Chinese international funds backed by the Shanghai International Trust and Investment Corporation and China International invested in hundreds of millions of dollars in Korean blue-chip stocks in November. South Korea's Financial Supervisory Service reported that investments from China increased to 73.1 billion won in November compared to only 2.5 billion won a year earlier. Korean financial experts expect that the Korean market will be a major beneficiary of the broader global trend of Chinese investments in hedge funds and private equity funds.

Korean telecoms continue to aggressively pursue opportunities in China, but the main focus has moved away from the booming opportunities to sell handsets of several years ago to efforts to link up with Chinese partners in order to jointly develop platforms for more advanced technological offerings. Such a strategy requires close cooperation with government owned and highly regulated Chinese counterparts as a means to capture the inside track for future sales opportunities in the retail handset market. For instance, SK Telecom has worked closely with Chinese partner China Unicom to develop new mobile platforms such as TD-SCDMA, which is designed to support expanded 3G video and internet telecom capabilities. SK Telecom has also promoted news and content development and distribution for the Chinese market through its joint venture with China Unicom called UNISK. Another component of SK's strategy involves the sale of Korean

entertainment products such as pop songs and photos of Korean movie stars to China Mobile.

The Korean gaming sector also has sought to expand into China with mixed results. One hot seller from Hanbit Soft is a multiplayer role-playing game entitled “Granado Espada,” which has over 4 million Chinese subscribers. NC Soft’s once-popular “Lineage” role playing game has lost considerable market share but the company is betting that the release of a new game called “Tabula Rasa” will generate replacement revenues by building popularity in China.

Tougher direct competition crosses borders

As Chinese companies grow more competitive, they aim to gain share in the Korean market. For instance, Chinese steel exports represent over half of all Korean steel imports, and Haier is looking to break into the Korean home appliance and consumer electronics sectors by building service and distribution networks and identifying niche products such as electronic wine cellars as a stepping stone to increased sales of home appliances and LCD TVs. On the other hand, as many as 10 percent of Korean companies in China who responded to a KOTRA survey intend to pull out of China due to increasing labor costs and the end of tax breaks on investment in labor-intensive industries in China.

The Korean exhibition industry is finding itself under greater pressure as a result of rising competition from places like Shanghai and Macao, which have upgraded convention facilities and tourist services and have a “hotter” international reputation. Likewise, the Chinese art market boom has attracted Korean participation at Beijing’s Dashaanzi, where Chinese contemporary artists unknown a decade ago are all the rage in the international art market. Several major Korean galleries have opened in China as part of the trend.

Another form of competition involves attempts by Chinese to immigrate to Korea, often through questionable or illicit means. Over 14,450 Chinese women legally married Korean men, mostly in rural areas, where another rising concern has been exploitation or domestic violence. The number of fake international marriages involving Chinese in Korea has doubled to over 1,653 from 698 in 2004, according to South Korea’s National Police Agency, representing over 10 percent of all marriages in China. Another way of getting to South Korea for many ethnic Koreans in China involves application for education visas and enrollment in schools under false pretenses. Lost or stolen Korean passports can go for up to \$10,000 in China. Finally, the Korean Meteorological Agency issued one of its earliest “yellow dust” alerts in late December, an unwelcome Chinese import to mark the new year.

“Plus Three” ready to stand on its own?

At the ASEAN Plus Three meeting in Singapore, Roh Moo-hyun, Wen Jiabao, and Fukuda Yasuo agreed to meet regularly to promote regional security cooperation,

cooperate to secure the denuclearization of North Korea, and establish a new multilateral security dialogue in Northeast Asia. Following the establishment of a regular dialogue among foreign ministers of the three countries earlier in 2007, the Northeast Asian “Plus Three” leaders seem to be on the verge of delinking top-level meetings in the context of ASEAN-sponsored dialogues.

The Roh-Lee transition and Sino-Korean relations

The election of Lee Myung-bak as South Korea’s new president can shift directions in South Korea’s foreign policy, including relations with China. The day following the election, Lee met with ambassadors from the four major powers and pledged to improve relations with all of Korea’s major neighbors. In his meeting with the Chinese ambassador, he pledged to continue to “upgrade” economic relations with China.

However, the initial focal point for Lee’s foreign policy has been the reconsolidation of the relationships with the U.S. and Japan. In particular, Lee has strongly supported revitalized trilateral coordination with the U.S. and Japan in dealing with North Korea. In addition, Lee’s policy toward the North emphasizes the need for greater reciprocity and will not avoid North Korea’s human-rights performance. While the Chinese Foreign Ministry spokesman welcomed Lee’s election, he stressed the need to honor the principle of noninterference when a journalist asked how China views Lee’s willingness to raise human rights issues with North Korea.

While there is every reason to believe that Sino-South Korean economic relations will remain a foundation for the “comprehensive cooperative partnership” that has been the cornerstone of the relationship, Lee’s initial foreign policy inclinations appear less likely to promote rapid improvement of political and security relations with China. Lee seeks to utilize the U.S.-ROK security alliance to increase South Korean political leverage to promote more effective policies of engagement with China.

