

# **Korea's FTA Policy: Focusing on Bilateral FTAs with Chile and Japan**

September, 2002

Inkyo Cheong

(Research Fellow, KIEP)

# **Contents**

## **Summary**

- I. Introduction**
- II. Background of Korea's FTA Policy**
- III. Current Progress of Korea's FTAs**
  - 1. Korea-Chile FTA**
  - 2. Korea-Japan FTA**
  - 3. FTAs with Other Nations**
- IV. A Korea-Chile FTA: Korea's First FTA?**
- V. Expected Effects of a Korea-Japan FTA**
- VI. Conclusion**

## **Appendix: Economic Impact of a Korea-Japan FTA**

## **References**

## **Summary**

A free trade agreement (FTA) eliminates tariffs and alleviates non-tariff barriers (NTBs), stimulating trade for member nations while limiting imports from non-member nations at the same time. In an effort to avoid the negative effects of exclusion from such agreements, to maintain economic reform and an open policy, and to actively cope with proliferating regionalism, the Korean government has decided to pursue FTAs with other nations. Forming FTAs will enable Korea to create political allies, attract foreign investment, and establish overseas footholds, as well as allow Korean companies to secure foreign export markets and overcome discriminatory practices under other FTAs.

This paper is aimed at providing an overview of Korea's FTA policy and progress of Korea's bilateral FTAs with Chile and Japan. This paper tries to present a comprehensive and organized view on Korea's FTA policy, not just a translation from Korean to English. It also provides a summary of recent developments in Korea's FTA policy. This paper counters those who criticize Korea's pursuit of an FTA with Chile as hasty and impulsive, showing that considerable research and discussions were behind the government decision to choose Chile as its first FTA partner. Regarding a Korea-Japan FTA, the author emphasizes that, despite many obstacles, a Korea-Japan FTA is strategically significant and offers various economic benefits, by strengthening the strategic alliances among the firms of the two countries.

Korea is in the process of FTA negotiations with Chile, and should expedite these negotiations to provide a feasible FTA environment internally and externally.

Furthermore, it should endeavor to seek a model FTA that provides a basis for negotiations to facilitate future FTAs. In the meanwhile, Korea should hasten to conclude the FTA negotiations with Chile to lay the foundation for future FTAs. Since Korea lags far behind other countries in concluding FTAs, it should hasten to conclude FTAs with major trading countries. Rather than waiting to complete an FTA with one country before deciding on the next FTA partner, Korea should simultaneously promote FTAs with multiple countries. Finally, it can be pointed out that Korea should enhance its capacity to implement its FTA policy by improving public awareness of the potential benefits of preferential FTAs.

## **I. Introduction**

Though Korea achieved economic growth through an export-oriented growth policy, its reaction to a widening spread of regional trading blocs has been lukewarm due to domestic opposition to a market opening under regional trade agreements (RTAs). However, since the financial crisis began, the Korean government has been reevaluating the potential gains to be made by removing trade barriers on a preferential basis, and has decided to pursue the establishment of preferential trading blocs.

A free trade agreement (FTA)<sup>1</sup> eliminates tariffs and alleviates non-tariff barriers

---

<sup>1</sup> RTAs can include all forms of preferential trading agreements, such as FTAs, customs unions, economic unions, etc. An FTA is the simplest form of RTA, in that it specifies tariff elimination among the member economies without introducing common external tariffs.

(NTBs), stimulating trade for member nations while limiting imports from non-member nations at the same time. In an effort to avoid the negative effects of exclusion from such agreements, to maintain economic reform and an open policy, and to actively cope with proliferating regionalism, the Korean government has decided to pursue FTAs with other nations. Forming FTAs will enable Korea to create political allies, attract foreign investment, and establish overseas footholds, as well as allow Korean companies to secure foreign export markets and overcome discriminatory practices under other FTAs.

This paper is aimed at providing an overview of Korea's FTA policy and progress of Korea's bilateral FTAs with Chile and Japan. While various types of reports on the issue have been published in Korean, there is little information available in English. Major parts of this paper are taken from the author's books on Korea's FTA policy, which were written in Korean. Some of sources are Cheong (2001a, 2001b) and Cheong and Lee (2000). This paper tries to present a comprehensive and organized view on Korea's FTA policy, not just a translation from Korean to English. It also provides a summary of recent developments in Korea's FTA policy.

Following the introduction, Chapter II examines the background of Korea's FTA policy, and Chapter III describes the FTAs that Korea is currently considering. In Chapter IV, this paper counters those who criticize Korea's pursuit of an FTA with Chile as hasty and impulsive, showing that considerable research and discussions were behind the government decision to choose Chile as its first FTA partner. Chapter V discusses expected effects of a Korea-Japan FTA, emphasizing that, despite many obstacles, a Korea-Japan FTA is strategically significant and offers various economic benefits. A

summary of an existing study on the economic effects of a Korea-Japan FTA is provided in the appendix for readers' reference. A conclusion is provided in Chapter VI, suggesting that the Korean government take a more active role in pursuing FTAs.

## **II. Background of Korea's FTA Policy**

One major reason for Korea's new thinking on regionalism is the trade diversion caused by the growth of RTAs. A WTO (1995) report discusses the causes of the rapid increase in the number of RTAs in the early 1990s. The report concluded that there was a growing trend of using regionalism as an insurance policy in the event of the failure of the Uruguay Round negotiations. An implication of that conclusion is that regional integration initiatives would be weakened as the multilateral trading system became firmly established. Yet following the inauguration of the WTO, regional trading blocs have continued to expand both in number and in scope.

Regionalism is one of the most dominant trends in the world economy today. There were only 26 new RTAs reported to GATT prior to 1969.<sup>3</sup> Following a weakening in the pace of regional integration in the 1980s, the number of RTAs exploded in the 1990s. Thirty-five additional RTAs were signed during the two years of 1995 and 1996, and 17 such agreements were concluded in 1997 and 1998. This demonstrates that major trading countries view regionalism as a viable commercial strategy that complements multilateral trade agreements rather than simply a type of insurance policy taken against the potential shortcomings of multilateral trade liberalization.

In line with this increasing trend towards regional integration and to minimize the losses from it, Korea has altered its past position of opposing RTAs and is now cautiously

---

<sup>3</sup> The arrangement of preferential trading blocs must be reported to the GATT/WTO according to GATT

investigating the possibility of establishing FTAs with major trading countries. Korea's decision to pursue FTAs was motivated not only by a fear of exclusion from the recent trend of growing regionalism, but also by the outbreak of the Asian financial crisis. Korea has opened most of its financial sectors to foreign investors and has implemented unilateral trade liberalization measures, while overcoming the Asian financial crisis.

Korea's new trade policy is aimed at promptly adapting to the changing economic environment, as well as resolving the nation's economic difficulties. Consequently, an ultimate goal of this policy is to transform Korea into an "open trading country," which makes a meaningful contribution to opening up the world economy at the international level. At the national level, the government remains committed to opening its market through a parallel development of democracy and a market economy.

In addition, it is recognized that the supplier-oriented trade policy of the past must be changed into a consumer-oriented policy, which maximizes the convenience and benefits to the general public. In terms of cost-efficiency, the public's well-being is better served when the majority of consumers can be supplied with low-cost, high-quality goods rather than defending the interests of a minority of domestic producers. Therefore, the government must perform the role of opening up the domestic market, so that consumers can enjoy an abundance of low-cost, high-quality goods and services.

While Korean companies have maintained a production system based on their comparative advantage in manufacturing technology, companies in other countries have

---

XXIV, GATS V, and the Enabling Clause.



made Korean products less competitive - through advanced technology in the case of developed countries, and low-wage price competitiveness in the case of developing countries.<sup>5</sup> FTAs can improve Korea's production structure and strengthen its exporting capabilities by enabling Korean companies to adopt advanced technology from foreign companies to integrate with Korea's production and marketing skills.

