



Discussion Paper 01-01

Korea's FTA Policy
Current Status and Future Prospects

Chan-Hyun Sohn and Jinna Yoon

**KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY**

KIEP Discussion Paper 01-01

Korea's FTA (Free Trade Agreement) Policy
Current Status and Future Prospects

Chan-Hyun Sohn and Jinna Yoon

September 2001

Executive Summary

The purpose of this paper is to give a general picture of Korea's FTA policy in terms of its background, current status and future challenges. Further, it suggests selection criteria for determining eligible FTA partners for Korea and presents important implications for how Korea's future FTA policy should be developed.

Until the mid 1990s, the trade policy of Korea has long been based on multilateral and bilateral trade liberalization, hardly paying attention to regional trading arrangements. However, both external and internal factors have influenced Korea's recent adoption of FTA policy. These include the growing importance of regional trading arrangements in the world trade, the changes in the international perception of regionalism, the need for securing export and investment markets, the continuation and acceleration of market openings and structural reforms, and the need for strengthening political and economic ties with major trading partners.

With this background, this paper first discusses the current status of Korea's major FTA initiatives: a 'Korea-Chile FTA,' a 'Korea-Japan FTA,' and a 'Korea-U.S. FTA.' A 'Korea-Chile FTA,' which is Korea's first FTA initiative, began in late 1998. It is still in the process of negotiations to narrow down differences over the tariff concession schedules. Talks on a 'Korea-Japan FTA' were also initiated in late 1998. Korea and Japan conducted a joint research on the bilateral FTA and exchanged its results at International Joint Symposium in May and September 2001 at Seoul and Tokyo, respectively. Currently the private sector is taking the lead in bilateral FTA talks through the Business Forum. As for a 'Korea-US FTA,' no formal bilateral FTA talks have yet been launched but discussions have been ongoing since the late 1990s in academic and business circles. Korea is also conducting feasibility studies on a 'Korea-Thailand FTA' and a 'Korea-New Zealand FTA.' Consideration is also being given to other FTAs such as a 'Korea-Japan-China FTA' and an 'ASEAN+3 (i.e., Korea, Japan and China) FTA' as a way to create a regional trading arrangement to counterbalance other major economic blocs such as the EU and NAFTA.

Korea, with all eagerness to adopt FTA as its trade policy priority, still lacks a definite and consistent orientation to project the future course of FTA initiatives. Therefore, in this paper, we suggest five important criteria that are useful in selecting desirable FTA partners for Korea. These are the structure of comparative advantage, income level, geographical proximity, market size, and the level of outstanding trade barriers.

Taking into account these five criteria, the U.S. and Japan are considered to be the

most feasible and desirable FTA partners for Korea. Recently, there have been prevailing talks on a 'Korea-Japan-China FTA' or an 'ASEAN+3 FTA' in order to create a regional trading arrangement in East Asia. However, this may not be feasible in the short run for two main reasons.

The first problem is China's capacity. To meet WTO entry criteria, China must reduce its average tariff rates from the current 16.8% to 9.44 % over the next three years (until 2004). Therefore, China may find it hard to make an additional tariff cut to zero in order to form an FTA with Korea and Japan. Moreover, since China maintains relatively higher actual tariff rates for Korea and Japan than for other countries, a complete elimination of tariffs for China to form a 'Korea-Japan-China FTA' does not seem feasible in the short run

The second problem is the compatibility of the said 'ASEAN+3 FTA' with the WTO. The FTA among ASEAN countries, namely AFTA is a preferential trading arrangement among developing countries. It is based on the GATT 'Enabling Clause,' not on GATT Article XXVI. It is therefore exempt from the provision of GATT Article XXIV. Before forming an 'ASEAN+3 FTA' or 'East Asian FTA,' AFTA should first be transformed into an FTA under the terms and conditions of GATT Article XXIV covering "substantially all the trade," which requires significant time and commitments.

Therefore, from a practical point of view, a 'Korea-U.S. FTA' and a 'Korea-Japan FTA' seem most feasible, with greater economic effects. A 'Korea-Japan FTA' is particularly recommended as it could later be developed into an 'East Asian FTA' through expanding membership to China and possibly ASEAN countries.

Dr. Chan-Hyun Sohn, a senior fellow at KIEP, earned his Ph.D. in economics from Case Western Reserve University, USA. He has served as a visiting fellow at the Economic Growth Center, Yale University and also as a visiting research professor at the International Centre for the Study of East Asian Development, Japan. He specializes in multilateral trade issues, including technical barriers to trade, intellectual property rights, trade facilitation, preferential tariff arrangements etc. of the WTO, OECD and APEC. e-mail: chsohn@kiep.go.kr

Miss. Jinna Yoon, a researcher at KIEP, earned her MA from Korea University. She specializes in international trade issues, including intellectual property rights, trade facilitation and FTA policy. e-mail: jnyoon@kiep.go.kr

Contents

Executive Summary	3
I. Introduction	9
II. Evolution of Korea's Trade Policy	11
III. Rationales for the Adoption of FTA Policy	13
1. Increased Importance of RTAs in World Trade	13
2. Changes in the International Perception of Regionalism	13
3. Securing Export and Investment Markets	14
4. Accelerating Restructuring and Opening of the Korean Economy	14
5. Strengthening Political and Economic Ties	15
IV. Current Status of Korea's FTA Initiatives	16
1. Korea-Chile FTA	16
2. Korea-Japan FTA	16
3. Korea-U.S. FTA	21
4. Korea-China-Japan FTA	26
5. Other FTAs under Consideration	30
V. Selection Criteria for Choosing Desirable FTA Partners	32
1. The Structure of Comparative Advantage	32
2. Income Level	32
3. Market Size	34
4. Geographical Proximity	35
5. Level of Outstanding Trade Barriers	35
6. Overall Assessment: Viable FTA Partners	36
VI. Future Prospects of Korea's FTA Policy	37
References	38
	40

Tables

Table 1. Evolution of Korea's Trade Policy (1950s-90s).	12
Table 2. Number of Regional Trade Agreements Notified to GATT/WTO	13
Table 3. Expected Economic Effects of a Korea-Chile FTA	18
Table 4. Economic Effects of a Korea-Japan FTA	22
Table 5. Overall Economic Effects of a Korea-Japan FTA	23
Table 6. Economic Effects of a Korea-U.S. FTA on the Korean Economy (KIEP)...	27
Table 7. Economic Effects of a Korea-U.S. FTA on the Korean Economy (IIE)	28
Table 8. Matrix of Spearman's Rank Correlation of RCA	33
Table 9. Korea's Actual and Predicted Trade	36
Table 10. Assessment of Selection Criteria of Korea's Major Trading Partners	

Figures

Figure 1. Comparison of Korea's RCA Structure with Large Economies	33
Figure 2. Accelerated Income Convergence Effect of FTAs	34

Korea's FTA (Free Trade Agreement) Policy

*Current Status and Future Prospects*¹

Chan-Hyun Sohn · Jinna Yoon

I. Introduction

So far, Korea has always preferred the multilateral framework to regional agreements and maintained its commitments to multilateral trade agreement because, due to their non-discriminatory and comprehensive coverage, they were considered to be the best way to achieve trade liberalization at the global level.

However, a tendency toward regionalism is now emerging as another paradigm for the world trading system, complementing multilateralism in achieving a global free trade regime. The strengthening of regional economic blocs such as the EU, NAFTA, ASEAN explains well this reality. The EU, which is the most advanced form of regional economic bloc, is under a process of continuous enlargement by admitting Central and Eastern European countries. On the other hand, NAFTA, which launched in 1994, is expected to transform into the Free Trade Area of the Americas by 2005, extending its membership to Central and South America. There also exist other economic blocs such as CER and MERCOSUR, which are also undergoing a deepening process of economic integration. In Southeastern Asia, 10 ASEAN countries have set the year 2003 as a target date for the formation of the ASEAN Free Trade Area (AFTA).

Amid the proliferation of regional trading blocs, however, the five economies in Northeast Asia - Korea, Japan, China, Taiwan and Hong Kong - are currently not members of any regional economic arrangement, leaving Northeast Asia as the only region in the world without any strong regional integration forces.

¹ An earlier draft of this paper was presented at the PECC (Pacific Economic Cooperation Council) Trade Policy Forum's seminar on Regional Trading Arrangements : Stocktake and Next Steps on June 12-13, 2001 in Bangkok, Thailand, under the title "Korea's FTA Developments: Experiences and Perspectives with Chile, Japan, and the U.S."

In this new world trading system characterized by a few regional groupings, Korea came to shift its trade policy toward FTAs, acknowledging the fact that some kind of closer regional economic cooperation is needed to accelerate the liberalization process and to countervail the current regional economic blocs. Besides the external factors, Korea's renewed interest in FTA policy has also stemmed from its own internal demand such as its high dependence on foreign trade, the need for securing export markets and accelerated opening and restructuring of the Korean economy.

As a first step, Korea has been negotiating the conclusion of an FTA with Chile since 1998. It is also examining the feasibility of an FTA with major economies such as Japan, the U.S., and also with Singapore, New Zealand and Thailand. Although its basic trade policy is still focused on strengthening the multilateral system, Korea now believes that regional trade agreements (RTAs) in the form of FTAs will be a stepping stone to achieve world trade liberalization.

This paper will mainly discuss the current status and prospects of Korea's FTA policy. Section II will describe the evolution of Korea's trade policy since the early 1950s. Section III will explain in detail the main rationales behind Korea's recent shift toward FTAs. Section IV will explain current status of Korea's FTA initiatives and compare different estimated economic effects of Korea's FTAs with Chile, Japan and the U.S., respectively. Section V will introduce five selection criteria that Korea should take into account when choosing desirable FTA partners. Lastly, Section VI will discuss the future prospects of Korea's FTA policy.

