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The Economic Impact and Strategic Importance of the Korea-Japan Free Trade Agreement (FTA)

Inkyo Cheong^{*}

Although Japan is a major trading partner of Korea, second only to the US, progress in the discussions of a bilateral FTA between the two countries has been slow. Official government reference to a bilateral FTA dates back to 1998. Economists have analyzed the impact of a Japan-Korea FTA since 1998, and both governments began to study the feasibility of a bilateral FTA between two countries this year.

A Japan-Korea FTA is expected to yield substantial benefits to both countries by liberalizing trade preferentially and strengthening the strategic alliances among the firms of the two countries.

Some of Korean people seem concerned about the negative effects of trade liberalization under an FTA with Japan, placing greater emphasis on the negative rather than the positive aspects. However, this paper emphasizes that Korea's industrial structure will not weaken as many people fear as long as Japan's high NTBs are mitigated, and a substantial amount of foreign direct investment flows into Korea.

A Japan-Korea FTA is regarded to have a strategic importance, in that the FTA can be a starting point for a Northeast Asian FTA and even further on for the East Asian FTA. In other words, they should complete their FTA as a strategic framework of the Northeast Asian FTA in the mid-term and then an East Asian FTA in the long-term.

Although the Korea-Japan FTA is important economically and strategically, there are social, political and historical issues, which should be solved before entering into an FTA. Thus, the two governments should endeavor to ease political and social conflicts. Co-hosting the World Cup games helped improve the relations between the two countries, and both parties should make efforts to enhance favorable environment for the FTA.

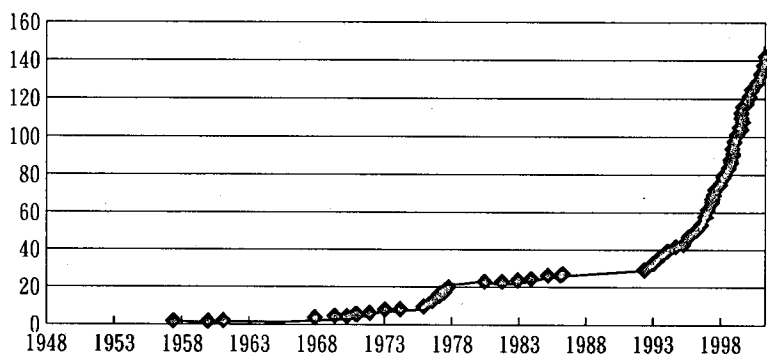
Key Words Free Trade Agreement, Regional Trade Blocs, Trade Liberalization, East Asian FTA

I. Overview of Regional Trade Agreements (RTAs)

The global economy is moving towards regional economic integration. Following the trend of globalization and regionalism, the world economy is rapidly pursuing regional integration to create economically reciprocal relations. In 2002, most countries, except for Korea and China, are members of regional trade agreements (RTAs).

The network of regionalism will continue to expand and deepen while the economic losses to non-members of RTAs will increase over time. Since the mid 1990s, the number of countries who have joined RTAs has surged. Between 1948 and 1989, the number of RTAs reported to GATT was only 29, but in the 1990s 126 RTAs were concluded.

Figure 1. The Trend of RTAs from 1948 to 2001



Note: Only Active RTAs reported in the GATT/WTO.

Source: World Trade Organization (WTO) at www.wto.org

The spread of regionalism is expected to continually grow as a result of a domino effect of RTAs, the loosened multilateral trading system (MLS) against RTAs and the advantages of RTAs.

The domino effect is seen when the proliferation of RTAs forces non-members to join RTAs. In other words, if the number of members increase continually or internal market size become large, the disadvantages to non-members become so substantial that those non-members gradually participate in RTAs.

The loosened MLS against RTAs also contribute to the spread of RTAs. Once a multilateral provision is created, it is difficult to amend later on. This is also true for provisions regarding RTAs under multilateral agreements. The GATT Article XXIV drafted in 1947, was created under the notion that economic integration would occur only under exceptional conditions. But, this article has remained unchanged for 50 years

despite the development of the global economic system and the expansion of RTAs. As the network of RTAs has spread, multilateral trading system has not functioned effectively. During the Uruguay Round, WTO members sought to clarify a number of provisions contained in the GATT Article XXIV. As a result of the debate, the Committee on Regional Trade Agreements (CRTA) was created, but even the CRTA shows difficulties in managing RTAs.