As part of its liberalization measures, the Korean government abolished the import diversification program (IDP) in the end of June 1999. The IDP, introduced in early 1978, was a system of restricting imports from specific countries (targeting Japan) with which Korea was experiencing a serious trade deficit. The abolishment of the IDP can be regarded as one of Korea's most dramatic liberalization measures. Most Koreans have viewed this liberalization as beneficial, and there is a growing perception that the establishment of FTAs with major trading partners will bring greater welfare gains. Moreover, Korea has recognized the importance of stable export markets; it is thought that the current account deficit that preceded the financial crisis was the major cause of the loss of international confidence in the Korean economy that followed.

Another important background factor for the current trend towards regionalism can be found in trade policymakers' recognition of the need to upgrade Korea's economic system to meet international standards. The Korean government, with its policy goal of building an "open trading country," is firmly committed to maintaining friendly trade

---

<sup>5</sup> Booz, Allen and Hamilton (1997) warned that Korea could be trapped in a "nutcracker"—being caught between China's low costs and Japan's technical excellence. It states that "Korea is too small to compete directly with either Japan or China over the long-term in its core industries," and thus, it suggests that Korea must leverage to the maximum extent possible the business and technical knowledge of the rest of the world.

relations with its trading partners, while also promoting strategic alliances in the form of FTAs and bilateral investment treaties (BITs).<sup>4</sup> Through such agreements, Korea seeks to establish alliances with its trading partners in order to secure its foothold in strategic regions and to upgrade its national competitiveness.

Though Korea has employed a relatively passive trade policy in the past, in the coming era of fierce competition, Korea must be equipped with a more active and assertive trade policy in order to lay the foundation for national prosperity in the 21<sup>st</sup> century. Also, it is important to maintain friendly relations with trading partners, and to secure a stable export performance based on competitive domestic industries. In addition, Korea must attract additional foreign investment, not only for financial purposes but also for acquiring the advanced technology of foreign companies.

The establishment of FTAs helps to attract foreign investment and establish overseas footholds. The expansion of the domestic market through FTAs with major trading partners may give rise to new investment demand by parties interested in using Korea as a production base. The ability to attract foreign investment depends on the size of the domestic market as well as a favorable investment environment; if Korea establishes FTAs, foreign companies interested in exporting products to countries affiliated with Korea will invest in Korea to avoid tariffs.

In the process of overcoming the financial crisis, the Korean government realized that economic reform and an open policy can greatly influence foreign credit ratings and that

---

<sup>4</sup> Korea signed the BIT agreement with Japan in March 2002, and is now negotiating a BIT with the US.

continuous efforts are necessary for Korea to fully recover and play a pivotal role in the world economy. Although FTAs had long been considered elements of a closed trade policy that offered exclusive benefits to members, recently FTAs have come to be widely seen as channels for an open trade policy. Multilateral trading organizations such as the WTO and OECD now evaluate FTAs as having a positive influence on world trade liberalization, and this fact has played a part in the Korean government's decision to promote FTAs.

On the other hand, the need for measures to cope with the expansion of FTAs has also increased. In the past, Korea supported the superiority of the WTO multilateral trade system; adhering to its standpoint that regionalism should conform to a larger world trade system. At the first WTO Ministerial Conference in 1996, Korea pointed out the negative effects of regionalism and demanded tighter regulations against the expansion of regionalism. However, even after the launch of the WTO, RTAs continued to spread and currently nearly all countries with the exception of Korea, China, and Taiwan are members of various RTAs. Members of RTAs rationalize their positions by asserting that further liberalization through regional trade agreements greatly contributes to a multilateral trade system, resulting in the creation of new trade opportunities. Thus, although various means of coping with the spread of regional trade agreements exist, the promotion of free trade itself, following the examples of other nations should be considered.

The new international order has shifted its emphasis from security and military-based power to economic power. The strong tendency to establish regional blocs through

economic integration is being witnessed within and across all the continents. Regional integration has offered countries a way to resolve issues that would be more difficult to resolve in the wider multilateral context. To take an example, for the European Community, greater trade and economic integration was seen, above all, as a way of welding Europe's political future and making another continental war unthinkable. Also in the case of NAFTA, the degree of economic integration called for a deeper and more comprehensive regime of rules than could be achieved in the larger multilateral system.

Finally, Korea's pursuit of FTAs with major trading countries does not mean that it is necessarily downplaying the role or significance of the multilateral trade system. Rather it means that Korea is pursuing regional economic cooperation within the framework of the WTO, in line with the growing presence of other regional groups including the EU, NAFTA, and AFTA. The Korean government is also actively participating in the process of creating a new free trade framework such as the WTO New Round to counter the threat of emerging protectionism. Therefore, it plans to sign FTAs with its trade partners, starting with Chile. Korea and Chile reached an agreement on the basic principles of an FTA during the APEC summit meeting in November 1998. Currently, the FTA is under negotiations.

### **III. Current Progress of Korea's FTAs**

#### **1. Korea-Chile FTA**

The basic direction of Korea's FTA policy was decided in a meeting of the Committee on International Economic Policy in November 1998. An FTA with Chile, currently under negotiations, would have priority and then sequential FTAs with similar small and medium-sized countries would be pursued after discussions with related government agencies and conducting studies on potential merits. Additional FTAs with major economies such as the US, Japan, and China would be decided upon after detailed in-depth analyses.

Korea and Chile agreed to begin official negotiations for a bilateral FTA in the Korea-Chile summit meeting held during the APEC Leaders' Meeting in Auckland in September 1999. Four rounds of negotiations were held in 1999 and 2000, but a fifth round is being delayed due to differences on concessions in the agricultural sector and Chile's tight schedule for negotiating FTAs with the EU, US and EFTA. While proceeding with the FTA negotiation with Korea, Chile simultaneously negotiated FTAs with EU, the U.S., and EFTA. Chile especially focused on the negotiation with the EU and concluded the Chile-EU FTA in May 2002. For this reason, at an LA meeting last February, Chile proposed that its negotiations with Korea be resumed in the second half of 2002.<sup>5</sup>

---

<sup>5</sup> Delegates of Korea and Chile met in Los Angeles in February 2002 to discuss the future negotiation

An agreement was reached at the bilateral summit meeting in Brunei in November 2000 to conclude negotiations as quickly as possible. Efforts to converge bilateral differences on agricultural concessions continued throughout 2001, with both countries airing their positions in a meeting between trade ministers in Santiago and agreeing to hold working meetings in the near future.

Positions are sharply divided on the issue of concessions in the agricultural sector, mainly regarding the number of commodities for which tariffs will not be eliminated within 10 years. Korea is demanding a flexible approach for highly sensitive items, while Chile wants all agricultural products to be liberalized within 10 years after the conclusion of the FTA.<sup>6</sup> While an agreement was reached on areas of mutual exemption regarding anti-dumping measures, customs procedures, telecommunications, competition policy, and dispute settlement, further negotiations on investment, product standards, rules of origin, and safeguards are necessary.

## **2. Korea-Japan FTA**

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. Anti-Japanese sentiments rising from historical antagonism, along with such thorny political, economic, and social issues such as Korea's demand for a formal Japanese apology for

---

schedules, including the fifth round negotiation, which will be held in August 2002.

<sup>6</sup> Although Chile maintains a position of complete liberalization, the country designated a substantial number of items (wheat flour, sugar, oil seed, etc.) to be excluded from the liberalization scheme.

past misdeeds, distortions in Japanese history textbooks, territorial disputes over Tokdo Island, and the issue of compensation for comfort women have aggravated fears over the bilateral FTA. In addition to these issues, Koreans are concerned about the possibility of economic subordination and growing trade deficit with Japan.