II. Evolution of Korea's Trade Policy

Korea's economic ascent over the past three decades, interrupted by episodes of import substitution policies, has been strongly driven by export-oriented manufacturing industries. In the 1960s and 1970s, active promotion of the export sector and support for domestic industries enabled Korea to aggressively advance into the world market, stimulating rapid economic growth and full integration with the world trading system. On the other hand, the import sector, which remained very restricted, started to undergo a gradual liberalization process with the adoption of the positive list system after Korea's accession to GATT in 1967.

The 1980s were characterized by the increased pace of market opening and liberalization based on the multilateral framework. Korea, partly due to severe trade disputes with its main trading partners such as the U.S. and the EU, but more importantly from its own need to modernize economic structure and increase competitiveness, made a fundamental shift in its industrial and trade policy, from the state intervention toward deregulation and competition. Positive aspects of import liberalization were acknowledged. Preferential export credits were abolished and the Fair Trade and Anti-Monopoly Act was enacted in order to stimulate competition through the market mechanism.

In the early 1990s, with the trend of accelerated liberalization in international trade, Korea had to face international challenges that required further deregulation and liberalization of the market as well as institutional and policy changes. To meet the challenges, Korea entered a deeper liberalization process, making trade-related economic reforms aimed at abolishing unnecessary regulations and restrictions in trade and investment policy and reducing tariff barriers in line with the UR agreement. As a trade-oriented country and a member of the WTO, Korea has become a strong supporter of multilateral trade liberalization. Also, active promotion of foreign direct investment, deregulation and competition policy took place in this period as part of the globalization process.

The financial crisis of 1997, however, clearly showed the structural weakness of Korean economy, which has been historically characterized by illicit ties between the government and protected industries. Therefore, the Korean government struggled to overcome the crisis and to modernize the economic structure by making overall reforms in every sector. With regard to foreign trade policy, in particular, Korea has established a new "open trade nation" paradigm with the specific objectives of becoming a market-oriented, freer and fairer trading nation.

The discussion about Korea's FTA policy actually began in the late 1980s and became quite intense in the late 1990s. In this period, as the movement toward

economic integration in North America became evident with the sudden reversal of the U.S. trade policy towards regionalism, Korea reviewed the possibility of a Korea-U.S. FTA, but without any government commitment.

Table 1. Evolution of Korea's Trade Policy (1950s-90s)

	Principle	Direction	Strategy
1950s	Attraction of Foreign Capital	<ul style="list-style-type: none"> - Strengthening of economic basis through the introduction of foreign capital • import in order to export • secure financial assistance 	<ul style="list-style-type: none"> - Promote the exportation of resources to secure foreign capital - Little interest in multilateral cooperation
1960-1970s	Expansion of Trade	<ul style="list-style-type: none"> - Mercantilist policy • trade policy based on international competition • export subsidy-import restriction policy 	<ul style="list-style-type: none"> - Stimulate economic growth through exports • import restrictions • protection of domestic industry • passive participation in multilateral negotiation
1980s	Market Opening and Liberalization	<ul style="list-style-type: none"> - Trade liberalization based on multilateral framework • worsening of trade disputes • passive trade opening policy 	<ul style="list-style-type: none"> - Deep interest in trade expansion • acknowledge positive aspects of imports - Focus on the settlement of trade disputes • expansion of market opening - Participate in regional cooperation body (APEC) • focus on bilateral trade negotiation
1990s	Globalization	<ul style="list-style-type: none"> - Positive-sum strategy based on mutual benefit • active opening and liberalization policy • need for coordination of international trade policy 	<ul style="list-style-type: none"> - Parallel approach of regionalism and multilateralism • overcome crisis through the stimulation of exports and investments • promote FDI and bilateral industrial cooperation • strengthen regional cooperation by adopting FTA policy

Sources: Sohn, Yang and Yim (1998).
Ministry of Foreign Affairs and Trade (1999).

In November 1998, however, the Korean government formally announced that it would seek an FTA first with Chile: bilateral FTA negotiations have been ongoing since December 1999. Also, Korea is currently studying the feasibility of FTAs with other trading partners such as the U.S., Japan, New Zealand and Thailand.

III. Rationales for the Adoption of FTA Policy²

As seen in the previous section, Korea has so far preferred the multilateral framework to the regional initiatives because, due to its non-discriminatory and comprehensive coverage, it was considered to be the best way to achieve trade liberalization at the global level. However, both external and internal factors made Korea reconsider the adoption of the FTA policy. These are: increased importance of RTAs in world trade; changes in the international perception of regionalism; the need for securing export and investment markets; the need for accelerating restructuring and opening of the Korean economy; and strengthening of political and economic ties.³

1. Increased Importance of RTAs in World Trade

While the world economy is becoming more integrated on the basis of the multilateral system of the WTO, there is also the additional tendency of strengthening regionalism due to the widening and deepening of regional economic agreements.

Table 2. Number of Regional Trade Agreements Notified to GATT/WTO

	1948	1955	1960	1965	1970	1975	1980	1985	1990	1995
	1954	1959	1964	1969	1974	1979	1984	1989	1994	2001.3
Number of notifications	2	3	12	9	21	19	6	5	47	101
Total notified	2	5	17	26	47	66	72	77	124	225 ¹⁾

Note: 1) Of the total notified, 152 RTAs are currently in force.
Source: WTO Secretariat (2001).

As seen in the Table 2, the number of regional trade agreements rapidly expanded in the 1990s. Also, the share of world trade conducted within the framework of regional agreements grew steadily. The spread of regionalism has also been

² Sohn (2001b). *The Economic Effects of and Policy Direction for a Korea- Japan FTA*. Pp. 4-16.

³ While traditional advocates of free trade generally argue that the formation of an FTA will enhance the efficient allocation of resources and reinforce the competitiveness of the sectors with comparative advantage, thereby stimulating economic growth and welfare benefits, others who are against FTA argue that trade diversion effect, which means substituting cheaper goods from outside the FTA for more expensive goods within the region may overwhelm the trade creation effect, leading to the worsening of consumer's benefits and misallocation of resources. For a more detailed explanation of the pro and cons of FTAs, see Sohn (2001a), pp. 5-8.

accompanied by a drastic increase in intra-regional and inter-regional trade along with their correspondingly increasing shares of world trade. The increase in intra-regional and inter-regional trade has highlighted the importance of regional economies in world trade.

2. Changes in the International Perception of Regionalism

In the past, regionalism, in the form of FTAs or customs unions, was regarded as a stumbling block to multilateralism due to its perceived undermining of the progress of the multilateral system of GATT/WTO. However, the WTO and the OECD, through their official reports, acknowledged the reality that the existence of FTAs is an established characteristic of the world economy and accepted regionalism as a building block for multilateralism.⁴ In addition, with the launch of the U.S.-Canada FTA in 1989, the U.S. abandoned its traditional anti-regionalism stance and embraced it by co-creating NAFTA and co-designing the FTAA. As a result, regionalism is no more regarded as a contradictory or damaging force to multilateralism, but as a complementary element to accelerate the progress of multilateralism in establishing a global free trade system.

3. Securing Export and Investment Markets

Due to its small size and scarce endowment of natural resources, Korea traditionally had relied mainly on overseas markets through an active export strategy to achieve its remarkable economic growth. Furthermore, with the acceleration of the integration of the world economy and growing economic interdependence, trade and investment are becoming more and more fundamental sources of Korea's economic development.

However, Korea's export market is now being challenged more and more by both developed and developing countries. Competition with developed countries is still difficult as they maintain a dominant position in the world market with their high technological skills. On the other hand, developing countries are capturing Korea's market share in traditional areas with their price competitiveness based on cheap labor.

Moreover, with the proliferation of FTAs, Korea's major trading partners are now diverting their trade and investment more and more to their own members to take full advantage of their free trade areas.

By joining a regional bloc and cooperating with other members, Korea can secure a stable export and investment market and defend itself against the discriminatory effects of other regional groups. In addition, if the potential FTA partner is already a member of another FTA, it would be easier for Korea to gain access and diversify its exports to larger regional market.

⁴ WTO (1995). *Regionalism and the World Trading System*.

OECD (1995). *Regionalism and its Place in the Multilateral Trading System*.

4. Accelerating Restructuring and Opening of the Korean Economy

The financial crisis of 1997 revealed the structural weakness of the Korean economy. To overcome the crisis and stimulate growth, Korea has undergone a drastic restructuring process in the financial as well as real sector. Korea feels that economic restructuring and opening are the only keys to achieve sustainable economic development. Through the establishment of a comprehensive FTA with Japan or the U.S., Korea will not only liberalize trade in goods and services but also adopt more advanced trade and investment-related rules and measures to increase the transparency and efficiency of its economy.

Successful regulatory reforms and conformity to the international rules and standards embodied in an FTA framework will help form a strategic alliance with those countries and promote technology and capital transfer, thereby accelerating the restructuring and opening of the Korean economy.

5. Strengthening Political and Economic Ties

The formation of FTAs has offered countries a way to resolve issues that would be more difficult to tackle in the wider multilateral context. By accepting higher levels of commitment than in multilateral agreements, member states have conducted successful negotiations in deeper and more comprehensive areas. For example, in the case of NAFTA, areas of higher obligation include investment, financial services and intellectual property protection. NAFTA also has side agreements covering labor and environmental regulations.

In this new era of economic interdependence, Korea needs to protect and maximize its national interest by joining or creating trading blocs. 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. By forming an FTA with its major trading partners, Korea will strengthen its bargaining position and enhance its political influence and diplomatic weight in multilateral fora such as the WTO, OECD and IMF.