Nonetheless, the development of inter-Korean relations, the sensitivity of continued implementation of Six-Party Talks agreements designed to bring about North Korea’s denuclearization, and the question of whether South Korean and Chinese economic policies toward North Korea are defined by competition or cooperation will be influenced by adjustments in South Korean foreign policy under President Lee. It remains to be seen whether other political or “values” issues become greater points of contention. However, it is unlikely that such issues would challenge the economic interdependence and mutual opportunities that have characterized the relationship.

Chronology of China-Korea Relations October-December 2007

Oct. 9, 2007: Chinese Foreign Ministry spokesman Liu Jianchao expresses China’s willingness to join peace talks to replace the military armistice and end the Korean War.

Oct. 10, 2007: The ROK protests China's use of force against South Korean diplomats while arresting North Korean defectors at an international school in Beijing.

Oct. 12, 2007: Two former POSCO employees are arrested for stealing steel processing technologies and selling them to a Chinese competitor.

Oct. 17, 2007: The Seoul Central Prosecutors' Office announces the arrest of six drug traffickers who used Korean ports as a transit point for methamphetamine from China to Japan.

Oct. 26, 2007: The Asset Management Association of Korea reports a dramatic drop of capital inflows into Chinese equity funds from around 400 billion won during the first three weeks of October to less than 100 billion won, reflecting greater caution among Koreans about Chinese equity risks.

Oct. 28, 2007: Air service opens between Seoul's Gimpo and Shanghai's Hongqiao airports.

Oct. 29-30, 2007: CCP Central Committee Publicity Department head Liu Yunshan visits Pyongyang and meets Kim Jong-il to deliver a verbal message from Hu Jintao and to provide information on the 17th CPC Party Congress.

Nov. 7, 2007: Asiana Airlines launches new twice-a-week service from Cheongju, Chungcheong province to Beijing.

Nov. 11, 2007: Woori Bank launches a Chinese subsidiary in an effort to provide retail-banking services in major Chinese cities.

Nov. 15, 2007: Korea's Financial Supervisory Service warns that South Korean local retail investors are overly exposed to China-related equity risks.

Nov. 18, 2007: KOTRA releases results of a survey showing 14 companies, or almost 10 percent of survey respondents among Korean companies operating in China, are seeking opportunities to relocate or return to Korea.

Nov. 20, 2007: Roh Moo-hyun participates in the South Korea-China-Japan summit held on the sidelines of the ASEAN Plus Three meeting in Singapore. Roh also holds bilateral discussions with PRC Premier Wen Jiabao.

Nov. 22, 2007: Korean Chamber of Commerce and Industry releases report criticizing South Korean failure to compete with China in developing natural resources in North Korea.

Nov. 26, 2007: Samsung Electronics Company announces that it will be a sponsor of the 2008 Beijing Paralympic Games.

Dec. 7, 2007: Korea Electric Power Corporation announces the launch of Gemeng International Energy Company, Ltd., a joint venture with Shanxi provinces SIEG and Deutsche Bank to acquire and manage Chinese coal mines, plants, and resources.

Dec. 8, 2007: Dongfeng Yueda Kia Motor Company opens second factory in Yenching, Jiangsu province. The new plant cost \$800 million and has an annual production capacity of 300,000 units.

Dec. 11-12, 2007: Six-Party Talks Economic and Energy Aid Working Group meets in Beijing.

Dec. 12, 2007: SK Telecom announces that its Chinese joint venture UNISK launched a mobile telephone newsletter service in partnership with China's major state-run newspaper, *The People's Daily*.

Dec. 13, 2007: MBC reports that former Hyundai Motor employees were detained on charges of providing proprietary automatic transmission technology to a Chinese company in 2005.

Dec. 17, 2007: The *Korea Times* reports that the Korea Institute of Finance has projected that China is emerging as a "new buying power" in global equity markets. The Financial Supervisory Service reports an almost 30-fold increase in Chinese investments to 73.1 billion won from 2.5 billion won during the past year.

Dec. 17-18, 2007: Six-Party Talks PRC lead negotiator and Vice Minister Wu Dawei visits Pyongyang for discussions on progress in disabling North Korea's Yongbyon facilities.

Dec. 20, 2007: South Korean President-elect Lee Myung-bak receives a congratulatory message from PRC Ambassador Ning Fukui and affirms his willingness to "upgrade" Korea-China economic relations.

Dec. 20, 2007: China and South Korea open military hotlines between their navies and air forces.

Dec. 26, 2007: PRC Ambassador to the DPRK Liu Xiaoming hosts a New Year's reception for leading DPRK government officials including DPRK Supreme People's Assembly Presidium Vice President Yang Hyong-sop.

Dec 27, 2007: South Korea's Hana Bank opens its first subsidiary in China in an attempt to develop a retail network in Northeastern China.