Official government reference to a bilateral FTA dates back to 1998. At a monthly meeting of the Federation of Korean Industries on September 16, 1998, then Japanese ambassador to Korea, Ogura Kazuo, mentioned the need for a joint study on a Korea-Japan FTA in an address entitled “Korea-Japan Cooperation in the 21<sup>st</sup> Century.” He also indicated the need to establish international regulations on anti-dumping and the opening of the rice market in order to cope with spreading globalization, as well as the need for expanded bilateral corporate alliances based on bilateral free trade. This was Japan’s first official remark on the need to pursue an FTA between the two countries.<sup>7</sup> Although it is not clear whether ambassador Ogura consulted with the government of Japan about the bilateral FTA proposal, the Ministry of International Trade and Industry (MITI), which was responsible for foreign trade in 1998, was evaluating the merits of FTAs.<sup>8</sup>

The official government proposal for a joint study on a Korea-Japan FTA was made during Korean president Kim Dae-jung’s state visit to Japan in October 1998. The Korean and Japanese governments appointed the Korea Institute for International

---

<sup>7</sup> Discussions in the private sector for a Korea-Japan FTA were also underway. At a Korea-Japan meeting in Tokyo on October 29, 1998, participants agreed to conduct studies on a bilateral FTA and a free trade agreement consisting of the three Northeast Asian countries of China, Japan and Korea.

<sup>8</sup> See Ojita (2002) on Japan’s approach to regionalism. The author states that “the end of ‘multilateralism supremacy’ – supreme advocacy for Japan’s trade policy of multilateral trade liberalization – began in late 1998.”

Economic Policy (KIEP) and the Institute for Developing Economies (IDE) affiliated with the Japan External Trade Organization (JETRO) as joint research institutions. During his visit to Korea in March 1999, Japanese Prime Minister Obuchi Keizo expressed his desire for strengthening bilateral relations beyond the scope of existing economic cooperation. Based on the results of a joint study, KIEP and IDE hosted the first symposium on a Korea-Japan FTA in Seoul in May 2000 (the second was conducted in Tokyo in September 2000).<sup>9</sup>

Korea's research concentrated on estimating the economic effects and devising measures to compensate for the resulting losses. The study outlined possible losses for Korea from the bilateral elimination of tariffs between the two countries. However, the report underlined that the Korea-Japan FTA could benefit Korea if Japan's non-tariff barriers are reduced and there are inflows of foreign direct investment.

The IDE Report emphasized the need to promote the FTA since it would benefit both countries (especially Korea). It concentrated on qualitative rather than quantitative analysis, and broached the possible problem of Japan's FTA partners expanding exports due to the gap in domestic and foreign prices.

During his September 2000 visit to Japan, President Kim proposed a Korea-Japan Business Forum (KJBF) to exchange views with the private sector, and proposed speedy negotiations for a BIT and expanded cooperation in the IT sector. Upon agreement, both countries set up a KJBF in the first half of 2001 and hosted the meetings in Seoul in

---

<sup>9</sup> The reports by KIEP and IDE can be found in KIEP-IDE (2000).



September 2001 and in Tokyo in January 2002. In-depth consultations covered such comprehensive issues as the effects of a bilateral FTA on both countries' industries and ways of fostering an appropriate environment for a bilateral FTA. The January 2002 forum adopted a joint statement saying that governments of both countries should hasten to conclude a bilateral FTA.

The main contents of the joint statement are as follows: the bilateral FTA will enhance the international competitiveness of firms in both countries; the FTA should conform to multilateral trade rules and give special consideration to sensitive sectors; a Korea-Japan FTA should be viewed within the context of an East Asian FTA; both governments should initiate negotiations for an early conclusion of the FTA; the cooperative atmosphere from the co-hosting of the World Cup should be reinforced and cooperation between private industries and the governments should also be strengthened.

Korea's President Kim and Prime Minister Koizumi of Japan held summit talks in March 2002 in Seoul, and agreed to continue probing the possibility of concluding an FTA through the introduction of a Korea-Japan joint study group including government officials, industry representatives and academics. The group held its first meeting in Seoul July 2002.

### **3. FTAs with Other Nations**

Korea is also currently studying possible FTAs with New Zealand and Thailand. At a meeting of trade ministers on November 14, 1998, Korea and Thailand agreed to initiate

a joint study on the feasibility of an FTA that would facilitate bilateral trade and investment. An agreement on a joint study was reached at the 11<sup>th</sup> Korea-Thailand Trade Commission Meeting in November 1999, with both governments designating the research institutions to conduct the study (Korea: KIEP, Thailand: Department of Business Economics under the Ministry of Commerce and Chulalongkorn National University). The joint study was conducted from November 1999 to March 2001, and the institutions subsequently exchanged their findings, which showed that positive effects would result from an FTA between the two countries.

During her state visit to Korea in July 1999, New Zealand's Prime Minister Jennifer Shipley suggested pushing forward with discussions on a Korea-New Zealand FTA. The two heads of state agreed to conduct a joint study on strengthening bilateral economic cooperation during President Kim's visit to New Zealand two months later. The designated research institutions in both countries (Korea: KIEP, New Zealand: New Zealand Institute for Economic Research (NZIER)) proceeded with the study. The two governments agreed to continue discussions on a bilateral FTA during Prime Minister Clark's visit to Korea in May, and a review meeting on the findings of the joint study was held in New Zealand in August 2001.

Although official discussions on a Korea-Singapore FTA have not yet taken place, the Singapore government has expressed an interest in concluding such an agreement. Michael Teo, Singapore's ambassador to Korea, sent a letter to Korea's Ministry of Foreign Affairs and Trade in 1999 expressing Singapore's desire to hold discussions on an FTA. At a summit meeting held during the APEC Leaders' Meeting in Auckland in

September 1999, Prime Minister Goh Chok Tong of Singapore proposed a bilateral FTA to President Kim, a proposal that Singapore's Senior Minister Lee Kuan Yew reiterated in October of the same year. At that time, Korea maintained the position that an FTA with Chile held higher priority and did not actively review Singapore's proposal.

#### **IV. A Korea-Chile FTA: Korea's First FTA?**

The successful conclusion of the first FTA will be especially important to Korea, and other potential FTAs will heavily depend on the first model. Prior to launching its long-term goal of establishing FTAs with larger trade partners such as the US, Japan, China and the ASEAN Free Trade Area (AFTA), Korea needs to pursue FTAs with smaller partners in the short term. The experience will help the government to minimize risks and possible losses, as well as to be better prepared for the operation and negotiation of FTAs. Korea chose Chile as its first FTA partner because of its high complementarity to Korea in terms of trade structure as well as for the potential learning effects from Chile's plentiful experience in regional trading agreements.

Specifically, Chile was considered to be the most appropriate partner for the following reasons. First, Chile's industrial structure, mainly concentrated on primary goods such as copper, wood and agricultural products, is highly complementary to Korea's industrial structure consisting of manufactured goods such as automobiles and electronics. Korea has few natural resources but has a large and well-trained workforce and well-developed technology. Chile is blessed with an abundance of natural resources and a strong agricultural base in fruits such as grapes and apples. Hence, the two economies, being dependent on different industries, can mutually benefit through strengthened economic cooperation. Moreover, because Chile is a small economy, the adjustment costs for Korea stemming from the FTA are expected to be lower. This economic consideration increases the feasibility of a Korea-Chile FTA.