IV. Current Status of Korea's FTA Initiatives

Korea is currently conducting FTA negotiation with Chile and examining the feasibility of FTAs with major economies such as Japan, the U.S. and China, which are Korea's main trading partners and present huge markets. On the other hand, it is also considering forming strategic FTAs with relatively small but open economies such as New Zealand and Thailand. In this section, we will mainly discuss the current status of Korea's FTA initiatives with Chile, Japan and the U.S., compare the estimated economic effects of the three potential FTAs assessed by different institutes, both domestic and foreign, and provide future policy challenges.

1. Korea-Chile FTA

A. Background and Current Status⁵

The initiative for a Korea-Chile Free Trade Agreement began in November 1998 with the decision of the Inter-Ministerial Committee on International Economic Coordination. The main objective was to overcome the structural weakness of the Korean economy sharpened after the financial crisis, and to maximize the economic benefits of market expansion and foreign investment.

Before establishing FTAs with larger trade partners such as the U.S. and Japan, however, Korea needed to pursue strategic FTAs with smaller partners in order to minimize the risk and possible losses and to gain negotiating and operational experience of an FTA. In this respect, Chile was chosen as Korea's first FTA partner because it showed a strong interest in concluding an FTA. Also, Korea believed that Chile's open trade policy and its accumulated experience in concluding FTAs with other countries would certainly serve as a guide to conducting successful negotiations.

In December 1998, the Korean government formed a special task force on a Korea-Chile FTA which consisted of five specific technical groups covering: market access, trade rules, services, intellectual property and legal procedures. A Korea-Chile FTA Joint Committee Meeting was held in Chile in order to discuss the specific negotiation procedures.

In April 1999, the Korean and Chilean governments initiated the first meeting of the high-level working group for FTA negotiations. The main goal of this meeting was to discuss in depth the current economic situation of the two countries and major

⁵ Cheong (2000) and Yoon (1999).

issues related to an FTA on the basis of the questionnaires previously exchanged. The second meeting was held in June 1999 in Santiago, Chile. This meeting was particularly important because the two countries, after extensive exchanges of information within FTA coverage, decided to design the Framework Agreement in a general meeting. Based on the draft of the Framework Agreement proposed by the Korean delegation, they agreed on three basic principles of a Korea-Chile FTA: a comprehensive FTA, liberalization in all areas and transparency. The comprehensive FTA implies their commitment to abide by the basic terms and conditions of GATT/WTO, which emphasizes wider sectoral coverage while avoiding the misuse of the agreement for narrow and discriminatory arrangements. The scope of coverage will include seven specific subjects: goods, services, investment, IPR, government procurement, competition policy, and dispute settlement and other legal matters.

After two successful high-level negotiation meetings, the two heads of the state declared an official launch of Korea-Chile FTA negotiations at the APEC summit meeting in September 1999. After the official declaration, four negotiations were conducted by a high-level negotiating group during the period of 1999-2000.

During the four consecutive negotiations, the two sides elaborated and reviewed the draft text of the agreement and exchanged their preliminary tariff concession schedules. However, some disagreements were revealed over the tariff concession for sensitive sectors. Korea had proposed that some sensitive sectors such as agriculture should be exempt, but Chile insisted on no exceptions and, if not, the exclusion of some manufacturing products from the tariff concession. As a result, FTA negotiations have reached a stalemate. To narrow the gap and break the deadlock, in June 2001, the two countries agreed to hold a high-level meeting to revise and adjust their respective tariff concession schedule, and both sides are currently trying hard to hold the final round of FTA negotiations.

B. Analysis of Economic Effects

The assessment of the economic effects of a Korea-Chile FTA using the CGE model was conducted by KIEP in 1998.⁶ In assessing economic effects, three basic scenarios are presented. The first scenario is based on complete tariff elimination by both countries across all sectors. The second scenario is based on complete tariff elimination in general sectors and partial tariff reduction for agricultural products and livestock. The last scenario assumes zero tariffs in all sectors except for agriculture and livestock.

According to Table 3, the three scenarios bring almost the same positive results for Korea's welfare level with an increase of about \$950-960 million.

⁶ The CGE model is a computable general equilibrium model that has the advantage of determining the reallocation effects of resources caused by the cross-sectoral transfer of production factors.

On the other hand, Korea will see its GDP increase by 0.01% in all three scenarios. Growth of Korea's exports to Chile (\$660 million) will exceed that of imports (\$240-260 million), thereby resulting in an additional trade surplus of \$400-420 million in all three cases.

Table 3. Expected Economic Effects of a Korea-Chile FTA

(Unit: US\$ million)

	Overall Tariff Liberalization	50% Tariff Reduction in Agriculture	With Agriculture Excluded
Welfare	960	960	950
GDP (%)	0.01	0.01	0.01
Exports ¹⁾	660	660	660
Imports ¹⁾	260	250	240
Trade Balance	400	410	420

Note: 1) In value terms.

Source: Cheong Inkyo (2000). *Korea-Chile FTA: Background, Economic Effects and Policy Implications*. KIEP Policy Analysis 00-07.

C. Future Challenges

The successful formation of an FTA with Chile will be of special importance for Korea's future FTA policy because other potential agreements will heavily depend on the first model. Particularly, it will bear an important symbolic meaning for other potential FTAs under consideration with large economies

Korea considers Chile an appropriate FTA partner due to not only economic but also strategic considerations. As the two countries share complementary trade and production structures, the conclusion of a Korea-Chile FTA, in general, will bring mutual benefits in the short term. Moreover, in the long term, the strategic location of Chile will serve as a gateway for Korea to gain access to the huge Latin American market and expand to other free trade areas previously established by Chile. However, some obstacles and challenges still lay ahead for the successful conclusion of a Korea-Chile FTA.

1) Geographical Distance

Frankel (1997), in his work, *Regional Trading Blocs*, emphasized the importance of distance, using the concept of a gravity model. Based on this model, it is assumed that trade between countries depends positively on their size and inversely on distance. The effect of distance on trade is directly associated with three categories of costs: shipping costs, time-related costs and cultural unfamiliarity costs. In order to reduce

these costs and maximize the benefits of trade liberalization, it is desirable to form regional trade agreements between neighboring countries, i.e., within a natural trading bloc.⁷

From this perspective, a Korea-Chile FTA can be regarded as a unnatural trading bloc, where a country forms a bloc with country on a different continent with which it has a relatively small volume of trade. The formation of such unnatural trading blocs may have smaller effects on welfare and trade expansion as intercontinental transport costs are very high. Therefore, the main challenge will be how to develop efficient infrastructures in three cost-related areas (shipping costs, time-related costs and cultural unfamiliarity) between the two countries so that the disadvantages of such long distance trading may be alleviated.

2) Response of Sensitive Sectors

One of the main obstacles in pursuing a Korea-Chile will be the response of sensitive sectors. Due to the complementary structure of Korean and Chilean industry, trade liberalization will certainly bring benefits to Korea's competitive export sectors such as electronics, automobiles and chemical products. However, an import surge is expected in sensitive sectors in which Chile has a comparative advantage such as agriculture, forestry and fisheries.

While the manufacturing sector has generally shown a positive attitude toward a Korea-Chile FTA, the primary sector, in particular agricultural groups, have expressed deep concern. The fiercest opposition comes from producers of fruit such as grapes, kiwis and apples, in which Chilean exports, both the natural and processed, are highly competitive and maintain a dominant position in the world market. Korean farmers and agricultural organizations fear that imports of grapes, kiwi and apples from Chile will dramatically increase as a result of tariff elimination, resulting in decreased sales and prices of domestic products and reduced income for farmers. Therefore, the basic position of the agricultural sector is to avoid the conclusion of a Korea-Chile FTA or at least to exclude agriculture from the tariff concession schedules.

However, Chile does not accept the exclusion of agriculture, on which it places the most interest. For its part, it hopes to exclude manufacturing sectors such as textiles, footwear, washing machines and refrigerators, which are considered sensitive areas due to comparative disadvantage.

Therefore, the successful conclusion of a Korea-Chile FTA will mainly depend on gaining domestic consensus particularly in sensitive sectors and making bilateral concessions that will bring more balanced and mutually satisfactory results.

⁷ Frankel (1997) examines how the effect of the formation of free trade agreements on welfare depends on international transportation costs. According to him, the formation of natural trading blocs, where each country forms an FTA with its neighbor, will improve welfare, while the formation of unnatural trade blocs has only lower welfare effects due to high intercontinental transport costs.

3) The Need for Support and Active Participation of the Private Sector

For the Korea-Chile FTA negotiation to gain a real momentum, it is important that business and industrial groups, who will be the main beneficiaries of an FTA, take an active role in the process. They can provide technical assistance and useful advice that reflects the practical needs and problems they come across in their daily business transaction and will facilitate the implementation of an FTA through technical cooperation, strategic alliances and private investment.

On the other hand, public promotional efforts regarding the ongoing process and its possible benefits and challenges are needed so that the general public does not suffer from the fear that such economic opening will lead to a surge of foreign imports and massive unemployment.

In fact, public concern is unavoidable as this is Korea's case of FTA. Therefore, policymakers need to work in a consistent and responsible manner to gain public confidence and support for its FTA policy.

4) Compatibility with Multilateral Initiatives

Regional integration agreements, by their preferential and discriminatory nature, seem to contradict the basic principles of the multilateral trading system based on Most-Favored-Nation (MFN) rules. However, accepting them as a reality, the designers of GATT/WTO tried to make such agreements compatible with a rule-based multilateral approach and with a more open world trading system.

However, some economists still argue that the current spread of regional trading blocs is undermining the principle of MFN treatment under GATT/WTO, as such agreements have many loopholes and that GATT/WTO does not effectively enforce its requirements for such regional agreements.