Most RTAs have focused on strategic trading policies to reap economic benefits. In the early 1990s, the emergence of RTAs was once considered a solution to overcome the problems of multilateral trading system and an "insurance policy" to protect against potential failures of the Uruguay Round. However, even after the launch of the WTO in 1995, more than 100 RTAs were concluded. Since many countries who have already participated in RTAs pursue other RTAs to increase economic benefits, RTAs are no longer considered an "insurance policy". Even non-members of RTAs also tend to participate in RTAs to correspond with the trend of regionalism and global economic integration. Especially, the high interest displayed by the US and EU in establishing RTAs shows the significance of RTAs in reality.

Finally, compared to multilateral trading system, FTAs provide numerous benefits to their members. Since an FTA is an exclusive and a preferential agreement for a small number of members, the negotiating time is shorter. Also, as each member exchanges reciprocal preferences to satisfy its member's demands, the operation of an FTA is very efficient and effective. On the flip side, the negotiation procedure of multilateral trading system is very complicated, and the importance of the agreement is not clearly recognized sometimes. For example, under multilateral trading system the negotiation of tariff reduction is based on bound tariff rates so that many of applied tariff rates are not changed. However, under RTAs the negotiation is based on applied tariff rates so that the process of tariff reduction is effectively implemented.

Domino effects, exclusive benefits, the high interest of the US and EU, and the limited ability of multilateral trading system will work to strengthen the expansion of RTAs. Countries, that are non-members of RTAs, will eventually incur substantial economic losses. There are already cases that show discriminative treatment against non-members. For instance, when the Mexico-EU FTA goes into effect, the tariff rate on Mexican exports imposed by the EU will decrease from 20% to 3.3% and will be completely eliminated by 2003, while non-members will continue to pay the original 20%

tariff losing a competitive advantage in price. The members of MERCOSUR that is organized by a group of South American countries, will apply zero tariff rates to their members, however, non-members are still be forced to pay a 14% tariff on average. And in Poland, EU automobile companies enjoy no tariffs on their vehicles under the FTA between Poland and the EU, with non-members paying a 35% tariff rate.

Discriminative treatment in non-tariff barriers (NTBs) is a serious matter in the EU. EU member countries are planning to create one standard on mobile phones, infrastructures, and wireless LAN. This implies that non-members will confront more restricted production standards and miss several exporting opportunities. RTAs will cause non-members to face limited market access and to lose competitiveness. For example, for electronic products, if a company based in any EU country receives approval to sell its electronic products in one EU country, it can also sell them in any other EU countries. However, companies from non-EU countries need to obtain approval from each EU country individually.

II. The Korea-Japan FTA: The First FTA in North East Asia

1. The Economic Impact of the Korea-Japan FTA²

Before explaining the strategic importance of the Korea-Japan FTA, its impact should first be discussed. Table 1 provides a brief summary of the economic impact after tariffs are eliminated and non-tariff barriers are eased. It is expected that the Korea-Japan FTA will offer economic benefits to the Korean economy.

The impact on Korea's GDP will differ, depending on parameters used in simulations. When tariffs are preferentially eliminated and Japan's NTBs are eased, it is projected that Korea may collect welfare gains. When looking at the economies of scale, the Korean economy is estimated to have a higher growth potential than before, with an additional growth rate estimated at 3.9% in the long-term. According to calculations by the GTAP parameter and by the Korean parameter,³ Korea's trade balance will be improved by \$5~\$8.3 billion and by \$6.5~\$9.8 billion respectively. The calculation done by the Korean parameters is larger because it has a relatively less elastic elasticity.

The statistics of Korea's trade balance with the world may vary depending on the

Table 1. Economic Impacts of a Korea-Japan FTA on Korea

(Unit: %, \$100 Millions)

	Study in 2000 (Tariff & FDI)	GTAP Parameter						GTAP+ Korean Parameter					
		Constant Return to Scale			Economy of Scale			Constant Return to Scale			Economy of Scale		
		Short	Mid	Long	Short	Mid	Long	Short	Mid	Long	Short	Mid	Long
GDP	2.81	0.32	1.63	1.10	0.43	2.32	3.91	0.30	1.88	1.42	0.42	2.39	3.58
Welfare	11.24	1.22	2.06	0.75	1.07	2.53	2.89	1.23	2.14	1.58	1.13	2.45	2.78
Equivalent Variations	454.99	4.80	8.10	2.93	4.14	9.76	11.16	4.86	8.43	6.19	4.24	9.18	10.38
Trade Balance with Japan	-41	50	50	64	73	71	83	66	65	76	92	91	98
Trade Balance with the world	4.66	-1.62	-0.59	11.38	-1.55	-0.47	21.77	-1.85	-1.06	7.78	-1.39	-0.15	6.72

Source: Cheong (2001c).

method of analysis. But it is expected to improve in the long-term after slightly worsening initially. A Korea-Japan FTA will eventually improve Korea's trade balance with Japan by \$2.2 billion.