Cheong and Lee (2000) analyzed the economic effects of the potential FTA between Chile and Korea by using a CGE model. The CGE model is a general equilibrium model that has the advantage of determining the reallocation effects of the resources caused by the cross-sectoral reallocation of production factors, which the partial equilibrium is not able to deal with.<sup>10</sup> Korea is expected to gain substantial benefits from the tariff elimination between the two countries. For example, preferential tariffs imposed by Chile on Canadian and Mexican exports through the bilateral FTAs with the two countries are now acting as the main barriers for Korea's export products such as automobiles, color TVs, and refrigerators. In this regard, the conclusion of a Korea-Chile FTA will improve the price competitiveness of Korean products, enabling them to better compete with other countries in the Chilean market. This inference can be supported by examining the case of Mexico. Mexican exports to Chile jumped from US\$180 million in 1992 to US\$930 million in 1996. Korea is expected to enjoy a similar level of export expansion effect, from an FTA with Chile. According to the authors' calculations, an FTA with Chile can result in an annual welfare improvement for Korea of US\$960 million. This result, however, does not consider scale and dynamic effects. The actual improvement is expected to be even greater if these factors are included.

Among Korea's export sectors, some competitive sectors with greater market share in

---

<sup>10</sup> This model, however, is not able to reflect the effects of economies of scale as it is based on constant returns to scale. Moreover, it has the limitation of disregarding most dynamic effects such as the effect of productivity enhancement due to the intensified competition as well as the effects of investment expansion and labor growth

Chile will benefit particularly from a Korea-Chile FTA. They are automobiles (occupying 18% of Chilean import market), refrigerators (31%), microwave ovens (69%), washing machines (65%), tires and automobile batteries, textiles, elevators and plastic products. As for Korea, among the manufacturing sectors, the copper processing industry will be most affected as imports of copper and related products from Chile will increase with the establishment of a Korea-Chile FTA. This is because Chilean copper is the world leader in terms of exploitable reserves, production and export volumes. The mining sector is the most important and competitive sector in the Chilean economy, accounting for more than one half of global exports.

One of the main reasons for selecting Chile as Korea's first FTA partner is that Korean businesses are currently being subjected to serious discriminatory disadvantages as Chile concludes FTAs with multiple countries. Chile has so far successfully concluded FTAs with the EU, Mexico, Canada, MERCUSOR, Peru, Venezuela, Ecuador and Columbia and is currently discussing the establishment of FTAs with the US, Bolivia, Panama, Cuba and the EFTA. Although a number of Korean industrial products currently have large market shares in Chile, their market shares are likely to decrease as the businesses of Chile's FTA partners start gaining an advantage in the market. Also, Korean businesses are demanding an FTA with Chile.<sup>9</sup> An FTA with Chile concurrently reflects the progressive goal of advancing into the Chilean market and the passive goal of supporting the industries to maintain their present level of market share in Chile.

---

<sup>9</sup> Through an official letter to the Ministry of Commerce, Industry and Energy, Korea's Automobile Manufacturers' Association requested the prompt conclusion of an FTA with Chile as well as promotion of FTAs with other Latin American countries.

Second, because Korea has no experience in FTAs, for its first FTA, the systematic establishment of an FTA policy at home might be more of a priority than gaining high benefits. High economic benefits call for strong restructuring. The forecast that an FTA with Chile would not greatly affect Korea due to its smaller economic size and geographical distance swayed the decision to select Chile as Korea's first FTA partner. Although Chile has competitiveness in certain kinds of fruit, the fact that it imports rice and beef, two highly sensitive items for the Korean agricultural sector are expected to lessen the negative impacts of the FTA. Although some suggest promoting an FTA with Singapore where trade of agricultural products would not be an issue, as Japan did, the suggestion did not receive attention in Korea.

Third, Chile has accumulated over 20 years of experience in regional agreements with small and large economies. It has implemented drastic economic and institutional reforms under an economic opening process and is currently enjoying the full benefits of trade liberalization. Also, Chile's experience with operating a relatively liberalized economic market under FTAs will provide a useful example for Korea in adapting to a newly liberalized environment. For Korea, which aspires to be an open trading country, Chile is a model case to learn from in the future. An FTA with Chile will enable Korea to study Chile's FTA promoting process and trade system.

Fourth, the successful establishment of an FTA is highly dependent on the willingness and matched interests of the negotiating countries. Chile considers Korea as a model country for industrial development and as a foothold for gaining access to and luring foreign investment from the East Asian market. Chile highly values Korea's close

linkage with neighboring Asian countries (Chile can take advantage of Korea's trade linkage to widen Chile's market access to other Asian countries), as well as Korea's growth potential by performing strong reforms in several sectors including the financial sector.

Fifth, Chile can serve as a bridge toward the newly emerging Latin American market. Recognizing the importance of this market for Korean companies and the need to overcome its trade dependence on the US and Japan, Korea has accelerated its advance into Latin America since the late 1980s. As a result, the percentage of exports to Latin American countries out of Korea's total exports increased from a mere 0.3% in 1964 to 6% in 1990, marking an annual average increase rate of nearly 50% during the period 1990-1995. This sharp increase of exports is mainly due to the increased demand for imports in Latin American countries resulting from political and economic stability and market opening since the early 1990s. Latin America has emerged as a newly developing region with its high growth potential. Moreover, with the establishment of NAFTA and other regional economic agreements such as MERCOSUR, CACM (Central America Common Market) and ANCOM (Andean Community), Latin America has been recognized as a new economic bloc with a big open market and increased competitiveness. Developed countries, such as the US, EU and Japan, have already been trying to secure this market to take full advantage of first entry amid fierce competition.

In order to diversify Korea's export market and fully exploit the comparative advantage of Korean products such as electronics, textiles and automobiles, Korea also needs to



take an aggressive export strategy towards this newly emerging continent. Chile, one of the most open economies, having a multiple set of trade relations with other countries in Latin America, can be an ideal strategic partner for Korea to penetrate the Latin American trading bloc.

In this new era of economic interdependence, Korea also needs to protect and maximize its national interest by joining or creating trading blocs. The economic cooperation is expected to spill over to political and diplomatic cooperation, covering a wide range of issues such as security, environment, labor and cultural exchanges. In addition to economic aspects, Korea will enhance its political influence and diplomatic weight in international organizations and inter-governmental institutions. Chile and Korea share common principles of democracy and a free market economy, and there is a strong eagerness to expand commercial and political relations among the government leaders of both countries. So, the successful signing of a Korea-Chile FTA will provide the momentum to reinforce diplomatic ties between the two countries and serve as a catalytic force to intensify cooperation between the continents of East Asia and Latin America. Through the strategic alliance, the two regions are expected to emerge as key players in a newly established world order.

The Korean government should take a deliberate stance against potential industrial damage to sensitive sectors by carefully examining the economic effects of a Korea-Chile FTA. To minimize severe restructuring costs, Korea can also consider the partial exclusion of the most affected sectors from the FTA or demand the provision of a transition period for sensitive sectors. The government officially decided to negotiate an

FTA with Chile in December 1999 and currently, the two economies are still negotiating the bilateral FTA. Talks regarding sensitive areas of trade could potentially prolong the negotiations.

A negative perspective on the proposed Korea's FTA with Chile was raised by Professor J. Bhawati who argues that Korea should not conclude an FTA just because all other countries are doing so.<sup>11</sup> Even if Korea does conclude an FTA, it should choose a country with a competitive economic and industrial structure; According to Bhawati, Chile, with its complementary industrial structure and geographical distance, is not an ideal FTA partner for Korea.

However, there are several problems with Professor Bhagwati's comments. First of all, it is prejudiced to assert that Korea is promoting an FTA following the world trend without a thorough analysis. Korea has been studying the feasibility of FTAs since the 1980s. Although an FTA was realistically necessary, it was not realized due to the difficult domestic situation arising from opening up the market. From the mid-1990s, a task force was assigned to examine the FTA policy and in 1997, the then Ministry of Trade and Industry began to examine the FTA policy. In 1998, immediately after the financial crisis, the Office of the Minister for Trade was established. A number of expert officials of the then Ministry of Trade and Industry were recruited to the Office of the Minister for Trade, and they began fully examining an FTA on a strategic trade policy level.

