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Policy Analyses

From East Asian FTAs to an EAFTA

Typology of East Asian FTAs and Implications for an EAFTA

Chang Jae Lee, Hyung-Gon Jeong, Han Sung Kim, and Ho-Kyung Bang (Dec. 2006)

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USD 7

As the number of Free Trade Agreements (FTAs) between East Asian countries continues to increase, the need for a region-wide FTA is emerging in East Asia. The main objective of this study is to develop the current study on the East Asia FTA (EAFTA) by suggesting likely options for an EAFTA that will both be feasible and desirable.

In search of an optimal EAFTA, this study analyzes the characteristics of six FTAs between East Asian countries: ASEAN Free Trade Area (AFTA), the ASEAN-China FTA (ACFTA), the Korea-ASEAN FTA (KAFTA), the Japan-Singapore Economic Partnership Agreement (JSEPA), the Korea-Singapore FTA (KSFTA), and the Japan-Malaysia EPA (JMEPA). Although the policies and instruments in existing FTAs cannot be directly transposed to the EAFTA, they are quite likely to serve as reference points in the future.

Chapter II examines the tariff concession structure of the six FTAs. The tariff concession structure of these FTAs can be grouped into two categories: an ASEAN-type approach and an item-by-item approach. The ASEAN-type approach divides tariff items first according to their sensitivity in the Normal Track and Sensitive Track. For those tariff items belonging to the Normal Track, they can be further divided into

i) tariffs that will be eliminated when the FTA comes into force and ii) tariffs that will be eliminated within predefined years. Those items belonging to the Sensitive Track can be further divided into the Sensitive List and the Highly Sensitive List, depending on the degree of sensitivity. The AFTA, ACFTA, and KAFTA belong to this ASEAN-type approach. The ACFTA differs from other agreements in having an Early Harvest Program.

The other type is the item-by-item approach, which sets tariff elimination schedules for each tariff item. KSFTA, JSEPA, and JMEPA have adopted this approach. This approach can produce a number of different tariff concession structures depending on the partner country, as can be seen in JSEPA and JMEPA.

This chapter also attempts to assess the quality of existing FTAs among East Asian countries in terms of trade liberalization in goods by analyzing the share of tariff lines in the Highly Sensitive List or the tariff lines of excluded items, both in terms of the number of tariffs and share of imports. Our results indicate that the quality of trade liberalization varies significantly among the FTAs. First, those FTAs involving ASEAN countries show relative overall weaknesses, mainly due to the CLMV countries (Cambodia, Laos, Myanmar, and Vietnam). Our analysis also reveals that even within a single FTA, there often exist asymmetrical situations in terms of trade liberalization among participant countries. However, it was difficult to conduct a more rigorous comparison among these FTAs due to the different use of classification systems in East Asian countries. For instance, Korea uses HS 10-digit codes, Japan and Malaysia use HS 9-digit codes, and China and the Philippines use HS 8 digit codes, whereas for some sectors, only HS 6-digit data were available.

From our analysis, we also identified the sensitive sectors in a

select number of countries. In particular, agriculture and fishery are the most sensitive sectors for both Korea and Japan. However, a more detailed comparison was once again difficult to make because of the use of different classification systems in East Asia.

Overall, although Korea and China show much more willingness in terms of trade liberalization in goods compared to the CLMV countries, the level of trade liberalization is limited due to the existence of sensitive sectors. Japan is also quite reluctant to open its markets, especially for agricultural and fishery products. It is, therefore, difficult to make a strong case that existing FTAs between East Asian countries are of high quality in terms of market access for goods.

Chapter III investigates the rules of origin in East Asian FTAs. Rules of origin are laws and administrative practices used to identify the country of origin of internationally traded goods. They are needed to limit the trade gains from FTAs to participating countries. However, they are sometimes looked upon as a necessary evil because they may distort markets and can be used as instruments to protect domestic industries.

Examining the six intra-regional FTAs, we observe that the AFTA and ACFTA have simple and compact rules of origin; for most products which are not wholly obtained and produced, rules of origin requires that non-originating import contents not exceed 60% or that the originating content is more than 40% of the FOB price of the product. On the other hand, rules of origin for KAFTA, KSFTA and those between Japan and two ASEAN member countries are based on product specific rules. These FTAs adopt changes in tariff classifications and use the percentage criteria as the main decision instruments. However, at the product specific level, the criteria of

conferring originating status varies and there are situations in which a country imposes different rules of origin for an identical product in any number of its FTAs.

The “rules of origin” clause reflects the bilateral (or multilateral) relationship between participating countries. What Country A adopts with Country B in one agreement can be a rule that Country A wants to avoid with Country C in another. This may cause complexities in the rules of origin in East Asia and it will become a critical factor that deters economic integrity in East Asia.

As a measure to mitigate the problem of rules of origin in East Asia, we look at the possibility of introducing diagonal cumulation. Given the web of bilateral FTAs in East Asia, diagonal cumulation may be the best way to integrate East Asian economies into a single territory, at least from the production side of the economy. However, each country may have a different perspective on this matter and introducing diagonal cumulation to East Asia may not be as easy as it seems. However, if countries in the East Asian region acknowledge the need for regional integration and regard the EAFTA as a common goal, diagonal cumulation will not be impossible to achieve. Furthermore, diagonal cumulation may be considered as an intermediate target for the EAFTA. By reaching this intermediate target, we can reduce the market distortion effects of rules of origin in the region, increasing integrity as a single production market and creating a better position to move forward with the EAFTA.

Chapter IV analyzes the characteristics of FTAs related to service and investment in East Asia. In the FTA between Korea and Singapore, a negative list method has been adopted to expand service and investment liberalization. With leading competitiveness in services, Singapore has a higher degree of market opening for its

service sector (95.6% vis-à-vis Korea) than Korea (72.3% vis-à-vis Singapore).

The opening ratio for Japan's service sector is 68.4% vis-à-vis Singapore, while Singapore's opening ratio is 66.2% vis-à-vis Japan. By adopting mechanisms like the positive list method, etc Japan has chosen to contract a defensive EPA with Singapore. In its EPA with Malaysia, Japan has restricted the liberalization of its service sector by stipulating that certain commitments can be modified or cancelled in the schedule of specific commitments. In its EPAs with Singapore and Malaysia, Japan has especially focused on intellectual property rights. Due to the weak competitiveness of its service industry, Malaysia has a low degree of service market opening at 27.7% vis-à-vis Japan.

Trade and investment facilitation is generally not an important item when dealing with FTAs. However, in East Asia, where there exist large gaps in economic development among countries, trade and investment facilitation is of particular importance. The AFTA, JSEPA and JMEPA ensure a higher level of trade and investment facilitation than the KSFTA. This is because both the AFTA's and Japan's EPAs are approached as forms of economic cooperation. With regard to development cooperation, there have not been any significant measures in the East Asian FTAs we examined, even though it is important element for (the EAFTA) given the disparity in the economic development levels among East Asian countries.

The last chapter suggests likely prospects for an EAFTA and proposes possible options of an EAFTA based on the analyses in the previous chapters. In addition, it also provides policy implications regarding the formation of an EAFTA for the governments of East Asia, with special regard to the Korean government.

As for the prospects of an EAFTA, after having examined rationales

and obstacles, three plausible scenarios to an EAFTA are presented. The issues of membership and schedules are also discussed. With regard to the possible EAFTA types, if East Asian countries choose to form an EAFTA that co-exists with other East Asian FTAs, this will result in a complex, multi-layered FTA web in East Asia. One advantage of this type of EAFTA is that it will be relatively easy to negotiate politically. However, since such an EAFTA would not prevent the “spaghetti bowl” phenomenon, one may question the rationality of creating a region-wide FTA that would only serve symbolic purposes. Another option would be to pursue a high quality EAFTA that would replace the majority of FTAs among East Asian countries. However, our analysis of existing FTAs in East Asia shows that given the diversity of East Asian economies, it would be rather difficult to agree upon a high-quality EAFTA in the near future. Nevertheless, it is precisely this sort of EAFTA that would maximize economic benefits, preventing the further proliferation of bilateral FTAs in the area.

One way of avoiding this dilemma altogether is by developing an EAFTA with i) a relatively flexible tariff concession structure, ii) simple and liberal rules of origin, iii) strengthened trade and investment measures, and iv) a concrete development cooperation mechanism. This type of EAFTA would probably not replace existing FTAs in high numbers, but it would be more than symbolic and tangibly contribute to creating freer trade and investment in East Asia.

Furthermore, the last chapter also provides policy implications regarding the formation of an EAFTA. In particular, this study proposes that the Korean government take the initiative and continue feasibility studies on an EAFTA, such as those conducted by the Joint Expert Group. Another important task to successfully realize an

EAFTA is related to Northeast Asian countries. Since an EAFTA cannot be realized until the establishment of a de facto China-Japan-Korea FTA, the three Northeast Asian countries must not neglect the importance of a CJK FTA in the establishment of an EAFTA. In this regard, it is suggested that the Korean government act as a facilitator persuading both China and Japan of the importance of a CJK FTA in achieving an EAFTA. As an alternative, the Korean government could also facilitate the formation of the CJK FTA and the EAFTA by concluding a Korea-Japan FTA and a Korea-China FTA as a first order.