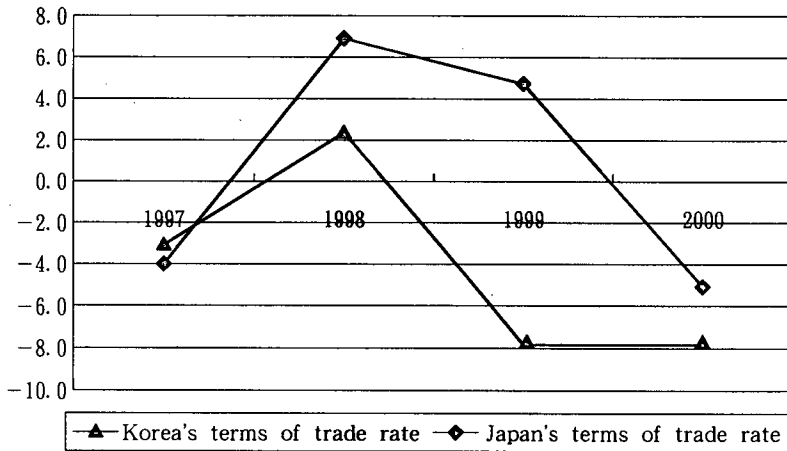
The estimates in Table 1 show a slight difference from those reported in the joint FTA study by Korea and Japan in 2000, although the estimates of GDP growth rate and welfare level show similar results. However, while the previous study concluded that Korea's trade balance with Japan would decline, this study suggested that the balance would improve. These different results could originate from different assumptions used on liberalization coverage, analysis methodology and data used, but the overall analysis in this study are more reliable.

Under a Korea-Japan FTA, improved cooperation among companies in the two countries will bring other benefits as well. Up to now those companies have invested in overlapping industries causing harm to each other. As shown in Figure 2, the terms of trade between the two countries have weakened over time, implying that companies of both countries are competing in the third market. Korea and Japan have tried to eliminate over-lapping investments, but they have not succeeded yet.

A Korea-Japan FTA will remove protective trade barriers in both countries allowing both Korean and Japanese companies to be able to cooperate strategically and survive in a more competitive environment.

An FTA between Korea and Japan is historically significant and important as an accelerator for economic cooperation in Northeast Asia and East Asia including China in the coming decades.

Figure 2. Changes in the Terms of Trade between Korea and Japan



Source : DRI-WEFA, *Country Outlook*, February 2001.

A comprehensive FTA between Korea and Japan including matters of tariffs, non-tariff barriers, trading rules, etc. will bring economic benefits to both countries. In order to secure their preferential benefits and to cope with a growing number of regional trading blocs, Korea and Japan should strengthen economic cooperation through an FTA.

2. The Strategic Importance of the Korea-Japan FTA

Consolidating inter-regional trade is a major trend with recently established RTAs. The FTA under negotiation between the EU and MERCOSUR is a trade agreement linking the regions of Europe and South America. The Free Trade Area of the Americas (FTAA) is another agreement for trade integration between North and South Americas. Moreover, a linkage between AFTA and CER⁴, and trade agreements between the EU and North America and between China and the AFTA are already under discussion. As a result of the growing number of larger RTAs, economic damage to non-members is inevitable.

The growing network of these inter-regional RTAs demonstrates the importance of a Korea-Japan FTA and the need for a larger FTA. Korea and Japan, individually or together, should push forward to initiate other FTAs with North America Free Trade Agreement (NAFTA) and the EU. However, the primary focus should be on FTAs in Northeast Asia and East Asia. The economic integration in Northeast Asia and East Asia is in the midst of discussions, and will emerge as a strategic solution to cope with

the trend of worldwide RTAs.

Northeast Asian countries - Korea, China, and Japan, have been against forming regional trade blocs until the financial crisis hit East Asia. The crisis was a catalyst in those countries to actively participate in regional trade arrangements. Since 1998, Korea and Japan have been negotiating their FTA, and China and Japan have been negotiating or proposing FTAs with Southeast Asian countries. Japan signed an FTA with Singapore in January 2002. Korea has also been negotiating with Chile. In November 1999, when the Presidents of Korea, China, and Japan held a gathering in Manila, they all agreed on the significance of stronger economic cooperation in Northeast Asia.

