

Despite South Korea's big bet on China's market, the relationship has not always been smooth. It deteriorated when South Korea announced in 2016 its intentions to deploy an American anti-ballistic missile defence system (Terminal High Altitude Area Defence or THAAD), a move that China strongly opposed and which led to its unofficial boycott of South Korea, by restricting imports of products (especially cosmetics), banning Chinese tour groups from South Korea and even cancelling K-pop concerts. An important lesson for Europe is how South Korea managed to end the year-long retaliation while still keeping THAAD on its soil. The strategy was basically that of de-risking, well before the president of the European Commission, Ursula von der Leyen, coined that concept in her speech in March 2023. South Korea decided to reduce its exposure to China by diversifying through nearshoring and to a smaller extent onshoring. Two sectors were key to this de-risking operation: retail and semiconductors. South Korea's largest chain of department stores, the Lotte group, with a significant presence in mainland China, saw most of its stores in China subjected to regulatory suspensions, resulting in plummeting sales. Relations between South Korea and China normalised in late 2017, but even so, Lotte decided to leave China in 2018. With that, China lost an important source of leverage. Lotte expanded in Southeast Asia, the region that has proved to be more resilient than China in terms of consumption, especially since the pandemic started.

When it comes to semiconductors, South Korean chipmakers account for about 20% of global production, with a focus on cutting-edge, upstream segments. Chinese semiconductor firms depend heavily on imported components from South Korea, which have continued to move up the ladder, thereby developing 'chokepoints' if China were to retaliate again.

In 2023, two major changes took place in South Korea's trade relationship with China. First, South Korea's long-standing trade surplus with China turned into a large deficit as exports fell by 20%, partly due to South Korea falling under the US export ban on advanced semiconductors to China and partly due to its excess capacity for legacy semiconductors, a market niche in which China has increased its presence. Second, the US became South Korea's most important trading partner; major conglomerates including Samsung, Hyundai Motor and even Lotte, have continued to increase investments in the US.

If we compare those trade developments with Germany, there is an apparent similarity: the sudden increase in the bilateral trade deficit (in Germany's case in 2022) after a previously balanced position. South Korean imports from China fell by 8% with very limited imports of green tech and plans to step up barriers for environmental reasons (non-recyclable lithium in Chinese batteries for example). Germany, on the other hand, has massively increased imports from China since 2021 with its doors still open to Chinese green tech, from solar panels to, more recently, electric vehicles.

All in all, South Korea's economic relationship with China offers lessons for Europe. First, a very complementary relationship can easily turn into one of competition and rivalry. Second, Chinese retaliation can be addressed through de-risking, defined as diversification through a combination of reshoring and nearshoring, but also by becoming indispensable in certain technologies. Finally, South Korea shows that leadership is needed to guide companies in the right direction.

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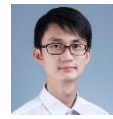
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