Global Imbalance and its Implications on East Asian Economies

Doo Yong Yang ed. (Dec. 2006)

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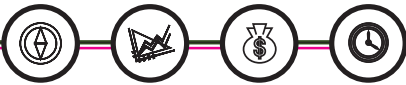
USD 10

The first paper, written by Professor Yung Chul Park and Barry Eichengreen, focuses on the impact of a disorderly adjustment in global imbalance on emerging markets. In the conclusion, they argue that commencing this adjustment process while global economic and financial conditions are still favorable will ease the adjustment process. They also state that the adjustment process will be eased if there is cooperation on exchange rates and other policies, and that it would be desirable if the United States participated in this process of cooperative policy adjustment by addressing the domestic roots of its twin deficits. The second paper, co-authored by Professor Jong-Wha Lee and Warwick J. McKibbin, analyzes global imbalance focusing on the investments and savings of East Asia and the United States. This paper demonstrates that since the 1997-98 crisis, many East Asian economies have been experiencing a permanent decline of domestic investment and output growth mainly resulting from increases in financial risk and decreases in the return on investment. According to the paper, the investment decline in East Asia, outside of China, combined with the fall in public and private savings in the United States, has

contributed to the recent levels of global current account imbalance. The third paper, written by Jacques Mazier, Yong Hyup Oh, and Sophie Saglio, focuses on analyzing the consequences of world imbalance on East Asian countries in the context of growing regional interdependency, and proceeds in two steps using in both cases simple multinational macroeconomic models. In the proceedings, exchange rate misalignments at the world level and for East Asian currencies are first estimated using a FEER approach, which combines a multinational model for the main currencies (dollar, yen, yuan, euro, and won), and a national model for the other East Asian currencies. This approach gives estimations in both real effective and bilateral exchange rates. In the fourth paper, Professor Eiji Ogawa points out that global imbalance has occurred in relation to the huge current account deficit of the United States in recent years. These current account deficits have been caused by the fiscal deficit of the US government since 2000. This is referred to as “twin deficits,” which the United States experienced once before in the 1980s. When we look back at the latter half of 1985, there was a large depreciation of the US dollar, and given that the fiscal deficits have recently been kept at a higher level, we can assume that it may lead to a similar result: a large depreciation of the US dollar. The fifth paper, written by Yong Seoung Jung, Changyong Rhee, and Doo Yong Yang, is on the topic of “Global Imbalance and Exchange Rate Adjustments.” Most agree that global imbalances should be recalibrated to a sustainable level. The main findings of this paper can be summarized as follows. First, the Korean won/US dollar reached equilibrium in 2006 in response to the external imbalance of the Korean economy. Both econometrics and model simulations show that the won/dollar

rates in 2006 appreciated enough to reduce the previous current account surplus in Korea. Second, even though the bilateral current accounts has balanced out in Korea, there exists the greater pressure of further appreciation of the won/dollar exchange rate due to the rigidity of other Asian currencies in response to global imbalance. Third, in order to minimize the burden of currency appreciation in Korea, the Chinese *renminbi* (rather than the yen) should appreciate substantially. In conclusion, regional and global cooperation on the adjustment of global imbalance would be much more beneficial to the Korean economy. The last paper presented, written by Deok Ryong Yoon, is intended to stress the need for collective action in the area of exchange rates and monetary coordination in East Asia to solve the problem of global imbalance. Important progress is already occurring in the area of emergence liquidity support (CMI and post-CMI projects) and the development of bonds markets in Asia (ABMI). Exchange rate coordination will be the next and most important agenda, which cannot be put aside any longer. This paper is an examination of exchange rate behavior and intervention in Korea, of why East Asian countries should continue to intervene in foreign exchange markets despite substantial costs of maintaining a fixed system, and a discussion of possible exchange rate coordination schemes in East Asia with some policy suggestions in this regard.

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Policy Analyses I (in Korean)

Korea's Mid and Long-term Strategies toward an Advanced Trading Nation

Wook Chae, Cae-One Kim, and Jai-Won Ryou *et al.* (Dec. 2006)

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USD 10

Changes in lifestyles, the international economic environment, governance, market structures have all caused a rapid paradigm shift in the Korean economy, requiring the establishment of new institutional practices and policy responses. The unsatisfactory outcome of the Korean economy in recent years may reflect the fact that the main economic entities are not responding effectively to this paradigm shift.

It is expected that diverse factors in the international trade environment will have a grave impact on the growth of the Korean economy in the mid and long run; they may include, among others, factors, such as the expansion of regionalism, changes in the power structure of East Asia as a result of increasing rivalry between China and Japan, multipolarization of world economic growth as a result of emerging BRICs economies, trade conflicts stemming from global current account imbalances, and the instability of the international energy market.

Trade policy, together with industrial policy, has played an important role in achieving rapid economic growth during Korea's industrialization. However, the traditional trade policy has been

unsuccessful in adjusting to the global paradigm shift, thereby obscuring trade policy objectives as well as failing to provide a basic system to reflect social consensus and the interests of diverse groups.

Korea's long-term vision is the ultimate realization of an advanced economy which will especially require sustainable economic growth. For such growth, the creation of an innovative economy, establishment of a growth-friendly distributive structure and effective governance will be necessary.

Accordingly, the objectives of trade policy must involve initiatives such as strengthening the competitiveness of business firms, quality job creation, and the establishment of a social environment that promotes market-opening.

In this respect, trade policy must be directed to create an economy that is open and globalized, strategically cooperative, and has effective governance - all of which may be considered as the 3 major strategies of trade policy.

These strategies can be achieved through a 10-item practical agenda and 30-item action plan, as summarized below.

3 major strategies	10 practical agenda	30 action plan
Open and Globalized Economy	Enhancing competitiveness through deepening of the market economy	<ul style="list-style-type: none"> · Introduction of a pre-announcement system for service market liberalization · Enhancement in the efficiency of tariff structures · Export-oriented industrialization of strategic service areas.
	Enhancing investment friendliness in the Korean economy	<ul style="list-style-type: none"> · Development of the investment environment · Improving the international competitiveness of specialized economic zones · Implementation of programs to strengthen the attractiveness of the Korean economy
	Fostering a finance hub and offshore financial markets	<ul style="list-style-type: none"> · Fostering offshore financial markets · Implementation of a global standard for financial regulation and supervision · Establishment of a specialized zone for international finance
	Internationalizing knowledge-capacity	<ul style="list-style-type: none"> · Liberalization of the educational services market · Recruitment of high-skilled foreign workers · Attracting global R&D facilities
Strategically Cooperative Economy	Implementing active trade policies for market expansion	<ul style="list-style-type: none"> · Striving for high quality FTAs · Creating a systematic FTA roadmap · External utilization of the WTO system
	Strengthening economic cooperation with developing countries	<ul style="list-style-type: none"> · Expansion and management of ODA · Expansion of GSP coverage · Establishment of an effective policy system to advance into emerging markets
	Strategic utilization of regional cooperation	<ul style="list-style-type: none"> · Activating economic cooperation in Northeast Asia · Practical management of regional cooperation · Expansion of free trade between the two Koreas
	Securing energy resources	<ul style="list-style-type: none"> · Increasing aid to develop energy resources abroad · Strategic implementation of resource diplomacy · Diversification of energy resource imports
Efficient Trade Policy Governance	Creation of a trade policy infrastructure promoting market-opening	<ul style="list-style-type: none"> · Establishment of business-oriented trade policy governance · Enforcement of trade policy coordination · Enforcement of Korea Trade Commission's functions · Establishment of a procedure for cooperation between the executive branch and the National Assembly for effective trade negotiations

Harmonization of Social Policy with Economic Policy and Social Consensus Building

Implications from the Experience of Major Developed Countries

Heungchong Kim, Jeongwan Shin, and Sangho Lee (Dec. 2006)

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USD 10

The Korean economy is now facing many challenges such as jobless growth, bi-polarization, and shrinking growth potential. This has aroused new demand for social policy. In the course of implementing more proactive social policy, however, tensions among policies are growing, and policy collusion arising from policy discord is often observed, which hinders successful and effective implementation of policy. In order to identify better methods of harmonization of social and economic policies and consensus building in the course of policy implementation, this study aims at deriving implications from the experience of advanced countries who have experience with problems of policy discord and policy collusion.

Sweden represents a type of country which has actively pursued harmonization of social and economic policies, and has derived at a consensus in society. It achieved higher economic performance together with full employment and realization of a welfare state, through successfully combining the Keynesian macroeconomics with proactive social policies. Policy complementarities are strong in the Swedish Model as it was designed by the Social Democratic

Party with the active engagement of the central negotiating organizations as a socioeconomic system.