East Asian countries recognize that their economic structures require regional economic integration to develop further. Growing interests in FTAs show the need to cope with the accelerated network of regionalism. East Asia is considered a critical player for the growth of the global economy. Northeast Asia especially, has the greatest potential to become a hub of the future global economy. Since it has many competitive advantages in resources, technology, and access to huge markets, it is able to manage an independent regional economy and economic cooperation. Economic cooperation in Northeast Asia will result in more favorable trade environment to countries located in the region and to the increased development of the regional market. Cooperation may be comprised of high technology and investments from Japan, production skills and development experiences from Korea, high quality laborers and natural resources from China. In order to facilitate the use of these resources and endowments and to face challenges directly in the global economic system, these countries need to actively consider FTAs among them.

Economic cooperation under an FTA will create substantial welfare gains to countries in East Asia. If each member can leverage the impact of free trade, the economic benefits will be significant. Table 2 shows the estimates of increased exports in three countries after the elimination of tariffs. The increased exports for Korea, Japan, and China are estimated at \$22.7 billion, \$60.6 billion, and \$24 billion, respectively. Thus, \$107.3 billion is the total amount of increased exports for all three countries every year.

If an FTA between Korea, China, and Japan is established, the increased activities of intra-regional trade will force industrial restructuring within each country and improve the quality of goods under a more competitive environment. In addition, these countries can create regional standards for distribution systems and management, and based on

Table 2. Intra-regional Trade Impacts under the Korea, China, and Japan FTA

(Unit: mil. \$)

	Korea	Japan	China	Total
Korea	—	332.00	22,385.67	22,717.67
Japan	8,506.73	—	52,122.21	60,628.94
China	4,664.93	19,310.44	—	23,975.37
Total Increased Exports				107,321.98

Note: increased amounts of exports by country

Source: Cheong (1999),

those standards, they can promote M & A or joint ventures of companies located in this region to compete in the international market. These M & A or ventures initiatives with cultural similarities will focus on specializing in an industry they are participating in and provide more sophisticated and diverse goods in a well-established production system.

If a Northeast Asian FTA is agreed, Korean and Japanese companies will concentrate on providing high technology and investment-oriented products, while Chinese companies, which have lower technology and investment capabilities, will provide labor-oriented products. This approach will strengthen the business competitiveness of Northeast Asian companies and create economies of scale.

The economic integration of Northeast Asia can be an initiative for integrating East Asia, whose market size and economic potential ranks third to North America and the EU. However, the region failed to develop an economic bloc because of several obstacles, such as each country is at different stages of economic development, hegemonic struggles and the absence of regional leaders. In the early 1990s, East Asia initiated the creation of an economic bloc called the East Asia Economic Caucus (EAEC), but due to a lack of internal support and interference of outside countries, the initiative failed. Despite its huge market, it could not find a common strategy to efficiently operate. But, recently the discussion on economic cooperation in this area has re-surfaced. A Northeast Asian economic bloc can be a driving force for the East Asian Free Trade Agreement (EAFTA).

For a Korea-Japan FTA, the significance of an economic cooperation in East Asia should be considered an important factor to guide the direction of their FTA policy. Since 1998, at every ASEAN+3 (Korea, Japan, and China) Summit, the importance of

an economic cooperation has been continually discussed as one of main issues. In November 2001, the East Asia Vision Group (EAVG) presented an EAFTA as a long-term economic cooperation goal at the ASEAN+3 Summit in Brunei Darussalam.

Although East Asia has many economic and political obstacles to overcome, its geographic closeness, economic and market similarities show a great potential for positive outcomes in an FTA for the region. What kinds of benefits can Korea and Japan expect from the EAFTA. If East Asia eliminates tariffs for its member countries, companies in the area will increase exports and enjoy further economies of scale. Moreover, the inflow of foreign direct investments that are targeting big markets will create more jobs and accelerate technology transfers.

If Korea and Japan, under their FTA, establish standards on production technology, product prices, distribution systems, and after-service system, they may lead other East Asian countries to adopt these same standards eventually becoming a major opponent against the standards created by the US and EU⁵.

Furthermore, in the discussion of economic cooperation in Northeast or East Asia, the rapid growth of China should not be neglected. Korea and Japan should plan to strengthen their cooperation with China as well as to benefit with its growth. China is growing rapidly with economic stability and has joined the World Trade Organization (WTO). The size and structure of China's market will greatly improve after hosting the Olympic Game in 2008. East Asian FTA may include a solution that provides an effective strategy to access the Chinese market and that will strengthen economic cooperation with China.

Finally, the EAFTA will contribute to stabilizing internal markets and strengthening international positions for countries located in the area. In other words, through the economic integration of ASEAN and Korea, the economically dominant positions of Japan and China will diminish. In the long-term also, leading North Korea to join the East Asia FTA will reduce tensions on the Korean peninsula.