---

<sup>11</sup> Refer to the newspaper article "An FTA should be concluded with a competitive country," in *Chosun*

At the time of the financial crisis, securing foreign currency through export expansion and upgrading the national credit rating were the most urgent problems the Korean government faced. The Korean government keenly needed to raise its credit rating by improving the trade balance by securing stable export markets as well as showing off its mindset of economic reform, and proving that it was strong enough to promote an FTA. In other words, Korea is promoting an FTA to meet economic needs, not thoughtlessly chasing the world trend.

Professor Bhagwati's contention that a country with a competitive trade and industrial structure would be a more appropriate FTA partner seems reasonable. If similar industries induce competition and reduce unnecessary sectors resulting in higher competitiveness in the economy in general, the effects of an FTA will be maximized with great economic benefits. However, high economic gains are based on a premise of painful structural adjustments of a vast scale. Let us return to the year 1998. In the midst of numerous businesses going bankrupt and the unemployment rate rapidly growing, government officials grappled with the question of which country to choose as an FTA partner, while considering the correlation between economic benefits and structural adjustments.

Since Chile has already concluded approximately ten FTAs, Korean products are being discriminated against locally. Thus, it was more urgent to improve the situation in Chile than in any other region. Not only is Chile an exemplary nation in Latin America, it is one of the most aggressive countries in pursuing FTAs. Consequently, Korea can learn

---

*Daily News*, July 11<sup>th</sup> 2002.

from Chile's experience in FTAs, which will be useful in promoting FTAs with a broad economic bloc such as Japan, the U.S., and China. There is no doubt that concluding an FTA with a nearby country would be more beneficial; however, FTAs between geographically distant countries have become more common in recent years, as can be seen in the EU's bilateral FTAs with Chile and Mexico.

After a comprehensive study, it was concluded that Chile is a suitable partner for Korea's first FTA since the effects of structural adjustment would be moderate due to Chile's distance from Korea, opposite seasons, and complementary trade structure, while the effects of increasing exports would be great. Also, the economic effects are not small. According to the author's estimation, Korea's export to Chile will double once the FTA is in place. In sum, Chile was selected as the first FTA partner after a thorough examination of several criteria and concluding an FTA with Chile will be a significant turning point, which will likely set the future direction of Korea's FTA policy.

## **V. Expected Effects of a Korea-Japan FTA**

Korea and Japan have decided to pursue FTAs with major trading partners in order to secure stable export markets, improve domestic business environment, and strengthen industrial competitiveness. However, these are merely the general goals of pursuing FTAs and may not be sufficient in providing a logical basis for an FTA between Korea and Japan. Notwithstanding that an FTA with Japan has more political and historical obstacles than agreements with other countries, the objectives underlying the pursuit of a bilateral FTA are as follows: to form a strategic alliance and ease the fierce competition between the companies of the two countries; to jointly prepare for Northeast Asian and East Asian economic integration; to strengthen international recognition; and to secure political stability in Northeast Asia.

What is Korea's motivation for concluding an FTA with Japan? First, among possible FTA candidates, Japan is the trading partner that can offer the most substantial increase in Korea's total exports. To date, the adverse effects of an FTA on the trading relations between Korea and Japan have been greatly emphasized. Despite the anticipated deterioration in its bilateral trade balance with Japan, Korea should re-evaluate the positive impacts of an FTA with Japan, which will increase Korea's total exports and improve its global trade balance gradually. The estimates on the impact of a Korea-Japan FTA are discussed in the Appendix.

Second, the opportunity costs of not having an FTA with Japan may be considerable.

As widely known, Japan's manufacturing sector is more internationally competitive than Korea's. Overlapping investments and price competition in export markets can bring serious damage to both countries. The bilateral FTA can play an important role in establishing strategic joint ventures between companies of the two countries. If Japan proceeds with FTAs with Taiwan and ASEAN instead of Korea, the economic damage to Korea will be tremendous. In other words, Korea needs to contemplate whether it is able to sustain its current status without an FTA with Japan.

Finally, a Korea-Japan FTA is strategically significant. Discussions on a Korea-Japan FTA will be a driving force for other FTAs with the United States, China, and ASEAN. If this FTA proceeds, China and the United States, who want to maintain their influence in Northeast Asia, may consider FTAs with Korea. Since last year, talks on an East Asia free trade area (EAFTA) have been active. A realistic and subtle approach to accomplishing this FTA is to conclude a Korea-Japan FTA first and link it to Southeast Asia's AFTA. In short, a Korea-Japan FTA plays a critical role in generating interest in forming an FTA with Korea among Korea's trading partners.

A Korea-Japan FTA is expected to bring substantial economic gains to Japan. First of all, Korea charges higher tariffs than Japan generally, and the bilateral trade liberalization will allow Japanese firms to increase their exports to Korea. While presenting the mutual benefits of a Korea-Japan FTA, Fukagawa (2000) evaluates Korea as one of the most appropriate FTA partners for Japan. A bilateral FTA could help foster more political stability on the Korean peninsula and allow Japan and Korea to enjoy greater economies of scale and larger inflows of foreign direct investment. Bilateral

trade liberalization would also reduce overlapping investments, while strengthened financial cooperation could expand Korea's use of capital in Japanese yen.

As for Japan, Korea is an ideal FTA partner since it can absorb Japan's various assets such as financial assets, technological assets and production know-how, more easily than other countries. Korea would be a strategic choice in converting Japan's full-set economy into a balanced economy of manufacturing and investment. Faced with an aging society, Japan needs to reorganize its industrial economic structure in haste. In order to avoid a labor shortage in the near future, Japan should relocate its production technology overseas and convert its industrial structure into a knowledge-based industry. Korea is also a model partner in this aspect since it can absorb Japan's high technology at low cost and cooperate with Japanese companies. Considering Korea's positive social climate resulting from its reforms after the financial crisis, as well as reforms in economic policy, a bilateral FTA would provide Japan with the momentum to pursue much-needed reforms. These advantages give Korea the highest priority over Japan's other potential FTA partners, following the Japan-Singapore FTA (officially named the "New Age Economic Partnership Agreement").

To elaborate further on the need for a Korea-Japan FTA, it should be pointed out that not only have shares of the world trade volume for both Korea and Japan been decreasing in recent years, but also trade between the two countries especially has declined after 1995. While there is no sign that the problem of overlapping and excessive investments will be resolved in the near future, excessive competition between Korean and Japanese companies for overseas markets continues to intensify.

The competition for the US market can be clearly seen in the export similarity index.<sup>12</sup> The sustained export similarity index between Korea and Japan from 1995 to 1999 shows that Korea is not differentiating its products from Japanese goods, resulting in prolonged bilateral competition. The table also suggests that Korea's competition with China and Taiwan is increasing. According to the similarity index in industry structure, Korea is failing in reducing the gap with Japan in terms of competition, while facing increased competition with China and Taiwan.

An examination of the competitiveness of Korea and Japan in the US market by industry through revealed comparative advantage (RCA)<sup>13</sup> shows that Korean products such as semiconductors, computers, automobiles, steel, textiles, musical instruments, and rubber products have comparative advantage as of 2000. The comparative advantage of computers, automobiles, machinery, chemicals, steel and rubber products, and textiles, has improved since 1995, while the index for semiconductors, apparel, leather and plastic goods, musical instruments, and footwear has decreased.