Tensions among policies in the Swedish Model, however, developed into policy collusion after the 1970s under unfavorable political and economic environments. After the economic crisis in the early 1990s, the Swedish government conducted a retrenchment policy, which reshaped the framework of social policy by curtailing government social expenditure and strengthening market-oriented factors. In the course of “modernizing” the Swedish Model, the Swedish government was successful in minimizing the resistance of voters through strong support of welfare for the poorest and reshuffling of the priority list of reforms. A Transparent reformation schedule under the tradition of social consensus has contributed to creating a credible government.

The United Kingdom has experienced drastic changes in its socioeconomic system as a representative welfare state to neo-liberalistic state. In the heyday of the British welfare state in the 1950s-60s, supported by the strong tradition of Keynesian economics and the influence of the welfare state of the Golden Era, social policy had greater room to harmonize with economic policy. However, there existed tensions among major policies in those days ; for example, the policy of liberalization and/or sound balance of payment, the Keynesian macroeconomic policy, collective bargaining, and comprehensive social security. Tensions among such policies developed into policy collusion in the 1970s when the macroeconomic environment went from bad to worse.

Thatcherism, under the theoretical background of neo-liberalism and supply-side economics, is a conceptualization of the national reformation process for solving structural problems and

enhancing economic efficiency in the British socioeconomic system. It is important to note, however, that social policy did not necessarily sacrifice economic causes in the Thatcher era. The reformation of the Thatcher government focused not only on budget cuts in the core areas of public assistance and social insurance, but on reforms in higher education, public housing, and local government as well. This can be interpreted as an outcome of compromise among policies through policy reform in a wider concept of social policy on the one hand, and policy accordance in the core areas of social policy on the other. The Blair government of the New Labor party solved the issue of policy harmonization by circumventing the issue and making into one of cooperation between the two policies toward enhancing national competitiveness. The Blair government has emphasized the role of social policy in contributing to the accumulation of human capital in British society.

The American experience shows an alternative pattern of socioeconomic policy harmonization in that it emphasizes the role of the market even in the implementation of social policy. Social policy in the United States has focused on implementing effective social policy against poverty, which implies that public assistance rather than social insurance is a major part of social security. This kind of “American exceptionalism” is rooted in a strong tradition of liberalism in America and the unique characteristics of American federalism. Even in the Golden Era of the 1950s-60s, social policy in America relied more on the market than in other advanced countries. In that sense, the emergence of neo-liberalism in the 1980s is seen as a strengthening of its tendency toward market-oriented social policies rather than as a big swing from the welfare

state, which is observed in its counterparts in Europe. Therefore, the harmonization of social and economic policies in the United States seems to have been achieved in the course of marketization of social policy realizing the philosophy of economic efficiency; American social policy, has achieved harmonization with economic policy in this respect.

The case study has ample implications for Korean society in many aspects, including basic recognition of harmonization and consensus-building, policy contents and directions, policy implementation and transmission, and others. First, the conflict between social policy and economic policy does not derive from the characteristics of the policies themselves, but from their content and policy directions. It should be recognized that economic policy can be successfully implemented without sacrificing social policy. Second, the harmonization of social and economic policy needs to be understood in a wider category of social backgrounds and external relations. Third, it should be kept in mind that market-oriented social policy does not necessarily lead to good performance, and social policy bears a strong tendency of path-dependency, so that it needs to be carefully designed and implemented. Fourth, consensus building can be induced not only through an agreement of power groups in a society, but also between the nation-state and individuals, and society and individuals. Thus, even without the tradition of corporatism, consensus building can be successfully achieved if the government and its citizens reach a general agreement on the direction of reforms.

With regards to policy content and the direction of policy implementation, the following implications can be drawn. First,

economic policy needs to include social considerations to be a “socialized” economic policy, while social policy should be adapted to be economically friendly with a long-term goal of economic growth. Social policy needs to be designed to play the role of a ‘social learning net’ and an ‘employment safety net.’ Second, the governments must make a decision on the coverage of governmental activity and intervention with regard to three categories of social policy, including public assistance, traditional areas of social service, and a wider range of social policy, such as public housing. Third, it would be a good strategy to place a superior policy objective to achieve harmonization between social and economic policies. Fourth, it is often observed that policy discord between social and economic policies is in reality a discord within economic policies and within social policies. Thus, it is strongly recommended that a separate inspection be conducted to see if there exists a fundamental discord within economic policies or within social policies.

It is important to note that policy implementation and transmission of a certain type of policy is important for harmonization and consensus building. First, transparency in the policy making and implementation process is highly important, and the process of policy production needs to be conducted under consensus building. Second, the introduction of deliberative democracy is strongly desirable. Third, a monitoring system to evaluate the effectiveness of a policy can enhance the efficiency of social policy. Fourth, it is important to establish a national vision to derive consensus among people. Also, considering the characteristics of public goods in public social policy, it is important to advertise the importance of public social policy. Otherwise,

public goods can easily be under-produced.

The financial source of socioeconomic policies is the economic activity of people; thus, it is very important to ease people's resistance to further taxation levied by the government. The case study shows that social policy needs to be universal, implying that most of the people in a society should be beneficiaries of the policy so that they can recognize the necessity of social policy. Second, it is important to improve the quality of and show justice in tax administration. Third, a flexible approach to financing the cost of social policy is strongly recommended.

Overall Strategy for Korean ODA Reform

Yul Kwon, Han Sung Kim, Bokyeong Park, Jooseong Hwang, and Sooyeon Hong (Dec. 2006)

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USD 10

Korea, as an emerging donor in the international community, has been providing ODA since the late 1980s. Although the volume of its ODA has been modest, the Korean government has made an effort to use its limited resources effectively. Since entering the OECD in 1996, the Korean government has further committed itself to increasing the amount of ODA.

Although ODA is becoming a popular issue, it is often difficult to coordinate between national interests and development values. Recently, the Korean government has established a proactive policy for cooperation with developing countries through mid-term financial plans for ODA expansion. Under the Millennium Development Goals (MDG), Korea will enhance the scale of its assistance and improve the development cooperation system commensurate with its weight and impact on the global economy. At the same time, the government is enforcing ODA reforms in a strategic and systematic manner to improve aid effectiveness. The Korean government is also considering joining the DAC (Development Assistance Committee) when requirements for DAC entry are fulfilled.

In this context, this study devotes itself to identifying Korea's new role in development cooperation and the overall strategy of Korean ODA reform. This study aims to examine the performance of Korean ODA and explore recent developments in Korea's ODA policy. This study also discusses the challenges and opportunities for the new ODA regime.

Korea's aid system lags far behind that of other DAC member countries, and the Republic of Korea is not strongly in favor of providing foreign assistance. Under these circumstances, Korea faces a formidable task in matching the standards of the international community.

In the process of aid delivery, the Korean government has been striving to conform to the guidelines agreed upon by the global development community. Korea may improve its aid effectiveness and efficiency, as well as enhance its own capacity in development cooperation through the mutual accountability framework expressed in the Paris Declaration. Such efforts will significantly contribute to improving aid alignment and partner country ownership.

Korea is one of currently 101 countries that have signed the Paris Declaration, and recent ODA reforms aim to make Korea's development assistance more effective. In order to harmonize with other donors, Korea will need to conform to the program-based approaches of major partner countries founded on mid-term country agendas and continuously monitor the effects of implemented projects to improve evaluation functions.

In this regard, Korea's international assistance policy is at a turning point. The task of Korean ODA reform is to find a way to maximize its potential while harmonizing aid policies and aligning them with those of the international community.

Issues and Evaluation of the Doha Development Agenda Negotiations until 2006

Korea's Perspective

Jin Kyo Suh, Backhoon Song, Yeongkwan Song, Jione Jung, and Chang-Soo Lee (Dec. 2006)

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USD 10

The members of the World Trade Organization (WTO) agreed at Doha, Qatar, in November 2001 to launch the Doha Development Agenda (DDA) for multilateral negotiations to reduce the use of trade-distorting policies and bolster the development relevance of the WTO. The Doha Agenda spans over numerous issues, including the reduction of agricultural support policies, market access liberalization for goods and services, and strengthening of WTO rules and dispute settlement procedures.

But progress on trade negotiation has been slow, especially in the key areas of agriculture, non-agricultural market access (NAMA), and service. In fact, the five-year-old DDA trade negotiations faced its a gravest crisis in July 2006. The negotiations were suspended at the end of July after an attempt by ministers from six key players (Australia, Brazil, the European Union, India, Japan, and the United States) to break the deadlock failed (on 23 July 2006).

Bitter recriminations have followed since the breakdown, particularly between the EU and the US. The EU blamed the US for refusing to offer any new cuts in farm subsidies; the latter countered that the EU gave too little market access to make such actions possible.

It was widely believed that restarting the negotiations would require parallel progress on a ‘triangle’ of issues: the US would have to agree to deeper cuts to domestic farm support; the EU to increased agricultural market access; and access; and, developing countries (such as Brazil and India) to lower industrial tariffs. Each group has been urging the other to move first.