As a Korea-Chile FTA also corresponds to such preferential and discriminatory trade agreements, the central concern is how to make the rules and procedures consistent with the multilateral rules of GATT/WTO.

Korea and Chile have traditionally favored the multilateral approach as their basic policy option for fostering trade and investment liberalization; therefore both countries committed themselves to faithfully abide by the rule-based requirements of GATT/WTO for forming an FTA, in order to not undermine the basic principle of non-discrimination and bring harm to third countries.

This position is reflected in the three basic principles of the Korea-Chile Framework Agreement: a comprehensive FTA, liberalization in all areas and transparency in implementation. This very spirit should be respected throughout the whole process of FTA negotiation and implementation.

2. Korea-Japan FTA

A. Background and Current Status

From the viewpoint of geographic proximity and cultural similarity, Korea and Japan could have maintained a much more cooperative relationship, yet for almost 30 years, since the normalization of diplomatic ties, bilateral relations have fallen short of expectations due to various issues. These include the import sources diversification program, the disputes over the Tokdo Island, past affairs, the prohibition of the importation of Japanese cultural products, and Korea's huge trade deficit with Japan, due to its high degree of economic dependency.

Recently, however, Korea and Japan have been actively seeking to pursue a bilateral FTA. Talks on a Korea-Japan FTA started in 1998 when President Kim Dae-jung and then Japanese Prime Minister Keizo Obuchi proposed the Action Plans for a New Korea-Japan Partnership for the 21st Century. The Action Plan suggested the promotion of trade, investment and cultural exchanges as the main subjects of cooperation. As the first concrete step, the two governments agreed to conduct joint studies on the economic effects of a Korea-Japan FTA at the private-sector level in October 1998. For that purpose, Korea and Japan established a 21st Century Korea-Japan Economic Relations Study Committee, and a joint study was simultaneously conducted by KIEP (Korea Institute for International Economic Policy) and IDE/JETRO (Institute of Developing Economies and Japan External Trade Organization) on the feasibility of a Korea-Japan FTA.

In May 2000, a joint symposium, "Toward a Korea-Japan FTA: Assessments and Prospects," was held in Seoul where the two sides presented the results of their respective studies and shared their views on ways to pursue an FTA. Although no official negotiations have yet been launched, the private sector took the lead in early 2001 in the form of a "Business Forum" where extensive exchanges of views occurred on pursuing a mutually beneficial FTA. The first joint meeting of the Business Forum was held in Seoul in September 2001, co-hosted by the Korea Chamber of Commerce (KCC) and the Japan-Korea Industrial Technology Foundation (JKITCF).

B. Economic Effects of a Korea-Japan FTA⁸

1) Effects of Tariff Elimination

Here we compare three different CGE analyses conducted by KIEP, Korea Institute for Industrial Economics and Trade (KIET) and IDE.

⁸ For a more detailed analysis, see Sohn, ed. (2001b). *The Economic Effects of and Policy Direction for a Korea-Japan FTA*. pp. 49-109.

The effects of a Korea-Japan FTA on the macroeconomic sector are summarized in Table 4.

As for real GDP, the KIEP and KIET studies give the same result; a fall in Korea's real GDP by 0.07%. This decrease in domestic production is due to the lower demand for investment and increased net imports from Japan, and also to the shift of domestic resources to inefficient sectors with lower factor productivity, such as agriculture and light industries. On the other hand, the effects of a Korea-Japan FTA on welfare are somewhat different. According to the KIEP analysis, the subsequent deterioration of real income will bring a 0.19% reduction of welfare. In contrast, the KIET report estimates that the welfare level will increase by 0.48%, which is attributed to the expansion of private consumption stimulated by the reduction of prices of Japanese imports after tariff elimination.

Table 4. Economic Effects of a Korea-Japan FTA

(Unit: US\$ billion)

Economic Indicators(Korea)		KIEP	KIET	IDE
Welfare (%)		-0.19	0.48	-
Real GDP (%)		-0.07	-0.07	-
Changes in Total Exports (%)		2.32	0.43	2.80
Changes in Total Imports (%)		3.40	1.00	2.47
Trade Balance	Changes in Trade Balance with Japan	-6.09	-3.36	-3.88
	Changes in Trade Balance with Other Regions	4.56	2.77	4.17
	Changes in Total Trade Balance	-1.54	-0.59	0.29

Sources: KIEP (2000). *Economic Effects of and Policy Directions for a Korea-Japan FTA*. Seminar paper.

IDE (2000). *Toward Closer Japan-Korea Economic Relations in the 21st Century*. Seminar paper.

KIET (1999). *Sectoral Effects of a Korea-Japan FTA and Policy Response*.

Although KIEP's estimates of export and import growth rates (2.32% and 3.40%) are higher than KIET's (0.43% and 1.0%), both studies equally expect that the growth rate of Korea's total imports will exceed that of total exports, thus aggravating the overall trade balance. In contrast, IDE estimated that the growth in Korea's total exports (2.80%) will surpass total imports (2.47%).

Korea's trade balance with Japan is expected to record an additional trade deficit of \$6.1 billion and \$3.4 billion, according to KIEP and KIET, respectively. IDE analysis also expects that Korea's trade deficit will grow additionally by \$3.88 billion. The increased trade deficit with Japan comes from the expansion of bilateral trade. This is due to Korea's inelastic structure of trade with Japan and trade diversion resulting in an additional shift to Japanese imports, as well as Korea's worsening of

terms of trade resulting from the elimination of its relatively higher tariff rates.⁹ However, both the KIEP and KIET studies estimate that trade balances with third countries will improve, recording a trade surplus of \$2.8–\$4.6 billion. Therefore, Korea’s total trade balance will post a deficit increase of only \$590 million–\$1.5 billion.

On the other hand, the IDE study even expects that Korea’s trade surplus with third countries will be greater than the trade deficit with Japan, thereby resulting in a \$290 million improvement of Korea’s overall trade balance.

2) Overall Economic Effects (tariff elimination + productivity enhancement)

The KIEP report extends its analysis by assuming that a Korea-Japan FTA will attract a yearly average of \$3 billion of FDI, mainly from Japan.

Table 5. Overall Economic Effects of a Korea-Japan FTA

(Unit: US\$ billion, %)

Economic Indicators(Korea)		Overall Economic Effects
Welfare (%)		11.24
Real GDP (%)		2.81
Trade Balance	Changes in Trade Balance with Japan	-6.53
	Changes in Trade Balance with Other Regions	8.01
	Changes in Total Trade Balance	1.48

Source: Sohn, ed. (2001b). *The Economic Effects of and Policy Direction for a Korea- Japan FTA*. KIEP Policy Reference Paper 01-03.

If this is invested mainly in Korea’s heavy and chemical industries, it is expected to increase Korea’s factor productivity by 1 percent point annually through the cross-sectoral reallocation of production resources. Based on this assumption, the KIEP study estimates the combined effects of tariff elimination and productivity enhancement under a Korea-Japan FTA (Table 5).¹⁰

⁹ Trade diversion effect occurs when country A diverts its imports from a low-cost foreign supplier to the high-cost FTA partner after the elimination of tariffs. This trade diversion brings a deadweight loss measured by the increased cost of procuring imports produced in the partner country.

¹⁰ In order to estimate the overall effects of a Korea-Japan FTA, we also need to take into account other important factors such as investment expansion and productivity enhancement, in addition to the elimination of trade barriers. The formation of an FTA can stimulate the expansion of FDI from the FTA partner and third countries as firms move their production facilities from nonmember countries to member countries in order to take advantage of zero tariffs within the free trade area. Also, the formation of a Korea-Japan FTA will attract FDI from nonmember countries trying to gain easy access to regional markets after tariff elimination. This increase in FDI, if efficiently reallocated between light industry and the heavy and chemical industries, is estimated to expand the level of output, thus

According to the KIEP analysis, with the combination of the effects of tariff elimination and productivity enhancement, Korea's total trade balance with the world is expected to improve by \$1.48 billion. Korea can expect real GDP growth of 2.81 percent point and an annual welfare level improvement by 11.24 percent point. It expects that the trade deficit with Japan will expand further by \$6.53 billion. However, with the more than \$7 billion improvement of the trade surplus by with the rest of the world, Korea's total trade balance is expected to improve slightly by \$1.48 billion.

C. Future Challenges

The peculiarities of Korea-Japan economic relations identified below may act as real barriers to realizing a successful Korea-Japan FTA. The key question is how to design a Korea-Japan FTA in a way that can maximize the mutual benefits, while addressing these challenging issues.

1) Further Deterioration of the Trade Balance

Although Korea and Japan are important trading partners for each other, Korea suffers from a serious chronic trade deficit with Japan.¹¹ If we examine bilateral trade for the period 1965-2000, Korea's trade balance with Japan steadily deteriorated, peaking at more than \$15 billion dollars in the mid 1990s. Immediately after the Asian financial crisis, it dropped sharply to \$4.6 billion in 1998. Yet, with the economic recovery, it is now worsening again, recording a deficit of \$11.4 billion in 2000. In fact, Korea suffers its largest negative trade balance with Japan.¹²

Moreover, the various economic feasibility studies previously mentioned predict that Korea's trade deficit with Japan will not improve but further deteriorate as a result of a Korea-Japan FTA. Although this negative result of tariff elimination is only a static, short-term effect of an FTA, much concern is being raised by the public over a worsening trade balance. The desirability of a Korea-Japan FTA itself may put into question by this negative public perception.