There are several possible ways to achieve the East Asia FTA. First, each country in East Asia can complete a bilateral FTA with the AFTA, and gradually developing and expanding as a base for the East Asia FTA. However, in this case, since the preferential rules of origin vary by each FTA, it will be difficult to standardize a multiple of FTAs later, under an East Asia FTA. In addition, multiple sub-regional economic blocs will lead each country to compete for a dominant position against the others. For an FTA

between economically strong and weak countries, it may be a position to create a relationship of hub and spoke countries. Thus, economically weak countries may remain spoke countries because of the dominant position of economically strong countries. Thus an FTA will lead weak countries to become subordinate players to strong countries.⁶

Cheong (2002)'s study suggests that countries in Northeast Asia should plan to create a Northeast Asia-wide FTA, rather than to form separate FTAs between pairs of countries, and then aim towards consolidating it with the AFTA. This suggestion will provide optimal approach for maximizing economic benefits.

Thus, Korea and Japan should plan their FTA as a starting point for a Northeast FTA and even further on for the East Asia FTA. In other words, they should complete their FTA as a strategic framework of the Northeast Asia FTA in the mid-term and then an East Asia FTA in the long-term. Considering the political and economic relations of countries in Northeast Asia, Korea and Japan should not neglect the presence of China. China has already announced its willingness to enter an FTA with ASEAN. Korea and Japan, who have similar economic systems, should establish their own FTA first. The FTA should consider China as a potential member in the near future and gradually lead China to join.

Figure 3. A Strategy for an East Asia FTA

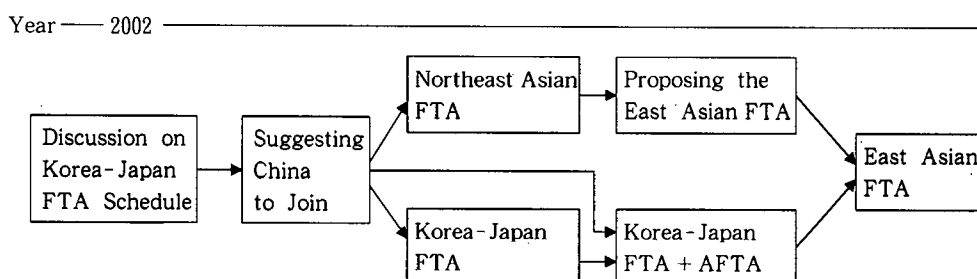


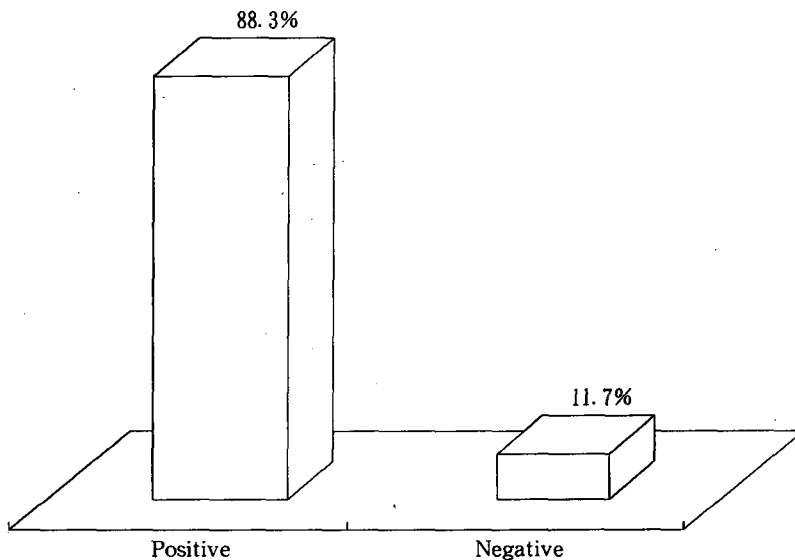
Figure 3 suggests a strategic approach for the East Asian FTA. As discussed above, Korea and Japan should first push forward to complete their bilateral FTA and, at the same time, invite China to join. It will be beneficial to both Korea and Japan to have China as a member of their FTA. However, there are some reasons that China is not ready to join. If Korea and Japan complete their FTA, they should move on to forming another FTA with AFTA and gradually initiate the East Asian FTA. Then, China would seriously consider joining the FTA. With China's participation in the East Asian FTA,

companies in this region will reap tremendous economic benefits. Once Korea and Japan strengthen cooperation in their Korea-Japan FTA policy, they may lead the East Asian FTA and act as the hub countries to link other East Asian countries.