Table 1. Changes in Korea's RCA by Commodity

Heavy and Chemical Industry	Electric/Electronic	(semi-conductors)	(computers)	Transportation Equipment	(automobiles)	Machinery	Precision Machinery	Chemicals	Steel
1995	2.55	5.57	2.10	0.52	0.79	0.37	0.37	0.21	1.36
2000	2.45	4.73	2.66	0.89	1.33	0.63oi	0.31	0.24	1.58
Light Industry	Textiles	(apparel)	(fabrics)	Leather	Musical Instruments	Plastic	Rubber	Footwear	Toys
1995	1.59	1.41	3.12	1.77	4.91	0.87	1.06	1.31	0.52
2000	1.32	1.15	3.17	0.82	3.41	0.77	1.31	0.28	0.37

<sup>12</sup> The export similarity index (ESI) illustrates the level of bilateral competition in a specific market. The makeup of export commodities is disparate when the index is nearer to 0 and similar when nearer to 1.

<sup>13</sup> Revealed comparative advantage (RCA) index allows for the comparison of competitiveness between countries with different sized economy. It is calculated by dividing a country's share of exports in a given commodity category by the share in the world exports of manufactured goods and is used to identify products in which a country does or does not have comparative advantage. If the index takes a value greater than 1, then the share of a product in a country's exports is larger than the corresponding world share, therefore that country has a revealed comparative advantage in that product.



Source: KOTIS Korea Trade Statistics, US Trade Statistics

A study of the export competitiveness of Japanese products shows that semiconductors, computers, automobiles, machinery, precision machinery, musical instruments, rubber goods, and toys have comparative advantage. The comparative advantage of automobiles, machinery, musical instruments, rubber goods, and toys has increased since 1995 but has decreased for semiconductors and computers.

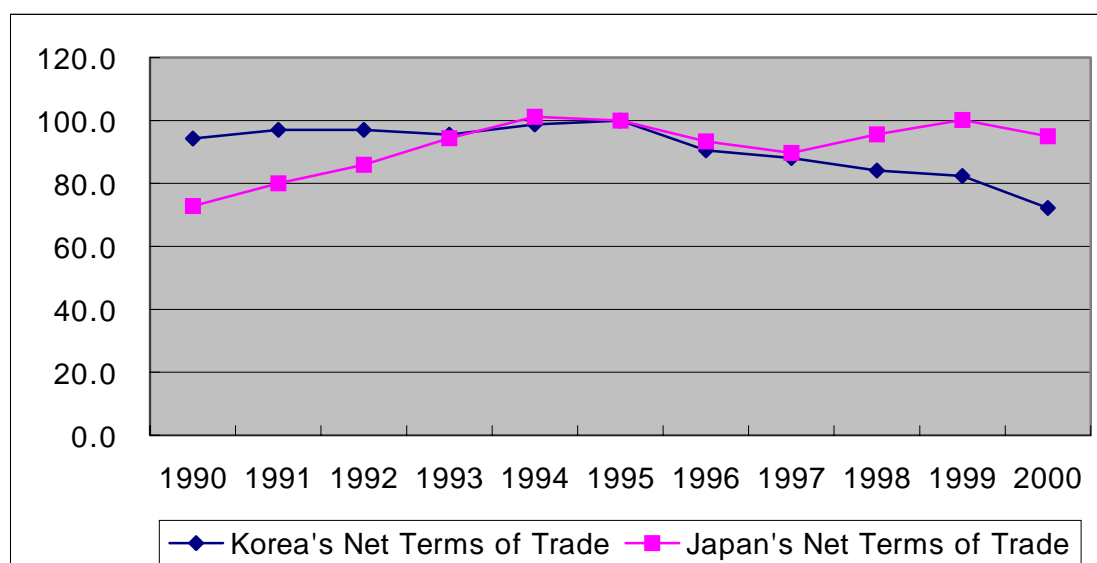
Table 2. Changes in Japan's RCA by Commodity

Heavy and Chemical Industry	Electric/Electronic	(Semi-conductors)	(Computers)	Transportation Equipment	(Automobiles)	Machinery	Precision Machinery	Chemicals	Steel
1995	1.55	1.63	1.58	1.77	2.03	1.68	2.07	0.86	0.77
2000	1.39	1.47	1.36	1.98	2.44	1.86	1.95	0.88	0.66
Light Industry	Textiles	(Apparel)	(Fabrics)	Leather	Musical Instruments	Plastic	Rubber	Footwear	Toys
1995	0.08	0.01	0.40	0.01	1.89	0.74	1.08	0.00	0.64
2000	0.08	0.01	0.40	0.01	2.30	0.75	1.44	0.00	1.03

Source: KOTIS Trade Statistics, US Trade Statistics

The intensifying competition with Japan for export markets is worsening Korea's terms of trade. Korea's export structure is heavily dependent on a few selected commodities such as machinery, semiconductors, and electric and electronic products, and therefore is volatile to world price fluctuations. As previously seen in Korea's RCA and Japan's export similarity index, rivalry with Japan combined with increasing competition from developing countries is weakening Korea's terms of trade.

Figure 1. Korea and Japan's Terms of Trade (95=100)



Source: IMF 2001, *International Financial Statistics*.

KOTIS 2001, *Major Trade Indicators*.

Note: Net terms of trade indicate the amount of products imported for one unit cost of export and is calculated by dividing the export unit cost index by the import unit cost index multiplied by 100.

For the last few decades, industries and related government agencies in both countries have held discussions on how to relieve the problem of excessive and overlapping investments and how to avoid bilateral competition. However, trends in the export similarity index, RCA, and terms of trade of both countries show that the attempts have had little effect, proving that systematic mechanisms are necessary to alleviate these problems. Establishing an FTA that will influence the actions taken by companies may be more effective in inducing them to achieve structural adjustment.

Another rationale for concluding a Korea-Japan FTA is the need for strengthening economic cooperation with rapidly growing China. With the accession of China to the WTO at the Doha Ministerial Meeting in November 2001, China is in a position to gain increased international recognition as well as rapid economic growth. A Korea-Japan

FTA can work as a catalyst toward examining the possibility of an FTA with China, a Northeast Asian FTA or even an East Asian FTA. A Korea-Japan FTA is expected to influence the struggle for leadership for Northeast Asian economic integration in the long run. After the Asian financial crisis, Japan tried to establish the Japanese yen as an international standard of currency in the East Asian region and to push forward with the establishment of an Asian Monetary Fund (AMF), but its attempts were thwarted by the objections of China, the US, and the EU. Given the recent discussions on a Northeast Asian FTA consisting of Korea, China, and Japan as well as an East Asian FTA, Korea and Japan may share a common interest in concluding a bilateral FTA first and then branching out to larger regional FTAs based on that experience.<sup>14</sup> Finally, a Korea-Japan FTA would strengthen the international status of both countries, and economic cooperation would considerably alleviate the political and historical tension between them.

---

<sup>14</sup> Discussions on a Northeast Asian FTA are currently underway between Korea, Japan, and China for cooperation in industries such as steel. Although industrial cooperation is expected to strengthen regional economic cooperation, there are fears that without the introduction of an eligible institutional system such as an FTA, allowing preferential tariffs on certain commodities to only the three countries may violate multilateral trade rules.

## **VI. Conclusion**

Korea is in the process of FTA negotiations with Chile, and should expedite these negotiations to provide a feasible FTA environment internally and externally. Furthermore, it should endeavor to seek a model FTA that provides a basis for negotiations to facilitate future FTAs. In the meanwhile, Korea should hasten to conclude the FTA negotiations with Chile to lay the foundation for future FTAs.