As for the coefficients within the “Swiss” formula for cutting industrial tariffs within NAMA, industrialized countries, including Japan, the US and the EU, have suggested a coefficient of “10” for themselves and “15” for developing countries. Industrialized countries agreed that developing countries should reduce tariffs from bound levels, and reductions be steep enough to cut into the applied levels for some products. Countries like Argentina, India, South Africa, and the Philippines, however, insisted that any reduction commitments for industrials should be balanced proportionally with the outcome in market access for farm products, maintaining that the coefficients for industrialized and developing countries should be close to each other.

With respect to agricultural tariffs and farm subsidies, farm trade negotiations hinged on how much the US would reduce its domestic farm support. Moreover, the two sides - major importers and exporters - remained at crossroads on the issue of sensitive products. Importers like the EU, Japan, and other members of the Group-of-10 Defensive Coalition referenced sensitive products with low tariff-rate quotas to shadow imports. But, they would not agree to “core” access as demanded by the United States. The EU and Japan suggested a hybrid approach in terms of the deviation between the tariffs for sensitive products and the normal formula.

2007 will be a defining year for the Doha Agenda. After six years, negotiators are weary and eager to see some light at the end of the

tunnel. Many hope to be able to deliver a deal in 2007. Political activity has already started with a host of bilateral meetings between the US, the EU, and Pascal Lamy, the Director General of the WTO. For now, Ministers are choosing their words carefully, trying not to raise too many expectations. Many eyes are focused on the upcoming World Economic Forum's Annual Meeting, to be held in Davos, Switzerland from 24-28 January, 2007. A mini-Ministerial meeting is expected to take place.

Domestic politics in the US, including the swearing in of the new Congress, the imminent expiration of the Fast Track (the trade promotion authority of the Bush administration), and the reform of the Farm Bill, will all play a decisive role in the WTO negotiations. If there are no clear signs of political engagement early in the year, it is unlikely that the US Congress will consider passing a new Trade Promotion Authority (TPA). The current TPA expires on July 1, leaving a short window for negotiators to reach agreement in 2007. If nothing happens in the early going, it could put the Doha Agenda into hibernation until the next US presidential election, in November 2008.

The successful conclusion of the DDA negotiation is expected to contribute to Korean economic growth through trade expansion and a transparent trading system. The simulation results based on the CGE analysis shows the growth rate of real GDP would increase by 0.72-0.88 percent. In terms of the value of sectoral output, the total value of economy-wide output would increase by 1.521-4.908 million dollars.

The one of the strategical options for Korea in the ongoing DDA negotiations is to maintain developing country status in agriculture. In NAMA negotiations, on the other hand, Korea needs to cooperate with developed countries to expand market access of the industrial sectors in developing countries. Finally, the positive effects of a

successful conclusion of the DDA negotiations on the Korean economy depends significantly on the level of market opening for the service sector.

Trade Facilitation in APEC

Economic Impacts and Policy Options

Sangkyom Kim, Sung-Hoon Park, Soonchan Park and Innwon Park (Dec. 2006)

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USD 7

APEC Leaders at the 14th APEC Economic Leaders' Meeting held in Hanoi on 18-19 November 2006 welcomed and endorsed the "Hanoi Action Plan to Implement the Busan Roadmap towards the Bogor Goals," which is a comprehensive set of specific measures, schedules, and capacity building initiatives. Specifically, Leaders highlighted numerous steps that have been taken to carry the Busan Business Agenda forward and welcomed the new trade facilitation framework that targets a further reduction of trade transaction costs (by 5%) in the APEC region by 2010.

Under this background, this study attempts to identify and construct concrete strategies to realize the Busan Roadmap with particular reference to the trade facilitation framework addressed in the Hanoi Action Plan. For the purposes of this study, qualitative, as well as quantitative analysis, is conducted. A survey was specifically conducted targeting Korean businesses engaged in trade activities with other APEC member economies to measure the relationship between trade costs and trade facilitation, encompassing customs procedures, standards and conformity, business mobility, and eCommerce usage. Building on the outcome of the survey analysis, we

first constructed the “APEC Trade Facilitation Index,” then estimated the economic effects of trade facilitation taking into account various policy options, and finally identified more concrete and specific strategies to promote trade facilitation in APEC.

This study employs the “Gravity Model” and the “Computable General Equilibrium (CGE) Model” to forecast quantitative economic effects; several effects are observed, mainly on the GDP. The outcomes of the forecasts indicate that a potential increase in Korea’s real GDP will range anywhere from 0.42% to 3.09% depending on different underlying assumptions and trade facilitation schemes. For example, Korea would experience a 2.07% GDP increase if all member economies successfully implement a 5% reduction in business transaction costs, as addressed in the Busan Business Agenda. On the other hand, if we factor in the diverse development levels of APEC members and adopt a 50% higher target rate of reduction (7.5%) for developed APEC economies, our results indicate that most member economies would experience an even greater GDP increase, with the exception of a few cases. For example, if we categorize Korea as a developed economy, Korea’s GDP increase would be 3.09% (cf. 2.07%) under the assumption that developed economies in APEC implement a 7.5% reduction in business transaction costs and developing economies adopt a 5% reduction. But, if all members fully implement their commitments under the current Trade Facilitation Action Plan (TFAP), results indicate that the expected economic effects would actually be smaller than the effects achieved by the 5% cost reduction. For example, Korea would only experience a 0.42% GDP increase compared to the 2.07% GDP increase in the initial scenario.

The outcomes above provide us with insights and strategies that APEC and Korea can implement to better cooperate with other

member economies and promote APEC's long term goal of establishing an Asia Pacific Economic Community. First, in terms of GDP growth, our quantitative measurements show that trade facilitation based on open regionalism and integration principles will result in more positive effects for APEC economies. Based on our research, it is suggested that APEC member economies take concrete action in four areas - i.e. customs, standards and conformance, business mobility, and e-commerce - consistent with respective policy priorities. Second, as most trade facilitation activities require huge amounts of fixed capital associated with modern technology, there is an immediate need to enhance capacity building for developing economies.

Our forecasts also show that trade facilitation implies huge economic benefits for Korea. In this respect, it is suggested that Korea take a leading role in promoting trade facilitation activities under the Hanoi Action Plan by developing a set of best practices. In one sense, Korea has already demonstrated its potential as a leading economy based on its achievements, inter alia, in the area of customs clearance, single window systems, and paperless trading. In the area of capacity building, the study concludes that Korea needs to identify and develop win-win strategies conducive to both the promotion of IT technology in lesser developed economies and the expansion of export markets for Korean businesses.

Firm Level Performances of Foreign Invested Enterprises in Services Sectors of Korea

Seong-Bong Lee, Mikyung Yun, and Hea-Jung Hyun (Dec. 2006)

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USD 7

This study analyzes foreign invested companies with foreign investment amounts of more than US\$5 million in Korea's services sector. The study classifies investing companies into investment types based on the profile of each company. The following criteria were applied to classify investment types: mode of entry, real investing country, and management control by foreign investors. This is the first time such a classification has been conducted at the firm level using Korean data.

The study then carries out a comparative analysis of firm level performance among various investment types. Firm performance is measured by such financial indicators as asset growth, profitability, and productivity. For higher comparability and credibility, only the firm performance for the years between 2002-2005 are used for long-standing companies that have invested in Korea before 2001. In particular, whether there is a significantly different impact on firm level performance by mode of entry is tested empirically through several simple regression analyses. Among the foreign investment, criteria mode of entry has the most important policy implications as since the current policy of providing incentives to

foreign investors is based on this characteristic. The results of the study show that there is little difference between greenfield investments and M&As. Among M&As, strategic M&As and financial M&As show some difference, with the latter comparatively underperforming with respect to growth and productivity. However, this difference originates from the contrast in the underlying purpose and nature of the two types of M&As, rather than due to real differences in financial performance.

Foreign Direct Investment and Deindustrialization

Hongshik Lee and Sung Jin Kang (Dec. 2006)

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USD 7

Global FDI (Foreign Direct Investment) inflows and MNEs (Multinational Enterprises) have increased significantly since the 1980s. Recently Korean FDI has also increased significantly since the Financial Crisis in 1997, even though its ratio to GDP is still smaller than those of any other country. The impact of FDI inflows and outflows on the industrial and employment structures is thus of great interest.

Furthermore, Korea has been sign of deindustrialization since 1989, which implies that the share of the manufacturing sector in terms of value added or employment has been decreasing. This study investigates the main characteristics of korea's deindustrialization and the role FDI plays as a source of deindustrialization.

Deindustrialization and hollowing-out are defined as a decreases in the employment rate of the manufacturing sector. The difference between the two terminologies lies in the source decreasing employment. Deindustrialization has various sources, while hollowing-out results mainly from FDI outflows. Hollowing-out is considered to be a part of deindustrialization, as FDI outflows constitute one of the various sources of deindustrialization.

A comparison of the deindustrialization experience of OECD countries shows that deindustrialization is not peculiar to Korea. However, the main characteristics of Korean deindustrialization show that the process is still in the early stages in terms of economic development and speed of deindustrialization. Per capita income in Korea when deindustrialization began in 1989 was \$6,130 at constant 2000 prices. This income level can be compared with those of other major countries: \$16,417 for the United States (1966), \$25,290 for Japan (1973), and \$15,493 for the United Kingdom (1970). In addition, we compare the employment rate in the year when deindustrialization began to its share 10 years later. The employment share in Korea decreased by 8.0 percent point in 10 years, from 27.8 percent to 19.8 percent, a very high rate when compared with those of other countries: the United States (4.0%), Japan (3.3%), the United Kingdom (5.8%), and Taiwan (7.0%).