III. The Perception of FTA: the Views of Korean Businesses

In Korea, the significance of FTAs is already recognized; however, some industrial sectors express negative attitudes. According to a study by the Federation of Korea Industries (2001), a majority of Korean companies agreed on a need for FTAs. As seen in Figure 4, 88.3% of respondents mentioned that FTAs should be actively promoted. This shows that many companies view FTAs positively.

Figure 4. The Perception of the Significance of FTAs



The FKI also reported that 6.5% believed that FTAs would have negative effects on the Korean economy, while 59.7% expected long-term positive effects, but short-term negative effects. Thus, 66.2% of respondents anticipated negative effects in the short-term. These results suggest that, despite the positive view of FTAs, there are still many barriers promoting FTAs in Korea.

According to respondents, the US and China are seen as the most favorable countries for FTAs for Korea, at 36.8% and 29.3% respectively. Ironically, the Korean government has not considered nor approached these two countries due to the many

Figure 5. The Economic Impact of FTAs on the Korean Economy

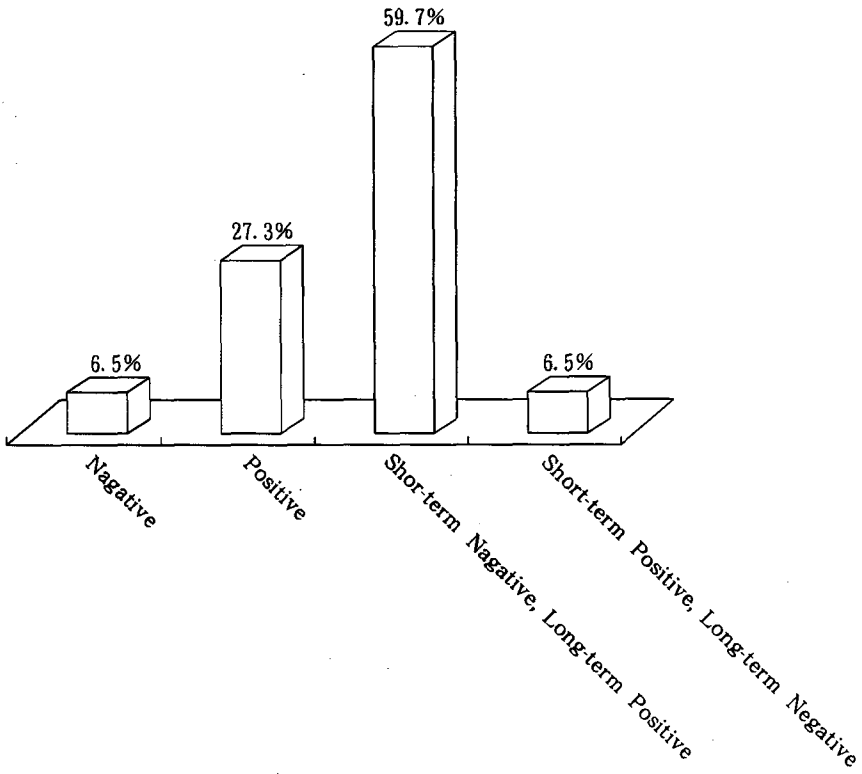
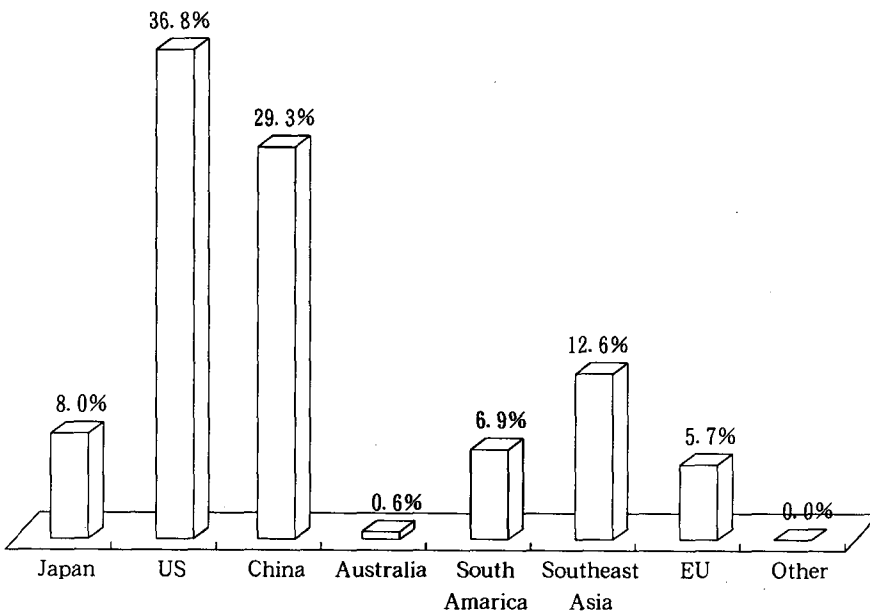


Figure 6. Favored FTA Candidates for Korea



possible obstacles they would bring to FTA discussions and negotiations. Instead, the Korean government has been actively pursuing a partnership with South America and Japan, which were cited at 6.9% and 8.0%, respectively.