In addition to the Korea-Chile FTA, Korea looked into the economic feasibility of an FTA with Japan in 1999 and came up with a positive prognosis. Korea's FTA with Japan is expected to yield substantial benefits by strengthening the strategic alliances among the firms of the two countries. A strategic alliance with Japan is especially critical, not only because of Japan's vast potential for providing investment capital but also because the combination of Japan's advanced technology with Korea's production capability will substantially enhance the competitiveness of domestic businesses. Moreover, an effective Korea-Japan partnership mechanism may mitigate Korea's trade imbalance with Japan.

Since Korea lags far behind other countries in concluding FTAs, it should hasten to conclude FTAs with major trading countries. Rather than waiting to complete an FTA with one country before deciding on the next FTA partner, Korea should simultaneously promote FTAs with multiple countries. A multi-track approach, that is, negotiating FTAs with multiple countries at the same time, is advisable in order to maintain the

momentum for FTAs. Some of the public seems concerned about the negative effects of trade liberalization, placing greater emphasis on the negative rather than the positive aspects. Many fear that competitive Japanese products will weaken Korea's industrial structure, pointing out that Korea's industrial competitiveness is weaker than Japan's, and that while Japan's average tariff rates range between 2 to 3%, Korea's are much higher at 7 to 8%. However, the study by Cheong (2001a) indicates 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. Instead, Korea would enjoy large mid- and long-term benefits under a bilateral FTA with Japan. Both Korean and Japanese companies have suffered from excessive competition in overseas markets mainly due to overlapping investments in their major industries. In order to alleviate this problem, the governments of the two countries have called for more bilateral industrial cooperation. A bilateral FTA would eliminate trade barriers and promote competition, leaving both Korean and Japanese companies with no choice but to pursue strategic alliances in order to survive. This can effectively eliminate overlapping investments and result in substantial long-term benefits.

Finally, it can be pointed out that Korea should enhance its capacity to implement its FTA policy by improving public awareness of the potential benefits of preferential FTAs. One of the main obstacles to gaining public approval for FTAs is the lack of public knowledge and negative preconceptions about trade liberalization. Most people think that trade liberalization will only contribute to the growth of imports. Some misunderstand that the complete elimination of tariffs will be applied as soon as an FTA comes into effect, thereby requiring huge adjustment costs in some sensitive sectors in

the short-term. The drawbacks of trade liberalization are usually exaggerated, while the benefits are often underestimated. Some even believe that an FTA with large economies will result in a form of economic subordination. Therefore, the government should strengthen public awareness campaigns on the pros and cons of preferential trade liberalization.

## Appendix: Economic Impact of a Korea-Japan FTA<sup>15</sup>

### I. Summary of a Joint Study by KIEP and IDE

KIEP and IDE conducted a joint study on the economic impact of a Korea-Japan FTA from 1999 to 2000.<sup>16</sup> KIEP's study results may be summarized as follows: 1) preferential tariff elimination between Japan and Korea may worsen Korea's GDP and trade balance with Japan; 2) a bilateral FTA may have a deep impact on Korea's heavy and chemical industry and worsen Korea's industrial structure; 3) in the case of an increase in foreign direct investment inflows under the bilateral FTA, Korea's total trade balance may improve substantially. However, studies conducted by other institutions show different results. While KIEP estimates that tariff elimination will cause Korea's welfare level to fall, KIET (1999) and Japan's IDE report opposite findings. With regards to effects on GDP, KIET and BDS (Brown, Deardorff and Stern 2000) offer similar results to the KIEP study, but IDE derived conflicting results. One common conclusion shared by all the studies is that Korea's trade balance will worsen under the bilateral FTA.

Table 3 Economic Impact of Korea-Japan Tariff Elimination (static model)

		KIEP	KIET	IDE	BDS
Korea	Welfare level (%)	-0.19	0.48	0.34	-
	GDP (%)	-0.07	-0.07	0.06	-0.23

<sup>15</sup> This part is a summary of Cheong (2001a).

<sup>16</sup> Some examples of studies on a Korea-Japan FTA are KIEP-IDE (2000), KIET (1999), Kwon (2000), Cheong (2001a), and Park (2001).

	Trade balance with Japan (US\$100 million)	-60.09	-33.60	-38.85	-
	Total trade balance (US\$100 million)	-15.43	-6.90	-2.7	-
<b>Japan</b>	Welfare level (%)	0.14	-	0.03	-
	GDP (%)	0.04	-	0.00	0.18
	Trade balance with Korea (US\$100 million)	60.90	-	38.85	-
	Total trade balance (US\$100 million)	-	-	54.79	-

The conflicting study results are attributed to differences in model structures, simulation methods, levels of shock of trade liberalization, and the selection of data. While KIEP, IDE, and BDS used the CGE model, which includes multi-regions and multi-sectors, KIET's study relied on a single country model that only considered Korea.

The CGE model has similar structures but there are slight differences in production structure. In other words, while the KIEP and BDS models assumed a Leontief style-fixed coefficient at the top of the production structure, the model used in IDE's study laid down a CES production function. Differences could also be found in assumptions about the movement of capital. The KIEP and BDS studies assumed an incomplete allocation scheme where the changes in world capital volume are distributed across the region by the same rate as the standard year, whereas IDE's study used a complete distribution method that allocates changes in capital volume by region in the short-term based on the rate of return on capital.

An increase in productivity is also expected under a Korea-Japan FTA, and both KIEP and IDE studies on the economic impact of such an increase show similar results. In



light of improved productivity under a bilateral FTA, Korea's welfare level is expected to increase by 7 to 11% and GDP by 3 to 9%. Any differences in estimated figures can be attributed to the assumption of increased productivity. In short, KIEP's study assumed that investment in Korea by foreign companies (including Japan) would annually increase by US\$2.5 to 3.5 billion with the elimination of tariff and non-tariff barriers under a Korea-Japan FTA. On the other hand, IDE's study assumed that Korea's productivity would increase 10 to 30% during a 10-year period according to industry. The FDI inflow figures estimated by KIEP were based on various FDI statistics and existing study results such as past foreign direct investment trends and Japan's total investment volume. IDE also provided the grounds for estimating a productivity increase of 10 to 30%, but many people question the validity of both KIEP and IDE estimates.

Table 4 Economic Impact of Korea-Japan Tariff Elimination (effect of increased productivity)

		<b>KIEP</b>	<b>IDE</b>	<b>Notes</b>
Korea	Welfare level (%)	11.43	7.09	- increased manufacturing productivity of an annual 1% during a 10-year period
	GDP (%)	2.88	8.67	
	Trade balance with Japan (US\$100 million)	-4.40	-24.60	
	World trade balance (US\$100 million)	30.14	408.00	
Japan	Welfare level (%)	-	9.29	- 10% increased productivity: textiles, manufacturing, services - 30% increased productivity: metals, transportation equipment, electronics, machinery
	GDP (%)	-	10.44	
	Trade balance with Korea (US\$100 million)	-	24.60	
	World trade balance (US\$100 million)	-	182.00	

## **II. Problems in Existing Studies**

As examined in the previous section, while the findings of the majority of studies on the economic impact of a Korea-Japan FTA are similar to KIEP's, there is a significant difference in the results of IDE's study. The varying analyses stem from differences in model characteristics, scope of analysis, simulation shock, and assumptions of international capital movements. One of the problems in existing studies is that the selected models assume that economic activity conducted by regional economic agents all follow an identical decision-making process. KIEP estimated a Korean version of GTAP parameters. The tariff rates used for simulation shock also present a problem. Existing studies analyze the impact of bilateral tariff elimination using the tariff rates of the GTAP database, and thus, are unable to indicate the effects on liberalization in non-tariff barriers and services sectors.

Another problem is the selection of models. Existing studies use the perfect competition model; however, this model does not reflect economies of scale and promotion of competition and can result in an underestimation of the economic impact arising from an FTA. Especially since the core industries of Korea and Japan have greater economies of scale, more focus should be given to the impact of such a characteristic. The effect of capital accumulation was also not well reflected in existing studies due to the exogenous savings rate and capital volume.