Previous studies on deindustrialization consider two categories: internal and external. Internal sources include increases in per capita income, productivity differences between the manufacturing and service sectors and domestic investment, while external sources are mostly related to trade with less developing countries. The main findings assert that about 70% of deindustrialization can be explained by internal sources. In these studies, however, either the specific role of FDI outflows is not regarded as a source or even if its role is considered it is not found to be a significant source. Interestingly, some studies in Korea find that FDI outflows tend to increase the share of employment in manufacturing.

Previous studies ignore the possible interdependence between internal and external factors, which leads to possible underestimation of external factors. This is because trade with foreign countries and

FDI inflows, for example, may directly affect the employment share of the manufacturing sectors and indirectly affect its productivity. Thus, in order to reclaim possible endogeneity issues, this study investigates the determinants of deindustrialization by using the Dynamic Panel System GMM Estimation for OECD countries. Unlike other studies, we find that FDI inflows are shown to be positive and significant, while FDI outflows are negative and significant for the share of employment in the manufacturing sector.

Looking only at the impact of FDI inflows and outflows on the employment rate in Korea only, this study investigates the linkage effects of FDI inflows and outflows by using Input-Output Tables. Through backward and forward linkage effects, the net effects of FDI inflows and outflows are shown to be positive in the 2000-2003 period and negative in the 1990-1994 period. During 1990-1994, the number of employees decreased by 305,723, while it increased by 140,236 during 2000-2003.

By examining deindustrialization in OECD countries as well as in Korea, this study suggests several policy recommendation as follows.

First, in order to advance Korea's industrial structure through higher added value in the manufacturing sector, it is necessary to foster related service industries such as finance, insurance, legislation, telecommunications, and trade. To induce FDI inflows, we need to take care of the interests of investors. For example, it is necessary to attract FDI in the regions where demand exists rather than where the government sees it fit to locate.

Second, a domestic high-skilled labor force is necessary. Royalty and business services, which constitute a major part of the deficit of the service balance cannot always be recovered simply through market openness. This is because these sectors have become much more

tradable through the development of information and communication technologies. Thus, the best policy would be to replace foreign skilled labor with domestic skilled labor through human capital investment in these sectors.

Third, the government needs to set up a labor allocation policy for various sectors and flexible labor policies to increase labor mobility based on predictions of decreasing employment shares in manufacturing.

Fourth, since the main sector for FDI inflows will be in the services sector, it is necessary to deregulate unnecessary restrictions in the service sectors and increase competitiveness through market openness. This will increase competition among domestic suppliers and improve productivity in this sector.

Lastly, the policies of developing countries, which mainly aim to attract FDI for the purposes of capital accumulation and employment, is inappropriate, since Korea is no longer in competition with other developing countries. Thus, government policies should target more capital-intensive manufacturing sectors, as well as the service sectors.

Derivatives Market Development in the Financial Hub Strategy

Yonghyup Oh, Jonghwa Cho, Deok Ryong Yoon, Won-Ho Song, Ho Jin Lee, Inhyung Lee, and Ick Jin (Dec. 2006)

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USD 7

The core vision behind the creation of a financial hub in Korea is to develop the financial sector as a new growth engine for the Korean economy. This strategy, if successfully realized, will attract more foreign financial intermediaries to Korea and stimulate the rapid internationalization of Korea's financial market. However, the potential instabilities that this strategy may cause make the establishment of a sound risk management plan. an impending necessity. This study is motivated by the idea that the development of Korea's derivative markets can satisfy this need.

Korea's derivatives market is one of the most dynamic markets in the world. The current trade volume of the KOSPI 200 index-based option alone marks the world largest index-based option trading at the national level and the KOSPI 200 index-based futures is the world's 4th largest. While these examples reflect the rapid growth of this market, Korea's derivatives market has yet to realize its potential scale or quality. The size of the OTC market, for instance, is 0.7% compared to BIS member countries and credit derivatives, or environment-related derivative products, are visibly underdeveloped.

This study consists of four parts. First, we look into the link

between the development of Korea's derivative markets and Korea's financial hub strategy. Second, we attempt to identify problems in derivatives products traded via Korea's stock exchange and issues in policy proposals. We note that a greater number of indexes need to be developed to match diverse risk preferences and give more examples of such indexes. Third, we also list some of the main problems in Korea's OTC derivatives market and propose a supervisory measure tailored to Korea's market, emphasizing the establishment of an integrated risk management system. We further emphasize the need for an effective judiciary investor protection mechanism for the OTC market.

Whereas the issues cited above are related to existing markets, this study calls for the introduction of a market that is more forward-looking, namely a carbon derivatives market following the Kyoto Protocol. Given the potential importance of this market for the region, encompassing China and Japan, we find it extremely important for Korea to prepare for the imminent introduction of this market and to establish international cooperation with other regional countries, like Japan, for technology development, as well as regional market creation.

Hedge Fund Regulations in Major Countries and its Implications on Hedge Fund Industries

Ho Jin Lee, Won Ho Song, Kook Hyun Chang, and Sam Y. Chung (Dec. 2006)

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USD 7

The scale and influence of hedge funds in the global financial marketplace has grown over the past decade. In 2006, the number of hedge funds in the world was over 8,800 with total assets exceeding \$1.2 trillion. This growth led to an in-depth review of hedge fund activities by the SEC that resulted in the first significant regulatory filing requirement for hedge funds in 2004. The ADV forms filed by hedge funds in February 2006 have provided considerable information on major US-based hedge funds, particularly with respect to operational risks that include potential conflicts of interest, ownership and capital structures, and previous legal and regulatory actions involving the management firm or related advisors.

In this study, we review the history and current status of hedge fund regulations. The main focus of this study is to question the relevance of the information contained in the ADV forms to participants in the investment market. We first link the SEC filings data with a comprehensive database of hedge funds and examine the relationship between commonly used risk variables and a number of other factors, including performance and capital structures. We then address the question of whether this mandated disclosure was relevant

to market participants. In particular, we test the hypothesis that the disclosures provided redundant information to equity investors, lenders, and share investors of hedge funds.

The results show that hedge funds filing ADV forms had better past performance, more assets, and were of higher quality than non-filers, supporting the assertion that filing is a potential sign of quality. Consistent with the intent to provide information relevant to detecting operational risks, we find a strong positive association between potential conflicts and past legal and regulatory problems in the ADV database. Funds with past legal and regulatory problems have a more concentrated management structure and less leverage than their “non-problem” counterparts on average.

A number of criticisms have been directed at the new hedge fund regulation, such as it will drive hedge funds offshore, the cost of compliance will erect entry barriers that keep new funds from launching, and, it will deter hedge fund managers from undertaking new and innovative investment strategies, leading to less efficient, less liquid, and less stable financial markets.

There is a certain amount of substance to these criticisms, just as there is substance to the arguments favoring more regulation. However, when one arrives at the question of whether more hedge fund regulation was warranted, it is worth noting that the SEC’s adopted rule change was a relatively modest step. It remains to be seen, however, whether this is just the first of many steps toward more substantive regulation in the hedge fund industry.

Since the SEC consciously shifted directions by deciding to regulate hedge funds, the SEC’s new hedge fund rule provides an opportunity to revisit the SEC’s overall regulatory philosophy and style. The SEC’s decision to regulate hedge funds, even if only by requiring that hedge


fund managers register under the Advisers Act at this point, raises questions over the circumstances under which government intervention is warranted to protect investors.

What does it mean for investors to be able to defend for themselves in the face of imperfect information militate against stricter regulation? More fundamentally, how should the SEC proceed when serving the goal of investor protection in the narrow sense of preventing fraud, remedying information asymmetries, and hedging against risks overburdening the capital formation process and compromising the efficiency, thickness, and smooth functioning of securities markets?

It is important to keep the concerns surrounding the hedge fund industry in proper perspective. The scandals and abuses that have marred the hedge fund industry are not representative. In reality, the vast majority of hedge funds are free from fraudulent or otherwise illegal behavior.

Whether it is because we are still in a post-Enron climate with an acute sensitivity to financial corruption or because attention rarely focuses on the banks that have not been embroiled in a scandal, the reality that hedge funds provide investors with legitimate opportunities to earn above-market returns is often downplayed. Additionally, whatever systemic risk is posed by the trading activities of highly leveraged hedge funds, hedge fund trading spins off important systemic benefits by leading to more efficient and more liquid capital markets.

however, hedge funds are with question shrouded in secrecy. The very nature of hedge funds requires that they operate under the radar because hedge funds make money by exploiting market inefficiencies and by taking positions based on anticipated market movements. The



opportunity to make money quickly vanishes when a trading strategy or an exact trade is disclosed and others start to make the same investments.