Of course, an FTA cannot be assessed only in terms of the short-term effects of tariff elimination. The long-term dynamic gains from the integrated market, intensified competition, corporate alliances, and attraction of FDI are expected to more than offset the short-term negative effects. However, to realize these dynamic gains, more sophisticated and detailed rules and cooperation mechanisms will be needed in designing a Korea-Japan FTA.

enhancing the total factor productivity as a result of the economies of scale.

¹¹Japan is the second largest exporter and importer for Korea, while Korea is the fourth largest importer and third largest exporter for Japan.

¹² Korea's total trade surplus in 2000 was \$11.8 billion, which almost equals its trade deficit with Japan as a single country. This clearly shows the enormous size of Korea's trade deficit with Japan.

2) Stagnation of Bilateral Direct Investment

Bilateral direct investment between the two countries has been relatively stagnant compared to the level of trade flows. During 1994 and 1995, however, it reached a record high, showing a downward or stagnant trend since then. Of Korea's total FDI, Japan's share peaked at 34.85% in 1994, but it has dropped drastically, accounting for only 7.6%-8.0% since 1997. Although FDI from Japan recently posted a growth rate of more than 200%, recording \$2.4 billion in 2000, its share (15.6%) is still below the level of Korea's other major trading partners such as the U.S. (18.6%) and EU (29.3%). Also, of Korea's total outward direct investment (ODI), Japan's share has stayed steady level at around 2.0%, recording \$94 million in 2000 (1.95%). The share is very insignificant compared to Korea's ODI in the U.S. (24.5%) and China (13.4%). The stagnation of bilateral investment implies that there exist significant investment barriers between the two countries such as complex administration procedures, labor inflexibility, unfair business practices and strict investment regulation.

The expansion of bilateral investment is of particular interest for Korea since it will not only increase the benefits of a Korea-Japan FTA by complementing trade, but may also be the most efficient complementary method for alleviating the negative impact of the tariff elimination of a Korea-Japan FTA on Korea's heavy and chemical industries.

3) Similarity in Production Structure: From Inter-Industry to Intra-Industry Trade

The traditional theory of comparative advantage based on the two country- two goods model argues that free inter-industry trade between two countries can be mutually beneficial as they specialize in production and export of sectors having comparative advantage.

According to the Revealed Comparative Advantage (RCA) analysis, however, Korea and Japan share a similar structure of comparative advantages, indicating that their export structures are assumed to be in a highly competitive relationship.

As a result, a Korea-Japan FTA is not expected to create an effective specialization system due to the similar production and export structures of the two countries. Moreover, if we assume that an FTA reinforces the current system of trade specialization between the two countries, a Korea-Japan FTA will negatively affect some of Korea's competitive sectors such as iron and steel, and electric and electronic products. This is because these sectors, in spite of their comparative advantages, will eventually lose competitiveness in the domestic and Japanese markets, thus resulting in import specialization from Japan. On the other hand, export specialization in some inefficient sectors, including primary and light industries, will reduce general production efficiency due to the absorption of production factors by these industries.

Therefore, the key question will be how to develop intra-industry trade in those sectors where Korea and Japan both have comparative advantage in the world and intensely compete with one another.

A fair system of specialization and product differentiation will promote intra-industry trade between the firms of the two countries so that intensified competition promote the dynamic gains of an FTA rather than develop into a battle for survival.

4) Need for a Comprehensive Business Initiative

In order to reap the full benefits of the expansion of trade and investment, and the stimulation of competition and productivity enhancement, a Korea-Japan FTA should be approached through a comprehensive framework that includes not only increased market access through the elimination of tariff and non-tariff barriers, but also the promotion of investment and technical and industrial cooperation; mutual recognition agreements; and the effective implementation of competition policy. In this regard, the two governments may closely work together to coordinate their domestic reform policies such as deregulation and increased transparency in corporate governance as well as their external policies for promoting bilateral cooperation in investment, industry and technology and the expansion of the exchange of human resources.

In addition, a wide range of discussions on a Korea-Japan FTA should take place within and between the business sectors of two countries to foster their crucial role as an integral part of designing an FTA.

3. Korea-U.S. FTA

A. Background and Current Status

Though Korea and the U.S. have been important trading partners for four decades, their trade relationship has been often threatened by serious disputes.

Talks on a Korea-U.S. FTA actually began in the late 1980s when both countries, in view of their growing economic interdependency, felt the strong need for deeper forms of bilateral cooperation, particularly in the trade sector. As Korean exports faced severe trade sanctions under the Section 301 of Trade Act of 1974, its main interest lay in securing the U.S. market by avoiding future trade retaliation and discrimination. On the other hand, the U.S. hoped that an FTA with Korea would reduce significant trade barriers, thereby facilitating access to the Korean market. With this growing interest in renewing the bilateral partnership, several academic studies have been conducted on the feasibility of a Korea-U.S. FTA.

Real progress, however, came in the late 1990s, when the two countries started to actively pursue FTA initiatives as a parallel approach to multilateral trade liberalization. Beyond NAFTA, the U.S. has initiated FTA talks with other strategic

partners such as Chile, Singapore; Korea, for its part, officially announced an FTA as its main trade policy framework. As a preliminary step to an FTA, in June 1999, the two heads of state agreed to launch talks on a bilateral investment agreement. Although the negotiations reached a stalemate due to screen quota problems, an intensive review is currently being made at the working group level for a breakthrough.

With no formal bilateral FTA initiatives yet at the government level, the private sector, particularly U.S. and Korean companies, have so far been leading talks on the possibility of an FTA. Also, on the political scene, Democratic Senator Max Baucus submitted a bill, The United States-Korea Free Trade Agreement Act of 1999, in 1999 that would authorize the U.S. government to launch FTA negotiations with Korea with fast-track consideration, and reintroduced the bill on May 23, 2001.¹³ As a part of this legislative initiative, in December 2000, the Senate Finance Committee requested the U.S. International Trade Commission (USITC) submit a report on the feasibility study on a Korea-U.S. FTA. Additionally, a public hearing was recently held by USITC to discuss the issues of a Korea-U.S. FTA from the business community's perspective. Four participating U.S. industries including the textile, automobile, cosmetic and footwear industries, expressed a rather reserved opinion of a Korea-U.S. FTA due to Korea's high non-tariff barriers and strong competitiveness.

Although not much progress is expected on Korea-U.S. FTA talks in the short term, the two countries show a preference for each other as potential FTA partners. Therefore, once the need for and interest in a bilateral FTA are clearly identified and recognized, Korea-U.S. FTA negotiations will gain momentum.

B. Analysis of the Economic Effects

Here two important studies on the economic effects of a Korea-U.S. FTA made by KIEP and Institute for International Economics (IIE) in 1999 and 2001, respectively are to be quoted.

The KIEP study is based on following different scenarios: a comprehensive liberalization, a partial liberalization with 50% tariff reduction in agriculture and 100% in all other sectors, and a partial liberalization with 0% tariff reduction in agriculture.¹⁴ As seen in Table 6, the greatest welfare increase (1.73 %) is expected in the case of comprehensive liberalization. If agriculture is completely excluded from the liberalization scheme, the welfare benefit is estimated to be reduced to \$3.3 billion. Real income is also expected to increase in all three cases, though in the case of the exclusion of agriculture (0.78%), the growth rate will be only half that for

¹³ Inside U.S. Trade. "Baucus Introduces Bills Authorizing FTA Talks with Korea, New Zealand, Australia." May 23, 2001.

¹⁴ For simplification, two other scenarios (50% reduction in all sectors with and without agriculture) were excluded from the discussion.

comprehensive liberalization (1.47%).

Table 6. Economic Effects of a Korea-U.S. FTA on the Korean Economy (KIEP)

(Unit: US\$ billion, %)

	Comprehensive Liberalization (100%)	Agriculture	
		Partial Liberalization (50%)	Whole Exclusion
Welfare Index (%)	1.73	1.51	1.19
Equivalent Variation	4.8	4.2	3.3
Real Income (%)	1.47	1.10	0.78
Price Index (%)	-3.11	-0.07	0.22

Source: Cheong, Inkyo and Yunjong Wang (1999). "Korea-U.S. FTA: Prospects and Analysis." KIEP Working Paper 99-03.

On the other hand, the IIE study estimates the welfare effects of a Korea-U.S. FTA based on two main scenarios: full liberalization and excluding agriculture. For each scenario, it also assesses medium-run and long run effects depending on a fixed or flexible endowment of production factors.

Table 7. Economic Effects of a Korea-U.S. FTA on the Korean Economy (IIE)

(Unit: US\$ million, %)

Economic Effects	Comprehensive FTA		Agriculture Excluded	
	Medium Run	Long Run	Medium Run	Long Run
Welfare Effects ²⁾	4,099.6 (0.91)	10,860.7 (2.41)	1,712.2 (0.38)	4,923.4 (1.09)
Exports to U.S. (%) ³⁾	26.2	30.3	23.8	25.5
Imports from U.S. (%) ³⁾	46.1	49.4	22.1	23.3

Note: 1) The base year for simulation is 1995.

2) Mean equivalent variation in millions of 1995 dollars; percent of GDP in parentheses

3) Percent change

Source: Choi, Inbom and Jeffrey J. Schott (2001). *Free Trade between Korea and the United States?*

As seen in Table 7, according to the IIE analysis, the two scenarios produce welfare benefits. However, the welfare gains are more than double under a comprehensive FTA, with \$4.1 billion in the medium run. If the allocation and the level of capital stock are to adjust in the long run, the welfare benefits are expected to be even greater, amounting to \$10.9 billion.¹⁵

¹⁵ The welfare gains for the U.S., according to IIE analysis, is estimated to be in the range of \$1.5 billion to \$8.9 billion, which means that Korea as a smaller economy will enjoy far more welfare gains in proportional terms. Moreover, the IIE analysis points out that the welfare gains of the two countries derive from different effects. In Korea's case, most gains come from allocative efficiency while for the U.S., the effects of improved terms of trade is the largest source of gains.