This study demonstrates that many companies do not have a clear understanding of FTAs. It may be due to a problem with the design of the survey questionnaires, but there seems to be a prevailing misunderstanding regarding the purpose and direction of FTAs, including a Korea-Japan FTA.

There are some issues that have been raised by companies, media, and academics about a Korea-Japan FTA. First, when tariffs are eliminated under an FTA, the enormous inflow of Japanese products to Korea may threaten many Korean industries. Many people argue that Japan's average tariff rates are already low at 2~3%, while Korea still charges 7~8% and that Korean companies are less competitive than Japanese counterparts. This may pose a threat, although the possibility is relatively low. Second, many people believe that FTAs may force immediate free trade on every product. In general, complete free trade will not be phased in for 10 years after the FTA is first signed. Table 3 summarizes the tariff reduction schedule under the Chile-Canada FTA. In sensitive industries such as polyethylene, clothing, shoes, etc., tariffs will be phased out over 7 years. For the most sensitive items such as poultry, cheese, and butter, etc., tariffs will not be changed at all. With a Korean-Japan FTA, given the tariff struc-

Table 3. Tariff Reduction Schedule under the Chile and Canada FTA

Period (yrs)	The Number of Items (by 8 HS)	Main Items
Now	6,824	Several agricultural products (HS 13, 14, 24), iron & steel, electrical machinery, vehicles, transport equipment (HS 28, 30~38, 41~50, 65~98), etc.
3	52	Snowboard, boots, etc.
5	572	Cotton, man-made filaments, man-made staple fibers, special woven fabrics, etc
6	85	Polyethylene, plastic tube, pipes, other plastic and articles thereof, other plates, sheets, and film, etc.,
7	567	Clothing, footwear for golf, hiking, climbing, skating, etc., waterproof-shoes, cherry, strawberry, vegetable fats, prepared tomatoes, etc.
Exceptions	96	Poultry, turkey, cheeses, butter, etc.

Note: based on the Chile and Canada Free Trade Agreement

Table 4. Price Differences Between Inside and Outside Japan

	Price Differences							
	US	Germany	Korea	Taiwan	Hong Kong	Singapore	China	Average
Manufacturing Industry	1.03	1.35	1.91	1.56	2.04	1.92	2.49	1.76
Material Industries	0.96	1.57	1.67	1.52	1.78	1.40	1.96	1.55
Textiles	1.05	0.89	1.22	1.29	1.43	3.02	1.84	1.53
Wood & Articles of Wood	0.74	—	0.63	2.50	1.56	1.43	1.61	1.41
Pulp	0.99	1.97	2.61	2.16	1.39	1.90	1.58	1.80
Chemicals	1.12	1.60	1.27	1.53	2.64	1.06	1.99	1.60
Ceramics & Cements	0.91	2.27	2.64	1.64	1.86	1.50	2.27	1.87
Iron & Steel	0.91	1.01	1.22	1.18	1.46	1.14	1.17	1.16
Base Metals	1.00	1.50	1.47	1.19	1.69	1.34	1.34	1.36
Metals	0.52	1.09	1.68	1.62	1.72	1.58	2.54	1.54
Mineral Products	1.80	5.81	3.84	2.16	4.15	2.20	7.46	3.92
Scrap Iron	0.89	1.09	0.73	0.69	0.97	0.56	0.81	0.82
Processing & Construction Industries	0.89	1.18	2.47	1.69	2.82	1.27	3.45	1.97
Machinery	1.15	1.43	3.03	1.71	5.03	1.65	4.50	2.64
Electrical Machinery	0.62	1.16	1.50	1.37	1.62	1.14	1.72	1.30
Transport Equipment	1.13	0.68	1.61	2.47	2.29	0.97	4.01	1.88
Precision Instruments	1.33	1.10	9.06	—	3.75	1.78	—	3.40
Other Industrial Products	0.84	1.03	1.56	1.93	0.96	—	3.27	1.60
Energy	1.53	1.24	1.78	1.50	1.03	3.77	3.00	1.98
Oil & Coal	1.79	0.89	0.85	1.42	0.98	5.40	2.76	2.01
Electricity & Gas	1.16	1.69	1.69	1.60	1.10	1.73	3.34	1.90
Electricity	1.11	1.77	1.77	1.76	1.29	2.11	3.43	2.07
Gas	1.36	1.38	1.38	1.03	0.42	0.42	3.01	1.26

Notes: 1) —means not available;

2) Since Germany and Hong Kong is using different classifications, they are not included.