It is important to stress, though, that there is a big difference between secrecy and engaging in illicit behavior. More to the point, to say that hedge funds “escape” regulation by “exploiting loopholes” leaves the misimpression that hedge funds are somehow evading the reach of the law in an unintended and unacceptable manner.

Changes in China's Business Environment and the Strategies of Foreign-Invested Enterprises

Wolla Park, Keun Lee, Jonghak Eun, and Hyunjung Park (Dec. 2006)

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USD 10

This paper attempts to analyze the strategies that foreign-invested enterprises have used to adapt to the rapidly changing business environment in China since 2000, especially after China's entry to the WTO. There have been two main factors that have brought about qualitative changes in China's business environment in the last five years. First, improvements have been made in China's infrastructure, specifically in transportation, logistics, and communications, as well as the easing of institutional regulations toward foreign investment. Second, greater developments in China's industrial structure have been made through the rapid growth of the high-technology industry and the service sector.

Improvements in China's infrastructure have allowed companies to decrease logistics and communications costs and increase accessibility to all regions of China, alleviating the deep-rooted problem of market segmentation between regions. Moreover, subsequent to China's accession to the WTO, the Chinese government has eased or eliminated regulations and policy constraints related to corporate governance. Such improvements in the material and institutional environment have led to structural changes in foreign-

invested enterprises manifest in the increase of wholly foreign-owned enterprises, conglomerate integration, and M&A projects with Chinese enterprises. Through these strategic changes, foreign-invested enterprises have been able to manage their organizational structures more effectively, allowing them to fully utilize domestic production factors and actively develop the domestic market.

The development of the high-technology industry in China, which has become a distinct trend since China's entry into the WTO, has mainly been pushed forward by foreign-invested enterprises. Foreign-invested enterprises in the high-technology industry have moved parts of their production facilities and equipment to China, thereby creating a global production system and expediting the move towards high-technology in Chinese industries. However, intellectual property rights infringement has increased with technology outflows and the protection of intellectual property rights has emerged as a critical issue for foreign-invested enterprises. Despite the Chinese government's continued efforts to improve intellectual property laws, the level of protection still remains very low. This is mainly due to the defects in law enforcement stemming from systemic, institutional, and cultural factors, such as vested local interests, lack of coordination between administrative units, and state-centered law enforcement. In response to the lack of intellectual property rights protection, foreign-invested enterprises in China are adopting various strategies, such as joint efforts with other foreign-invested enterprises in China, government-level lobbying, and multilateral solidarity with the Chinese government, enterprises, and social organizations.

The development of the service industry in China after its WTO accession has also created an advantageous environment for foreign-invested enterprises to expand their business domains. The strategic

response by foreign-invested enterprises to environmental changes can largely be divided into two categories. First, an increasing number of foreign-invested enterprises are utilizing China as a business process outsourcing base. Second, these enterprises are making full use of local professional business services, such as legal and business consulting, R&D, and distribution, and are also making an effort to claim market shares in these areas.

Foreign-invested enterprises in China are adopting aggressive strategies to optimize the use of production factors in China and to take advantage of the changing material and institutional environments and the trends towards high-technology and service industries in the post-WTO Chinese market. This strategic shift should motivate Korean enterprises focused solely on using China's cheap labor for processing trade to reexamine their strategies. This reevaluation process also applies to the Korean government and its supporting policies for such enterprises.

Recently, there has been rising pessimism among small and medium Korean enterprises with regard to China's changing business environment. This growing consternation has mainly arisen from the Chinese government's amendment of FDI policies - i.e. the reduction of preferential treatment and tightened control over foreign-invested enterprises. However, these measures should be regarded as part of China's shift towards a more open market economy and the improvements in the legal environment that come with it. These changes are an inevitable adjustment to China's growth strategy as its economic structure continues to develop. Therefore, Korean enterprises must focus more on the business opportunities that such improvements in the industrial structure and business environment bring, rather than fret over short-term losses caused by China's new

policies. In this respect, a benchmark study examining the strategies utilized by other foreign enterprises will prove to be useful in maintaining a balanced perspective of the business environment in China.

China's FTA Strategy and its Policy Implications

Chang-Kyu Lee, In-koo Lee, Jina-Yeo, and Hyun-Jun Cho (Dec. 2006)

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USD 7

This report mainly deals with the objectives and motives of China's FTAs (Free Trade Agreement) and analyzes China's FTA strategies, both quantitatively and qualitatively, in order to draw up more viable suggestions for future Korea-China FTA negotiations.

Chapter 2 briefly describes several important FTA negotiations currently in progress at the moment. China-ASEAN FTA negotiations began in July 2005 to promote the full liberalization of trade in goods and is expected to close by 2010. China has completed two bilateral FTAs with Chile and Pakistan; with Hong Kong and Macao, China has concluded a CEPA (Closer Economic Partnership Arrangement) to include the liberalization of trade in both goods and services. FTA negotiations with developed countries, such as Australia and New Zealand, are now underway, and energy security issues with the GCC have been on the negotiation table since 2004.

In Chapter 3, we explain the objectives of China's FTA promotion agenda and analyze the decision criteria in selecting FTA partner countries. There are two broad categories: (1) diplomacy and security and (2) economic interests. From the point of view of the first category, China has located itself at the center of an Eurasian FTA as a long-

term blueprint to parallel the EU and the FTAA. It appears that China wants to strengthen its leadership and to offset the influence of the US in the region in order to form a Sino-centric type of East-Asianism.

In terms of economic interests, the main concerns are securing overseas energy and raw material resources; evading trade disputes (by diversifying export markets to enter new emerging markets, roundabout trade to western markets, etc.); eliciting recognition of China's MES (Market Economy Status); enhancing industrial competitiveness; dealing with pressures from US trade sanctions; promoting the "Great West Development" and "Northeast Revival"; strengthening ties with overseas Chinese; and, accelerating the Chinese companies, "going abroad" process, etc.

In sum, China seems to prioritize FTA partner countries in its vicinity over developing or third world countries and non-Western countries. More specifically, China tends to prioritize countries that can be used as roundabout routes for its exports to western markets, followed by countries that could help China to secure energy and raw materials and also those countries that could provide an advantage to the enhancement of industrial competitiveness and promotion of West and Northeast development.

This argument is also supported by the empirical study presented in Chapter 4. By employing the Probit Gravity Model, we show that China promotes FTAs mainly with (1) adjacent and nearby countries and (2) countries with abundant natural resources.

In Chapter 5, we selected from China's FTA draft texts and joint feasibility study texts several the key issues that are on the negotiation table. This work allowed us to look more closely into China's behavior in dealing with several imperative norms and issues in different FTA negotiations. The selected FTA norms in this paper fall into three

categories: tariff removal, rules of origin (ROO), and investment treaty. Agriculture, other manufacturing sectors, and the service sector were identified as key issues in China's FTA negotiations, and are also expected to be crucial issues in the upcoming Korea-China FTA negotiations.

Chapter 6 focuses on the conclusions drawn up from China's FTA strategies and their implications for future Korea-China FTA negotiations. A Korea-China FTA is expected to have a dramatic economic impact on both countries as a result of the trade of trade barriers and trade promoting effects. Korea will witness a surge in its imports of final goods from China and an increase in the welfare of its domestic consumers. Moreover, access to China's huge market of 1.3 billion people will be made easier for Korean exporters through simplified clearance processes, tariff removal, eased trade remedies, etc.

On the other hand, in order to maximize the expected benefits from the FTA, Korea must make a full effort to conclude a comprehensive Korea-China FTA, such that it includes intellectual property rights, investment-related issues, and service sector liberalization in the negotiations. There is no doubt that more and more Korean firms are investing in China as China's importance as a sales market grows. Moreover, economic cooperation, such as an FTA is likely to increase FDI flows between the two economies, as trade liberalization makes markets within the FTA area more attractive through the reduction of trade costs and improvements in the investment environment. Therefore, in order to promote bilateral economic relations between Korea and China, the two countries need to improve a framework of regulations that comply with international investment protection standards.

A Study on Japan's Economic Reform and its Implications for Korea

Sung Chun Jung, Yang-Hee Kim, Hongbae Lee, Hyong-Kun Lee, and Eun Ji Kim (Dec. 2006)

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USD 12

The Japanese economy has finally recovered from a decade of recession. According to the Japanese government's official report on its country's business cycle, the turning point from contraction to expansion in the Japanese economy likely occurred near the start of 2002. Today, Japan is in the middle of the longest expansion period since World War II. It is argued that Japanese firms played a vital role in eliminating the major obstacles to economic recovery - i.e. excessive employment, equipment, and debt. Moreover, the Japanese government is also said to have succeeded in facilitating economic recovery by improving the business environment.

The objective of this paper is to provide a detailed description of the economic and structural reforms in Japan since the late 1990s. In the first chapter, we examine the efforts made by Japanese firms to help eliminate the major obstacles to economic recovery. In the second chapter, we provide an extended analysis of the Japanese economy from the early 1990s to the present. From our results, we notice that the Japanese government's economic policy has changed significantly under Prime Minister Koizumi and that this change in policy contributed greatly to Japan's economic recovery.