In terms of real income, it is estimated that comprehensive liberalization in the long run will result in a growth rate of 2.41%, more than double that of the case of partial liberalization with agriculture excluded (1.09%), which is similar to the KIEP results.

As for bilateral trade volumes, a Korea-U.S. FTA is expected to result in an increase in Korean exports as well as imports from the U.S. Korea will enjoy an additional trade surplus with the U.S. if agriculture is excluded. It is estimated, however, that under a comprehensive and medium run scenario, the growth of Korea's imports from the U.S. (46.1%) will exceed export growth, thereby leading to a deterioration of Korea's trade balance with the U.S. However, in the IIE report, Korea's trade balance with Japan is expected to improve and therefore its overall trade balance may become positive depending on the magnitude of trade creation and trade diversion.

C. Future Challenges

Although a Korea-U.S. FTA in general is expected to bring economic benefits through the expansion of bilateral trade and investment and efficient allocation of resources, the two countries may face several difficulties in carrying out successful negotiations when different interests are involved.

One important issue is how to cope with the strong opposition from sensitive sectors: agriculture in Korea's case; textiles, apparel and automobiles in the U.S. As we have already seen in the case of a Korea-Chile FTA, the main cause of the stalemate in negotiations is Korea's agriculture sector, which is strongly against the opening of the agricultural market. Taking into account the high competitiveness of the U.S. in the production and exports of agricultural products, even greater opposition is expected from Korea's agricultural sector when pursuing a Korea-U.S. FTA. The U.S., on the other hand, is also expected to receive strong pressure from the textiles, apparel, and automobile industries, in which Korea is highly competitive.¹⁶ The two countries should therefore seek to make mutual concession in the areas where most interest is at stake. In this sense, a Korea-U.S. FTA, though basically based on a comprehensive framework, could allow some reservations and exceptions in some specific areas, as was the case with NAFTA.

Another issue is the trade balance problem. As shown in the analysis of economic effects, Korea's trade balance with the U.S. is expected to deteriorate as a result of a Korea-U.S. FTA. Some may raise the question of the merit of an FTA with the U.S. if it will result in worsening, not improving, Korea's trade balance. However, the short-term negative effects could be offset in the long run by strengthening Korea's competitiveness through FDI and technology transfer from the U.S. Moreover, Korea will enjoy a trade expansion effect by avoiding significant trade barriers in the form of

¹⁶ Choi & Schott (2001).

antidumping and countervailing measures by the U.S.¹⁷

The U.S. is also showing great interest in the opening of the financial and service sectors and trade rules-related areas such as the elimination of restrictive trade regulations and unfair practices, and protection of intellectual property rights and raising labor and environmental standards. Also one of the main objectives of Korea's FTA policy is the restructuring of the economy through the adoption of rules and standards of developed countries. Therefore, in the case of a Korea-U.S. FTA, Korea should work in closer cooperation with the U.S. to improve its inefficient economic structure, thereby maximizing the potential gains of an FTA.

4. Korea-China-Japan FTA¹⁸

Since the Asian financial crisis, Northeast Asian countries have felt a pressing need to strengthen economic cooperation through the establishment of some kind of regional economic integration. Currently there are various ongoing talks on possible approaches to materialize cooperation in Northeast Asia.

The first approach is to establish a trilateral FTA among Korea, Japan and China. In this way, Japan and Korea can take advantage of the huge market and cheap natural and human resources of China, while China can benefit from technology transfer and FDI from Korea and Japan. Moreover, no one is likely to suffer from a unilateral trade imbalance after tariff elimination, as the trade deficit with one will be partly compensated by a trade surplus with the other, according to the current trade structure.

However, this approach seems difficult to achieve in the short term due to several reasons. First, although China is expected to the WTO by 2001 and is committed to reducing its average tariff rates from 16.8% to 9.44% by 2005, its applied tariff rates for Korea and Japan are expected to be still high, making a Korea-China-Japan FTA unrealizable. Moreover, China currently shows little interest in pursuing Northeast Asia economic integration. On the other hand, China and Korea may fear that the economic integration will become another form of Japanese dominance, due to their deepening economic dependency on Japan.

The second and more feasible approach is two-staged economic integration: form a bilateral FTA between Korea and Japan first and incorporate China at a later stage. As both Korea and Japan have a market economy and the economic gap between them is narrower than with China, relatively lower institutional barriers lie in the way of them forming an FTA. Moreover, the successful launch of a Korea-Japan FTA will

¹⁷ In addition, the IIE report points out that this kind of trade balance problem could still be beneficial to Korea in terms of its trade relations management with the U.S. and Japan. As Korea is under pressure from the U.S. due to its chronic trade surplus on one hand and suffering a chronic trade deficit with Japan, the trade diversion from Japan to the U.S. as a result of a Korea-U.S. FTA is expected to enable Korea to mitigate the trade imbalances with the US and Japan.

¹⁸ For a more detailed explanation, refer to Sohn (2001a) and Cheong (1999).

motivate China to join it as soon as possible in order to avoid serious trade diversion, thereby accelerating the process of Northeast Asian economic integration. However, the second approach also has drawbacks as seen in the previous discussion on a Korea-Japan FTA. In general, Korea, with its higher tariffs and lower level of technology, fears a deterioration of the trade imbalance with and deepening of economic dependency on Japan. On the other hand, China could take a negative stance on any kind of preferential trade agreement between Korea and Japan that excludes it.

Discussions have already started on the possibility of establishing Northeast Asian economic cooperation in the form of a Korea-China FTA, Korea-Japan FTA or Korea-China-Japan FTA. Considering the high concentration of intra-regional trade among the three countries, the complementarity of their industrial structure and geographic proximity, there is a high probability that they will create some kind of economic cooperation in the future. The creation of an FTA between Korea, Japan and China will promote regional trade liberalization and high specialization in relatively competitive industries; therefore, it is expected to bring economic growth and raise the welfare level of the three countries. However, to realize such an FTA, a careful feasibility study based on possible trade and welfare effects should be performed in advance. In addition, as the three economies differ considerably in their trade norms and institutions, they need to harmonize their trade-related rules and procedures before the formation of an FTA. Moreover, overcoming historical animosity and forming public consensus will be another crucial task in addition to economic considerations.

5. Other FTAs under Consideration

Korea has also been conducting a joint feasibility study of FTAs with New Zealand and Thailand at the level of private institutes since September and November 1999, respectively. In Korea's case, KIEP was in charge of conducting the analysis.

The results of the interim report of feasibility analysis of a Korea-Thailand FTA were completed and exchanged in March 2001 and that of a Korea-New Zealand FTA are expected to be released in late 2001.¹⁹ These studies will serve as a useful foundation for taking further steps in FTA negotiations with those countries.

There are also ongoing informal talks on the need for the formation of ASEAN+3 (i.e., Korea, Japan and China), which could serve as an East Asian economic arrangement to counterbalance other major regional economic blocs such as NAFTA and the EU.

¹⁹ This is from an update on the official website of MOFAT in August 2001. However, according to informal sources, the deadline for the completion of the interim report on a Korea-New Zealand FTA may be extended until next year.

V. Selection Criteria for Choosing Desirable FTA Partners

Even though Korea is determined to actively pursue the FTA policy, finding a good FTA partner that could maximize the gains of trade liberalization is not a simple proposition. Korea's FTA initiatives, still in its initial stages, lack clear and consistent direction. In order to define and project the future course of Korea's FTA policy, however, some clear selection criteria for choosing a desirable FTA partner will be needed.²⁰

Therefore, in this section, we suggest five important selection criteria that could be useful in determining eligible FTA candidates. These are: the structure of comparative advantage, income level, geographical proximity, market size and the level of outstanding trade barriers.²¹

1. The Structure of Comparative Advantage

Comparative advantage reflects a country's industrial and trade structure and according to the traditional theory of comparative advantage based on the two country- two goods model, free trade between the two countries can be mutually beneficial as they specialize in production and export of sectors having comparative advantage. The structure of comparative advantages, therefore, will be one the most important criteria for determining eligible FTA partner.

As seen in Table 8, according to the RCA (revealed comparative advantage) analysis, Spearman's rank correlation coefficient of the RCA indicator between Korea and U.S or Korea and China is relatively low, implying that they have complementary structures of comparative advantage. Therefore, an FTA with China or the U.S. is expected to foster inter-industry trade based on an efficient system of specialization, bringing trade benefits in the form of economies of scale and efficient allocation of resources. This is also the case for a Korea-Chile FTA.

²⁰ Although many FTAs currently exist in the world, there is little literature that suggest clear criteria for the selection of desirable FTA partners. Multiple factors, not only from economic but also historical and political dimensions, may intervene in the formation of FTAs. However, in this paper we consider five important criteria taking into account only economic factors.