Source: Japan's Ministry of Economy, Trade and Industry (2000)

ture and industrial development of two countries, tariff reduction would be exercised in Japan first. Since it is difficult to eliminate tariffs on sensitive items, the short-term negative economic effects will not be as significant as many people dread.

If a Korea-Japan FTA could loosen NTBs, Korean companies will be able to increase the amount of exports to Japan. Last year a study reported by Japan's Ministry of Economy, Trade and Industry indirectly shows the existence of non-tariff barriers in

Japan. Table 4 shows price differences by industry inside and outside Japan. It seems that some of these differences have been generated due to the non-tariff barriers existing in Japan. According to a study by Cheong (2001c), even if some of these non-tariff barriers are eased, its expected effect can potentially exceed that of tariff elimination.

In order to participate in the globalization trend, Korea should use multilateral and bilateral or regional approaches at the same time. It should actively participate in multilateral trade liberalization, while promoting FTAs with major trading partners. Since the 1990s, FTAs have broadly covered wide issues of trading rules, investments, services, and new trade provisions. Thus, they will play a critical role in improving Korea's economic system and commercial practices. In addition, developing countries such as Chile, Mexico, etc. highly evaluate the lock-in effects in economic reforms through FTAs, implying efficient control of domestic resistance to economic reform. For example, after joining the NAFTA in 1993, Mexico could succeed in persuading anti-reformers that, in order to receive preferential treatments from the US, it should exercise NAFTA provisions within its domestic economic system.

IV. Policy Implications

A Korea-Japan FTA should be a base for an economic integration in Northeast Asia. Given the economic structure of East Asia, it will be difficult to form an East Asian FTA if Korea and Japan do not succeed in creating their FTA. Thus, the most realistic approach would be to consolidate the FTA and AFTA after the Korea-Japan FTA is established.

Governments of both Korea and Japan should focus on educating the public about their bilateral FTA in terms of the economic benefits, strategic importance, obstacles to operation, and solutions to such obstacles. They should also investigate any possible policy directions and implementing strategies to provide the optimal roadmap for the bilateral FTA.

Although a Korea-Japan FTA is important economically and strategically, there are social, political and historical issues, which should be solved before entering into an FTA. Many people express concerns that these different views can be a serious hindrance to the FTA. The recent debates on the Japanese history textbooks and the Yasukuni Jinja worship by the Japanese Prime Minister have worsened the bilateral relationship between two countries. These political and social issues will be a large

influence when the two countries discuss a comprehensive framework of economic cooperation. Thus, the two governments should endeavor to ease political and social conflicts. Co-hosting the 2002 World Cup games helped improve the relations between the two countries, and both parties should make efforts to enhance favorable environment for the FTA.

On the other hand, these conflicts can be also a factor in stressing the importance of strengthening economic cooperation. For example, the primary initiative of the EU was to prevent wars between Germany and France through strengthening economic cooperation. Thus, for better relations between Korea and Japan or even among Northeast Asian countries, strengthened economic cooperation under FTAs may be an elementary factor to reducing political and social conflicts in the future.

At the bilateral summit between Korea and Japan March 2002, both parties agreed to launch a joint study group for the FTA, with the participation of the government, in addition to academics and business circles of Korea and Japan. The study group will explore how to achieve the FTA.

Notes

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The views expressed in this paper are the author's and do not necessarily reflect those of KIEP.

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1 See Bhagwati (1993) for detailed discussions.

2 Based on Cheong (2001c).

3 Computational general equilibrium (CGE) model needs parameters on the behavior of economic agents. See Dimaranan, et al (2002) on the GTAP parameters, Cheong (2001c) on the Korean parameters.

4 Closer Economic Relations (CER) is the FTA between Australia and New Zealand.

5 This point was suggested in Igawa and Kim (2001).

6 According to Wonnacott (1996a,b), spoke countries in FTAs may have more disadvantages than hub countries, however, maintaining a hub country position for multiple FTAs does not provide benefits all the time. In other words, the total benefit, as a hub country, under multiple FTAs may be lower than that of consolidated small hub-and-spoke FTAs. This result is due to the inefficiency created by overlapping FTAs.

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