In the third and fourth chapters, we give a full account of the economic and social reforms made at the government and firm levels. In the last chapter, we present the policy implications of Japan's experience on Korea's economic reforms.

Our conclusion is that it is very important to stabilize government finance in the long run. Japan's experience tells us that once the stability of government finance breaks down, it requires significant time and effort to reconstruct a stable and sound financial system. We also suggest that the Korean government reform its public sector by making it more efficient and be more cautious when planning to expand fiscal spending or the social safety net through tax rate increases.

For Korea's economy, long-term, supply-side economic policies are more important than short-term, demand-side policies. From Japan's experience in the 1990s, the effectiveness of total demand management declines sharply in the short-run. We believe this has also been true for the Korean economy since 2000. Therefore, we suggest that the Korean government put more emphasis on structural reforms in the governmental sector and raise the potential growth rate of the Korean economy, rather than pursue short-term fiscal expansion.

Strategies for Eastern Russia's Development and the Implications on the case of Korea's Involvement

Focusing on the Energy Sector

Jae-Young Lee, Cheol-Won Lee, Hyeon-Joon Shin and V. D. Kalashnikov (Dec. 2006)

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USD 10

The Russian government has recently been trying to promote the economies of Eastern Russia. Major superpowers surrounding Eastern Russia have also recognized it's economic and diplomatic importance of the region and have advanced into it. This study analyzes the development strategy in Eastern Russia and the advancement strategies that major superpowers have used to enter the region. As such, the current status of Korea's advancement into the region will also be evaluated and some national strategies and action plans for Korea's advancement into East Russia will be suggested.

In Chapter 2, this study makes a comprehensive analysis of the development strategy in Eastern Russia and its implications for Korea. The keynote strategy for development in Eastern Russia is bringing into focus energy development and construction of energy infrastructures. Korea's advancement into Eastern Russia has very important economic and diplomatic implications for Northeast Asia, such as oil and gas security, construction of the East Siberian oil pipeline, electric power connecting the ROK, DPRK, and Russia. Thus, it is necessary to understand the importance of Eastern

Russia's development strategy and establish a comprehensive advancement strategy.

Chapter 3 analyzes the current status and strategies of major countries that have entered Eastern Russia and derives implications for Korea. Major countries, such as the US, Japan, China, and EU, consider Eastern Russia as an important energy superpower, supplier, export and investment market in Northeast Asia. The US is generally viewed as wanting to hold Russia's rise as an energy superpower in check and is trying to tighten energy security by importing oil and gas from Eastern Russia. For these purposes, the US government has opened a US-Russia dialogue channel and oil majors in the US have focused on the development of new oil fields and M&As with Russian oil companies. Japan is similarly in the process of setting up an intergovernmental cooperation action plan and is providing official aid through a permanent economic cooperation body. Japan's national energy companies are participating in the energy development business and private companies are trying to expand their overseas market in Eastern Russia, especially for capital goods. China is also strengthening its strategic partnership with Russia and investing in energy assets in Eastern Russia to secure a stable supply of energy. Likewise, the EU is focusing on solidifying an energy alliance with Russia and oil majors in the EU are investing in oil and gas fields in Eastern Russia.

Korea also considers Eastern Russia as an emerging energy supplier and a new export and investment market in Northeast Asia. Korea, however, has limited capabilities compared to the major countries and oil majors in terms of foreign power and financial resources. However, the strategies employed by major

players provide invaluable lessons for Korea. This is especially true with regard to countries like Japan, which has a similar economic structure and geopolitical status as Korea. Accordingly, Korea, like Japan, should consider providing official aid and development loans to Eastern Russia and actively endorsing national energy companies more actively. In addition, the Korean government can draw some important lessons from Chinese strategic policies, such as establishing intergovernmental partnerships with Russia and maintaining consistency in its foreign energy policy.

Chapter 4 reveals that Korea's advancement in Eastern Russia is far below what should be expected. These sub-standard results stem from a lack of systematic strategies and a poor investment climate in Eastern Russia. This study has surveyed Korean companies in Eastern Russia in order to evaluate the actual investment climate in Eastern Russia. Our results indicate that there are major problems with customs procedures, the distribution system, and local financing systems, etc. But the results also suggest a positive outlook for the investment climate in Eastern Russia and a bright future for the energy development sector.

Chapter 5 suggests Korea's basic strategy, its policy formation, and sectoral action plans for Eastern Russia. Korea should establish a strategic position in Eastern Russia, consolidate various undertakings, and strengthen Korean-Russian cooperation. Russia has a plan to diversify its key industries in the mid and long-term, but it is expected to concentrate on developing energy, as well as energy-related infrastructures, in the short-term. Therefore, Korea has to take greater interest in the following: development of oil and gas fields, increasing electric power cooperation, and the construction of the East Siberian oil pipeline.

The ultimate goal of participating in the development of oil and gas fields in Eastern Russia is to strengthen Korea's energy security. National energy companies, especially KNOC and KOGAS, should take a greater role in this process. They need to establish national or international consortiums, rather than act independently, to avoid investment risks and accumulate the know-how to establish energy businesses in Eastern Russia. In particular, an international consortium with Russian energy companies could be very beneficial as it can cause a ripple effect in other Eastern Russian energy-related industries that Korean companies want to enter. Financial and humanitarian aid to Eastern Russia is, perhaps, the best way to improve the image of Korea and Korean companies, and trust between Korea and Russia.

Korean-Russian electric power cooperation is advantageous not only in terms of economic profits, but also for the expansion of Korea's and the DPRK's economic cooperation. The economic feasibility of Korean-Russian electric power interconnection has already been proven, but there exist some unaddressed political issues with the DPRK, as the power transmission lines need to pass through DPRK territory. Other related issues this project will impact are the peaceful settlement of DPRK's nuclear crisis and the economic opening of the DPRK. Our basic strategy for this project consists of a three-step approach: passive in the short-term, active in the mid-term, and leading in the long-term. In the short-term, Korea should concentrate on power transmission to the DPRK and watch the development of electric power interconnection between the DPRK and Russia. In the intermediate term, we can try to promote a Korea-DPRK-Russia tripartite electric cooperation and initiate electric power interconnection plans from Russia to Korea

via the DPRK. In the long-term, Korea must take leadership in realizing tripartite electric power interconnection plan and help the DPRK to fundamentally solve energy shortages.

Construction of the East Siberian pipeline is the largest energy-related infrastructure project in Eastern Russia. In the early stages, the Russian government mentioned that foreign capital and technology would be needed to start construction on the pipeline. But recently, it declared that the first half of the East Siberian pipeline will be built by Russia's own capital and technology. So, it has become difficult for foreign countries, including Korea, to participate in the construction of the East Siberian pipeline. Russia is, however, open to Korea's participation in the building of an oil terminal in Kozmino Bay, as well as the second half of the pipeline. The Korean government should intensify negotiations through diplomatic channels, such as a Korea-Russia summit meeting and joint committees. Moreover, Korea should provide financial and institutional support to companies that want to join the construction of the East Siberian pipeline. Companies are required to establish a network with Russian companies and institutions, and collect detailed information on construction.

With regard to participating in the development of Eastern Russia, this study proposes the establishment of a new diplomatic channel and support system, tentatively called the 'Korea-Russia Cooperation Center for East Siberia and Far East,' which would serve as an integration of existing diplomatic channels.

Management Survey of Korean Firms in India and Strategies for Localization

Sooncheul Lee, Jaewan Cheong, Yoonjung Choi, Minah Oh (Dec. 2006)

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USD 7

India's consistent growth performance and large high-skilled workforce provide enormous opportunities for both domestic and foreign investment. Since 1991, India has initiated major economic reform programs in the fields of investment, trade, and finance, in addition to the enactment of competition laws, amendments to intellectual property rights laws, etc.

Korean investments in India have steadily risen in recent years: increasing by 2.4 fold in 2004 and 2.2 fold in 2005. Most of the Korean firms that invest in India are large enterprises and operate in a variety of sectors, including manufacturing, construction, mining, and real estate.

According to our survey results, the main factor driving Korean investments to India is market-oriented, centering on India's potentially enormous market demand. Korean firms in India are also performing very well as of late and are expected to branch out to other industries in the near future. In order for Korean investments to succeed in India, localization in management is urgently required.

However, Korean firms looking to invest in India today are only able to obtain relevant information on investment policies and

procedures through established Korean firms in India or personal networks. To encourage greater investments and ensure the success of Korean businesses operating in India, the Korean government is called upon to establish easily accessible information channels and credible networks for Korean businesses, which can be achieved by pursuing a partnership with the Indian government.

The difficulties of conducting business in India stem from a number of factors, including complicated administrative procedures, passive government officials, poor infrastructure, difficulty in the procurement of raw materials, and poor management of human resources. Moreover, because most Korean firms deliver products directly to Indian companies, they are forced to deal with local business transaction issues like collecting bills, price competition, warranty maintenance fees, etc.