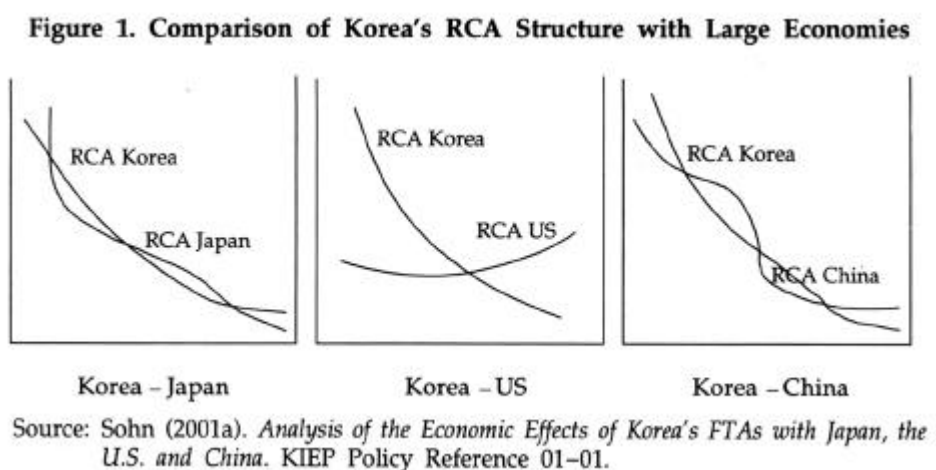
²¹ The determination of the five criteria may seem somewhat arbitrary but it actually derives from our previous empirical studies including "Does the Gravity Model Fit Korea's Trade Patterns?" (KIEP Working Paper 01-01, 2001), "Free Trade Agreements and the Income Convergence of Member Countries: Lessons from the EU, NAFTA and ANZCER," (*Journal of International Economic Policy Studies*, Volume 4, 2000), and *Analysis of the Economic Effects of Korea's FTAs with Japan, the U.S. and China, Japan*. (KIEP Policy Reference 01-01, 2001). For a more detailed and synthesized theoretical foundation, see also Sohn (2001b), *The Economic Effects of and Policy Direction for a Korea-Japan FTA*, (KIEP Policy Reference 01-03).

On the other hand, modern trade theories based on the differentiated products model argue that countries having similar structure of comparative advantage will trade more through product differentiation based on intra-industry trade.²² This type of trade is typical among developed countries such as the EU or the U.S.-Canada FTA. Also, it would be the case of a Korea-Japan FTA as the Spearman's rank correlation coefficient of the RCA indicator between them is 0.5984, which is fairly high.

Table 8. Matrix of Spearman's Rank Correlation of RCA

	Japan	China	U.S.
Korea	0.584	0.2852	- 0.0576
Japan	-	0.1754	0.3094
China	-	-	- 0.3049

Source: Sohn (2001a). *Analysis of the Economic Effects of Korea's FTAs with Japan, the U.S. and China*. KIEP Policy Reference 01-01.



This means that Korea and Japan sharesimilar structures of comparative advantages and maintain a competitive relationship in their export structures. However, a Korea-Japan FTA, if properly designed, has the possibility to develop into an advanced form of intra-industry trade, mitigating competition and increasing efficiency and strategic alliances.

2. Income Level

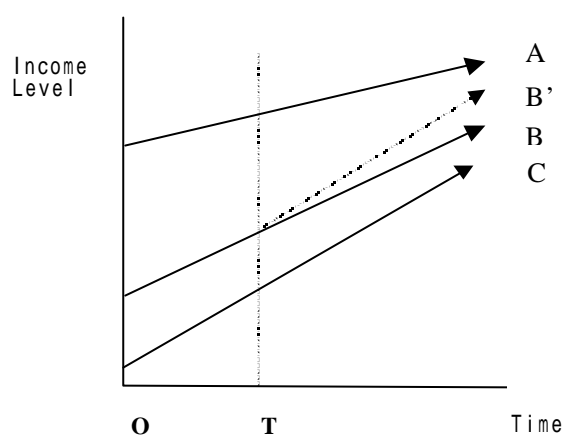
It is generally known that an FTA between countries at different economic levels will deepen the economic dependency of the lower income country as the higher

²² Helpman (1987).

income country will monopolize the benefits of free trade by means of abundant capital, efficient markets and advanced technology.

However, Sohn and Yim (2000) in their empirical analysis of the EU, AFTA and ANZEC, showed that an FTA will produce economic convergence among its members.²³

Figure 2. Accelerated Income Convergence Effect of FTAs



Source: Sohn and Yim (2000). “ Free Trade Agreements and the Income Convergence of Member Countries: Lessons from the EU, NAFTA and ANZECER.”

Figure 2 shows the accelerated income convergence effect of an FTA. If the countries A and B form an FTA at time T, the income level of country B is projected to converge with that of A at a faster (B') than without an FTA (B). For example, in the case of the EU-6, the income convergence indicator almost doubled after the launch of the EEC (European Economic Community) in 1958.²⁴

The convergence of income means that the benefits of an FTA with developed countries are realized not only through the increased trade benefit from the elimination of tariff and non-tariff barriers but also through technology transfer, increased capital productivity and savings rates. Therefore, Korea, by forming an FTA with developed countries such as Japan or the U.S., is expected to enjoy an accelerated income convergence effect in addition to the potential trade gains from free trade.

²³ Sohn and Yim (2000).

²⁴ EU-6 means the six countries that were the first members of the EEC which later became the EU through a process of enlargement. These include, West Germany, France, Italy, Belgium, the Netherlands and Luxembourg.

3. Market Size²⁵

Market size is considered one factor in explaining bilateral trade volumes. From an export perspective, it reflects the production capacity and from an import perspective, it implies purchasing capacity. Larger countries with large production capacity are more likely to achieve economies of scale and increase their exports. On the other hand, they have large domestic markets to absorb more imports. Therefore, the larger a trading partner's market size, the more room for trade expansion.

According to the empirical analysis of Korea's trade patterns based on the gravity model, it is found that the GDP variable as a proxy of market size is the most influential determinant of Korea's bilateral trade volumes, explaining 47%. As one of the main objectives of Korea's FTA policy is to secure export markets and maximize the benefits of market integration and trade expansion, it would therefore be more desirable for Korea to pursue an FTA with large economies such as Japan, China or the U.S.

4. Geographical Proximity

While traditional international trade theories emphasize the importance of purely economic factors such as comparative advantage and factor endowment in determining bilateral trade volumes, modern theories, in particular, the gravity model, pay more attention to the role of geographic elements such as distance, adjacency, population, language and cultural similarities.

Some fundamental reasons why distance can act as a determinant factor in international trade can be mentioned.²⁶ First, short distances will reduce shipping costs and transport times. This, in turn, will lead to regional agglomeration of specific industries across borders, thereby expanding bilateral trade. In addition, countries close to each other have a strong policy preference to increase not only regional welfare benefit but also their market power in the world economy by forming a natural trading bloc. In reality, the importance of distance is also evidenced by existing RTAs such as NAFTA, the EU, MERCOSUR, ANZCER, whose members are all closely situated.

As for Korea, the distance was also found to be an important factor, explaining

²⁵ The next three criteria are mainly based on the gravity model, which aims at explaining the bilateral trade flows and patterns between two economies by regarding them as organic bodies that attract each other in proportion to their economic size (GDP) and inversely to their distance. According to the empirical study of Sohn and Yoon (2001), it was found that Korea's bilateral trade patterns follow the basic gravity model, implying that bilateral trade flows will increase in proportion to the trading partner's GDP and decrease in proportion to the distance involved. Therefore, in order to expand bilateral trade flows, it appears to be more desirable for Korea to promote bilateral trade with countries in close proximity and having large economies. For a more detailed analysis, see Sohn and Yoon (2001).

²⁶ Frankel (1997).

17% of its bilateral trade volume. Therefore, from the perspective of the gravity model, it would be desirable for Korea to conclude an FTA with geographically proximate countries such as Japan or China.

5. Level of Outstanding Trade Barriers

The bilateral trade volume between two countries largely depends on existing trade barriers. If Korea's actual trade volume with a certain country falls far short of the potential value, it implies that a significant level of outstanding trade obstacles exist, both in the form of tariffs and non-tariffs barriers.²⁷

Table 9. Korea's Actual and Potential Trade¹⁾

(Unit: US\$ million, %)

Country	Actual Trade (T)	Potential Trade (\hat{T}_{ii})	T_{ii}/\hat{T}_{ii} (%)
Chile	1,583	668	237
Italy	4,400	3,293	134
Malaysia	5,001	4,105	122
U.S.	50,184	45,845	109
Australia	5,039	4,717	107
Taiwan	6,166	6,123	101
New Zealand	989	1,003	99
China	19,165	22,343	85
Canada	3,830	5,616	68
Japan	46,896	70,059	67
Thailand	3,342	5,231	64

Note: 1) 1995 as the base year

Source: Sohn and Yoon (2001). "Does the gravity Model Fit Korea's Trade Patterns? : Implication For Korea's FTA Policy and North-South Korean Trade."

The existence of "missing trade" can be a determinant factor in choosing a desirable FTA partner for Korea. The wider the gap between the actual and potential trade volume, the greater trade expansion effect that will take place through the elimination of the trade barriers. As seen in Table 9, Korea's trade with Japan and China, in particular, having all the favorable factors for expanding bilateral trade, such

²⁷ Here, potential trade volume means the level of bilateral trade volume that could be achieved under normal conditions where a country imposes an average level of trade barriers on its trading partner. If the actual trade volume is much smaller than potential trade volume, it means that there exist outstanding trade barriers (so-called "missing trade") far beyond the average level.

as large economic size and close proximity, fall short of the potential trade flows by 33% and 15%, respectively, implying the presence of outstanding trade barriers. Through an FTA with these countries, Korea is therefore expected to expand bilateral trade flows not only in the form of the trade creation effect but also through the recovery of the missing trade caused by outstanding trade barriers.

6. Overall Assessment: Viable FTA Partners

Taking into account all five criteria mentioned above, we can assess which countries are Korea's most viable and desirable FTA partners in the future. An FTA with China is recommendable as it has a huge market, geographical proximity and the presence of significant missing trade. A Korea-U.S. FTA is also very desirable as the U.S. has a complementary structure of comparative advantage, high income level and huge market.