These problems suggest that the economic impact of a Korea-Japan FTA will be limited. This study aims to rectify the problems found in existing studies, especially by analyzing agricultural tariffs, barriers in trade in services, and the equivalence of non-tariff barriers in tariffs.

### III. Major Findings of Cheong (2001)'s Study

#### 1. Preferential Tariff Elimination between Korea and Japan

Table 5 presents the impact of bilateral preferential tariff elimination on Korean macroeconomic variables. The results of the 2001 KIEP study, in which the estimates were based on a new model with economies of scale, capital accumulation effects, and Korean parameters, are significantly different from those reported in the previous study. First, unlike the 2000 study, the new study indicates that the conclusion of a bilateral FTA will likely cause a rise in Korea's GDP in addition to having other extensive effects. In the short-term, Korea's GDP is expected to rise by 0.22 to 0.33%, but if capital accumulation accelerates in the mid to long-term, this figure can reach 0.82 to 1.90%.

Table 5 The Effects of Tariff Elimination on Macroeconomic Variables

(%, US\$100 million)

	2000 Studies	GTAP Parameters				GTAP + Korean Parameters			
		CRS		Economies of Scale		CRS		Economies of Scale	
		Short -term	Mid to Long- Term	Short- Term	Mid to Long- term	Short- term	Mid to Long- Term	Short- term	Mid to Long- term
Real GDP	-0.07	0.22	0.82	0.30	1.90	0.21	0.96	0.33	1.79
Price Level	0.71	0.37	-0.31	0.23	-0.46	0.48	-0.19	0.31	-0.26
Welfare Level	-0.19	0.28	0.44	0.33	1.31	0.30	0.66	0.38	1.39
Equivalent Variations <sup>1)</sup>	-7.66	1.10	1.7	1.3	5.1	1.2	2.6	1.4	5.2
Savings	-	0.68	3.06	0.60	7.91	0.77	2.84	0.71	5.05
Capital Volume	-	0.13	1.38	0.12	2.50	0.13	1.76	0.13	2.52
Terms of Trade	-	0.03	-0.46	-0.01	-0.76	0.13	-0.35	0.09	-0.49
trade Balance <sup>1)</sup>	- 15.34	-1.0	2.3	-1.0	6.4	-1.1	1.6	-1.1	3.4

Note: 1) Equivalent variations and changes in trade balance are expressed in US\$100

million, and the remaining figures represent changes expressed in percentage (%).

## 2. Impact of Easing Non-Tariff Barriers

The impact of easing NTBs on macroeconomic variables is shown in Table 6. Although an assessment is generally difficult since the extent of trade liberalization differs by industry, easing NTBs is expected to have a similar impact as tariff elimination, thus increasing GDP. Estimates using GTAP parameters predicted higher GDP growth than those using Korean parameters. The scenario using economies of scale predicts an additional 2% growth of Korea's economy resulting from easing NTBs. The constant returns to scale puts the figure at 0.28%, while the economies of scale simulation predicts a 2.01% increase in the mid to long-term.

Table 6 Effects of Easing Non-Tariff Barriers on Macroeconomic Variables

(%, US\$100 million)

	GTAP Parameters				GTAP + Korean Parameters			
	CRS		Economies of Scale		CRS		Economies of Scale	
	Short-term	Mid to Long-Term	Short-term	Mid to Long-Term	Short-term	Mid to Long-Term	Short-term	Mid to Long-term
GDP	0.10	0.28	0.13	2.01	0.09	0.46	0.09	1.79
Price Level	1.80	0.04	1.20	-0.34	1.93	0.54	1.36	-0.26
Welfare Level	0.94	0.31	0.74	1.58	0.93	0.92	0.75	1.39
Equivalent Variations <sup>1)</sup>	3.7	1.2	2.8	6.1	3.7	3.6	2.8	5.2
Savings Rate	1.99	8.85	1.39	16.46	2.11	7.00	1.50	5.05
Capital Volume	0.10	0.31	0.09	2.21	0.11	0.83	0.07	2.52
Terms of Trade	1.23	0.05	0.88	-0.601	1.35	0.40	1.06	-0.49
trade Balance <sup>1)</sup>	-0.6	9.0	-0.5	15.4	-0.7	6.2	-0.3	3.4

Note: 1) The units for the conversion equivalent and changes in trade balance are in US\$100 million, and the rest are changes in %.

Easing NTBs between Korea and Japan will promote Korea's welfare level. A US\$300 to 400 million improvement is expected in the short-term and US\$500 million in the mid to long-term.

Based on the results analyzed so far, the following conclusion can be conservatively presented: Korea and Japan can both benefit from a bilateral FTA, and a Korea-Japan FTA is economically feasible, when bilateral trade liberalization is linked with easing Japan's NTBs and a deliberately designed investment scheme.

## References

- Booz, Allen and Hamilton, Inc. (1997) *Revitalizing the Korean Economy towards the 21<sup>st</sup> Century*. Report for Vision Korea Committee. October.
- Brown, Drusilla K., Alan V. Deardorff and Robert M. Stern. 2000. "CGE Modelling and Analysis of Multilateral and Regional Negotiating Options." forthcoming in Robert M. Stern (ed.). *Issues and Options for US-Japan Trade Policies*. University of Michigan Press.
- Cheong, Inkyo. (1999) "Keeping Korea's FTA Policy Consistent with APEC Goals," in *Journal of APEC STUDIES*, Vol. 1, No. 1, pp. 31-50.
- \_\_\_\_\_. (2001a), *The Economic Effects of A Korea-Japan FTA and Policy Implications*, KIEP Policy Paper 01-04, Seoul: KIEP.
- \_\_\_\_\_. (2001b), *How to Cope with the Expansion of FTAs?*, KIEP FTA Research Series 01, Seoul: KIEP.
- \_\_\_\_\_ and Lee, Kyunghee. (2000) *Korea-Chile FTA: Background, Economic Effects, and Policy Implications*. KIEP Policy Analysis 00-07, Seoul: KIEP.
- Fukugawa, Y. (2000) "Japan-Korean FTA as a New Initiative in East Asia: Beyond Bitterness." Global Communications Platform from Japan. May.
- Igawa, Kazuhiro and Kim, Bonggil. (2001) "A Note on Possibilities about Japan-Korea

- Free Trade Area: A Theoretical and Strategic Approach.” Mimeo, Kobe, Japan: Kobe University.
- IMF (1997) *Direction of Trade Statistics Yearbook*, IMF Statistics Department, Washington D.C.: IMF.
- \_\_\_\_\_ (2001) *International Financial Statistics*, Washington D.C.: IMF.
- KIEP-IDE. 2000. Toward a Korea-Japan FTA: Assessment and Prospects. Presented at an international seminar Towards Closer Korea-Japan Economic Relations: Proposal for Formulating a 21st Century Partnership. Seoul: Shilla Hotel.
- KIET. 1999. Korea-Japan FTA and New Industrial Policy. Seoul: KIET.
- Kwon, Youngmin. 2000. “Trade between Korea and Japan and the Effects of Tariff Elimination.” Seoul: KERI.
- Ojita, Tatsushi. 2002. “An Approach towards Japan’s FTA Policy.” APEC Study Center, Institute of Developing Economies. Chiba, Japan: IDE-JETRO.
- Park, Soon-Chan. 2001. “The Formation of a Korea-Japan FTA and Capital Formation.” Seoul: KIEP.
- World Bank (1996) *World Development Report 1996*, Washington D.C.: World Bank.
- WTO (1995) *Regionalism and the World Trading System*, WTO Secretariat, Geneva: WTO.