Table 10. Assessment of Selection Criteria of Korea's Major Trading Partners

	U.S.	China	Japan	EU	AFTA
Structure of Comparative Advantage	Complementary	Middle	Competitive	Competitive	Complementary
Geographical Proximity	Distant	Close	Close	Distant	Middle
Income Level	High	Low	High	High	Low
Market Size	Big	Big	Big	Big	Small
Level of Missing Trade	Low	High	High	Low	Middle

Note: The structures of comparative advantage of EU and AFTA are qualitatively conjectured, whereas those of the U.S., China and Japan are empirically estimated.

However, as seen in Table 10, a Korea-Japan FTA is assessed to be the most desirable as all five criteria could be met provided that it is designed in such a way that promotes intra-industry trade.

VI. Future Prospects of Korea's FTA Policy

As emphasized earlier, Korea regards the multilateral approach as its basic policy option for fostering trade and investment liberalization and therefore commits itself to faithfully abide by the rule-based terms and conditions of GATT/WTO.

However, in this era of the coexistence of multilateralism and regionalism, it is believed that RTAs, in many cases, have served as stepping stones to integration into the global free trading system, helping industries, sectors and countries adjust to the competitive winds of liberalization. Therefore, acknowledging that regional and multilateral agreements are complementary rather than contradictory in the pursuit of more liberal and open trade, Korea also pursues a parallel approach of multilateral and regional trade initiatives in order to protect and maximize economic benefits of the continued liberalization process.

Korea's future FTA strategy, in this regard, can be promoted in two main directions.

First, in order to maximize the benefits of trade and investment liberalization, to secure export market and to modernize its economic structure, Korea needs to design FTAs with large and advanced economies such as the U.S., EU and Japan. An FTA with those countries will not be feasible in the short run, as various conflicting issues such as trade imbalance problems and opposition from sensitive sectors remain unsolved. Therefore, they should be pursued in the long run with a deliberate and sophisticated approach. In the short run, it will be necessary for Korea to restructure its economy and accumulate more experience in operating under a freer trade regime.

Secondly, Korea should consider a strategic FTA with China, Japan and ASEAN countries (ASEAN+3) to become an East Asian regional trading arrangement, which could promote regional interests and serve as a countervailing force to other dominant trading blocs such as the EU or NAFTA.

However, from a practical point of view, the formation of a regional economic arrangement in the form of ASEAN+3 is not quite viable in the short term for two main reasons.²⁸

First, as mentioned earlier, China will be busy meeting WTO entry criteria by implementing significant tariff cuts from 16.8% to 9.44% by 2004 and thus will hardly be able to bear the burden of an additional tariff cut to zero in substantially all trade for an FTA with Korea and Japan.

Secondly, as AFTA (ASEAN FTA) is founded on the basis of the 'Enabling Clause' of the GATT, being regarded as an exceptional case of preferential trading

²⁸ For more details, see Sohn (2001c).

arrangements among developing countries, the incorporation of Korea, Japan and China to form an ASEAN+3 FTA will not be feasible unless AFTA is transformed into an FTA under GATT XXIV, covering substantially all trade.²⁹

As a result, the formation of ASEAN+3 will be a time-consuming and complex process, requiring China and ASEAN countries' full commitment to zero tariffs in almost all sectors. The most feasible and practicable choice for Korea in Asia, therefore, will be a Korea-Japan FTA, which could prompt China's participation from the fear of suffering serious trade diversion and later allow the incorporation of AFTA members. In sum, the most viable FTA partners for Korea will be the U.S. and Japan.

After all, Korea should ensure that FTA initiatives are consistent with multilateral trade rules so that both multilateral and regional approaches can engender a synergic harmonization and accelerate the progress of a 'freer and fairer trade and investment' in the Korean economy.

²⁹ Paragraph 2(c) of the Enabling Clause allows the formation of preferential trading arrangements among developing countries in goods trade, even though it does not meet the condition of covering "substantially all the trade" stipulated in GATT XXIV.

References

- Cheong, Inkyo and Yunjong Wang. 1999. "Korea-U.S. FTA: Prospect and Analysis." KIEP Working Paper 99-03. Seoul: KIEP(Korea Institute for International Economic Policy).
- _____.1999. *Economic Integration in Northeast Asia: Searching for a Feasible Approach*. KIEP Working Paper 99-25. Seoul: KIEP.
- _____ and Kyounghee Lee. 2000. *Korea-Chile FTA: Background, Economic Effects and Policy Implications*. KIEP Policy Analysis 00-07. Seoul: KIEP. (In Korean).
- Choi, Inbom and Jeffrey J. Schott. 2001. *Free Trade between Korea and the United States?* Policy Analyses in International Economics. Washington, D.C.: Institute for International Economics.
- DIRECON of Chile. 2000. *Current Status of Progress in FTA Negotiation with Korea*. Various background materials. Santiago: General Administration of International Economic Relations. (In Spanish).
[online]. Available: <http://www.direcon.cl/acuerdos/index.htm>.
- Frankel, Jeffrey A. 1997. *Regional Trading Blocs in the World Economy System*. Washington DC: Institute for International Economics.
- Helpman, Elhanan. 1987. "Imperfect Competition and International Trade: Evidence from Fourteen Industrial Countries." *Journal of Japanese and International Economy*. Cambridge, MA.: MIT Press.
- IDE. 2000. "Toward Closer Japan-Korea Economic Relations in the 21st Century." Paper presented on May 24, 2000 at the International Joint Symposium on Toward a Korea-Japan FTA: Assessments and Prospects. Seoul, Korea.
- Inside U.S. Trade. "Baucus Introduces Bills Authorizing FTA Talks with Korea, New Zealand, Australia." May 23, 2001. [online].
Available: <http://www.insidetrade.com>. (restricted access).
- KIEP. 2000. "Economic Effects of and Policy Direction for a Korea-Japan FTA." paper presented on May 24, 2000 at the International Joint Symposium on Toward a Korea-Japan FTA: Assessments and Prospects. Seoul, Korea.
- KIET. 1999. "Sectoral Effects of a Korea-Japan FTA and Policy Response." KIET Policy Discussion Paper. Seoul: Korea Institute for Industrial Economics and Trade. (In Korean).

- Ministry of Foreign Affairs and Trade. 1999. *Korea's Mid and Long Term Trade Policy*. [online]. Available: www.mofat.go.kr. (In Korean).
- OECD. 1995. *Regionalism and its Place in the Multilateral Trading System*.
- Sohn, Chan-Hyun. 1989. "U.S. FTA Policy: Background and Korea's Position." *Monthly Korea Trade Focus*. pp.12-19. Seoul: Korea International Trade Association. (In Korean). (February)
- _____, Junsuk Yang, and Hyo Sung Yim. 1998. "Korea's Trade and Industrial Policies: 1948-1998." KIEP Working Paper 98-05. Seoul: KIEP. (In Korean).
- _____ and Hyo Sung Yim. 2000. "Free Trade Agreements and the Income Convergence of Member Countries: Lessons from the EU, NAFTA and ANZCER." *Journal of International Economic Policy Studies*. Vol. 4, No 1: pp.3-39. Seoul: KIEP. (In Korean).
- _____ and Jinna Yoon. 2001. Does the Gravity Model Fit Korea's Trade Patterns?: Implications For Korea's FTA Policy and North-South Korean Trade." KIEP Working Paper 01-01. Seoul: KIEP.
- _____ ed. 2001a. *Analysis of the Economic Effects of Korea's FTAs with Japan, the U.S. and China, Japan*. KIEP Policy Reference 01-01. Seoul: KIEP. (In Korean).
- _____ ed. 2001b. *The Economic Effects of and Policy Direction for a Korea-Japan FTA*. KIEP Policy Reference 01-03. Seoul: KIEP. (In Korean).
- _____. 2001c. "Korea-Japan FTA: Korea's First Step toward East Asian Economic Cooperation." *The Policy Forum : Minjoo Nondan*. No.5: pp 47-56. Seoul: The Millenium Democratic Party. (In Korean). ((Summer)
- WTO. 1995. *Regionalism and the World Trading System*.
- _____. 2001. "Facts and Figures: Regional Trade Agreements Notified to the GATT/WTO and in Force." *Regionalism in the WTO*. [online] Available: http://www.wto.org/english/tratop_e/region_e/region_e.htm (March 2001).
- Yoon, Jinna. 1999. *A Korea-Chile FTA: Economic Effects and Policy Implications*. unpublished master's thesis. Seoul: Korea University.

國文要約

Trade Agreement) FTA (FTA: Free FTA

FTA 1998 FTA 가 EU, NAFTA, AFTA

FTA 가

FTA FTA 1998 11 FTA , 2000 12 4

가 2000 5 ‘ - FTA’ 1998 9 -

FTA ‘ - FTA’

‘ - FTA’ 1980 가

가 ‘ - FTA’ ‘ - FTA’

‘ - - FTA’ ‘ASEAN+3(, ,) FTA’ 가

FTA , FTA

FTA

5 가 FTA

가 5 가
 가 FTA 가 EU,
 NAFTA ' - - FTA', ' -ASEAN FTA', ' ASEAN+3', ' FTA'
 가 FTA
 가
 , WTO 가
 16.8% 2004 3 9.44%
 FTA 0% 가
 ' - - FTA'
 , ASEAN GATT (Enabling
 Clause)
 FTA ' (substantially all the trade)
 GATT XXIV
 AFTA ' ASEAN+3' ' FTA' GATT XXIV
 ASEAN
 GATT XXIV FTA ' ASEAN+3' '
 FTA'
 ' - FTA' ' - FTA' 가 가
 가 FTA
 ' - FTA'
 ASEAN 가

**KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY**

300-4 Yomgok-Dong, Seocho-Gu, Seoul 137-747, Korea

Tel: (822) 3460-1114

Fax: (822) 3460-1122

URL: <http://www.kiep.go.kr>