Thus, it is crucial for the Korean government to support Korean investments in India by providing appropriate business information and establishing a human resource exchange program so as to procure experts from various fields.

The success of these investments depends on key factors like the localization of management systems, technology, human resources management, finance, organization, regulations, and culture.

Finally, greater assistance for small and medium firms is required to help these firms expand their businesses in India. Most Korean firms in India import parts and components from Korea and assemble the final products locally. Taking this into consideration, the early conclusion of a Korea-India CEPA (Comprehensive Economic Partnership Agreement) would be greatly beneficial for Korean firms in India.

Policy Proposal for the Economic Cooperation between Korea and the Middle East in the Era of Oil Boom

Bokyeong Park, Jooseong Hwang, and Chulhyung Park (Dec. 2006)

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USD10

Since the oil price boom in 2000, vast sums of oil dollars have flowed into the Middle East. With the revival of the Middle East's economy based on increasing monetary flows, the region has aroused the world's interest. This study begins with a comprehensive analysis of the economic trends of the gulf region where oil producing countries are clustered and suggests ways for Korea to strengthen cooperation and relationships with countries in this region. This study specifically addresses the amount and flow of oil dollars to the gulf region, the current economic policies of gulf countries, strategies the world's major countries have adopted toward the Middle East, and suggestions on cooperation policies with the Middle East.

With rising oil prices in the last six years, the total amount of oil money that has flowed into the Middle East is estimated at US\$1.3 trillion. About 40% of this amount has flowed back to the world through imports. But, as oil prices continue to soar, the rate of outflow has declined. Figures indicate that the current account surplus of gulf countries is expanding rapidly and global imbalances are continuing to aggravate. In the meantime, gulf countries are investing approximately 40% of their current account surplus as portfolio

investments in the world market and are retaining about the same amount as foreign reserves. In contrast to the 1970s, gulf countries are increasing their proportion of portfolio investments in total investments, rather than decreasing their proportion of foreign bank accounts.

The main economic policy goals of gulf countries are to secure a stable income on the sale of oil and gas and to diversify economic structures in preparation of natural resource exhaustion. Gulf countries are seeking to extend their production capacities of oil and gas, convinced of the growth prospects of world energy consumption. With respect to economic diversification, these countries plan to foster the growth of manufacturing and service industries by promoting privatization and foreign investment. Moreover, economic reforms, such as downsizing the government's role and opening of markets, are also being pursued to remove structural obstacles for economic diversification.

The world's major powers, such as the US, EU, China, and Japan, are also trying to strengthen political and economic cooperation with gulf countries, not only because energy security has required greater importance in responding to high oil prices, but also because the influx of oil money has led to the rapid growth of the import market in this region. Moreover, recent crises in the Middle East have shown that energy security issues can directly impact domestic security and social stability. In particular, the US has set up revolutionary goals for the Middle East, with democratization of the political system and integration of the region into the world economy being top priority agendas. The EU has also tried to strengthen its influence through economic integration with the Middle East, while China's strategy of guaranteeing energy security has been to take

advantage of the conflicts between the US and the Middle East.

The economic outlook for the Middle East should continue to be bright just as long as geopolitical risks do not worsen. Also, Korea's heavy dependence on the Middle East is expected to deepen as the influence and importance of this region in the world energy market is expected to increase much more in the future. Therefore, this study suggests some methods to broaden and strengthen political and economic cooperation with the Middle East. First, the Korean government and Korean public should acknowledge the importance of the Middle East and support the sustainability of Middle East policies. Second, Korea should pursue reciprocal cooperation with the Middle East, rather than unilateral market penetration. Third, limited cooperation in specific areas, such as product exports, plant projects, and energy imports, should be expanded. Korea should also diversify areas for inter-regional cooperation. Fourth, the Korean government should establish comprehensive strategy and policy packages to deal with each of the major issues. Fifth, the government should give indirect support to the private sector to strengthen their competitiveness. Sixth, the government should make more commitments to strengthen foreign relations with the Middle East. Finally, the importance of Iran should be properly assessed and cooperation efforts with Iran should be strengthened.

MERCOSUR's Free Trade Negotiations and Implications for a Korea-MERCOSUR FTA

Won-Ho Kim, Ki-Su Kwon, Jin-O Kim, Swan Park, and Jae-Sung Kwak (Dec. 2006)

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USD 10

This study explores the free trade negotiations of the Southern Common Market (MERCOSUR), which comprises Brazil, Argentina, Paraguay, and Uruguay, in an attempt to derive implications for a future Korea-MERCOSUR Free Trade Agreement (FTA). Beyond South America, MERCOSUR has successfully launched Preferential Trade Agreements with India and the South African Customs Union (SACU) as pre-FTA arrangements, and negotiated an FTA with the European Union (EU) and the Free Trade Area of the Americas (FTAA), although these two negotiations have stalemated in the last couple of years. This study covers four cases of negotiations looking specifically at their backgrounds, economic relations, negotiation modalities, issues, and prospects.

Our examination leads us to the conclusion that Korea and MERCOSUR will tend to reserve the agricultural industry and automobile industry, inter alia, as sensitive sectors, when the two parties undertake FTA negotiations. As evidenced in the most relevant precedent, the MERCOSUR-India PTA, it is expected that the two parties will have difficulty acquiring free access to each

other's sensitive sectors, and that the ultimate trade agreement will be limited in its coverage. Technical difficulties will increase when Venezuela joins MERCOSUR as the fifth member state, since MERCOSUR does not have a supranational negotiating authority like the European Commission. Furthermore, Korea should take a pragmatic and progressive stance toward negotiations with MERCOSUR as the future trajectory of the regional bloc is quite uncertain given the number of bilateral and intraregional relationships.

Regional Trade Agreements and Productivity Improvement

Hongshik Lee, Kwanho Shin, Jong-Wha Lee, and Hyungju Kim (Dec. 2006)

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USD 7

The underlying position of Korea's external economic policy has been the strengthening of the multilateral trading system under the GATT/WTO.

Korea had been a beneficiary of multilateralism for 40 years. Entering into the 1980s, however, the Korea government started to gradually take notice of regionalism. The transition of Korea's external economic policy stems from the new trend of increasing regionalism in the world trade environment, as well as its firm belief that expansion of trade is indispensable for sustainable economic growth.

One crucial reason that Korea is actively promoting RTAs, besides a significant increase in trade volumes, is that RTAs are a key way of bringing about greater competition and higher productivity in all domestic industries, driving the participants to higher levels of efficiency, advanced economic structure, and strengthened competitiveness. This study estimates the validity of the argument that RTAs improve the productivity of an economy through empirical analysis.

In this study, we consider two channels through which the

formation of RTAs improves productivity of the economy. First, if a country forms an RTA, it can increase the volume of trade not only with member countries, but also with non-member countries, which contributes to higher productivity growth. In particular, by taking into consideration trade structures (export similarity), as well as the other economic characteristics of member countries, we try to estimate more precisely the trade creation effects of an RTA. Second, we also examined another possibility, in which an RTA would directly influence productivity without increasing trade. For example, the formation of an RTA could force institutional reforms and encourage skill transfers. Further, removal of trade restrictions also foster more competitive and efficient markets. The direct effects of an RTA could also contribute to higher productivity growth.

We find that in both channels the formation of an RTA improves productivity. In general, RTAs increase trade volumes between member countries. The trade creation effect of an RTA turns out to be even larger for countries with high export similarity. Further, we find that formation of an RTA increases trade volumes between member and non-member countries as well. Overall, this increased trade contributes to higher productivity growth in the first channel. In addition, even after controlling for the effects of increased trade, we find strong evidence that an RTA itself contributes to higher productivity. Hence, our results suggest that formation of an RTA directly increases productivity growth through the second channel as well.

We apply our methodology estimating the productivity growth effect assuming that Korea forms an FTA with the us. Our estimates indicate that the Korea-us. FTA could boost the annual productivity

growth rate by 0.06-0.12% point. However, this estimate should be interpreted with caution due to the following limitations. First, our estimate is derived from the experience of existing RTAs, whereas the Korea-us. FTA negotiations are still in progress and the concrete contents of the FTA have not been revealed yet. Second, we did not consider the specific industry structures of Korea and the us. or for possible differential effects of productivity growth across industries. Third, our estimate could be biased, if RTAs are formed endogenously. Last, we were not able to investigate more detailed pathways (the second channel) of the RTA's direct effects on productivity. The remaining issues should be studied in future researches.

KIEP



Conference Proceedings

Africa in the World Economy

National, Regional and International Challenges

Jan Joost Teunissen and Age Akkerman eds. (Apr. 2006)

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USD 10

The contributors to this book examine the economic constraints to growth and development faced by sub-Saharan African countries. These constraints include the underdevelopment of domestic capital markets, the lack of national and regional infrastructures, and continuing dependence on the export of commodities whose prices and markets are volatile and remain largely determined by large companies in developed countries.

At the same time, the book discusses the international community's response to remove obstacles of its own making and creating the necessary conditions that would enable Africa to overcome its development and poverty problems.

Experienced scholars and policymakers from Africa, policy-oriented experts from Western and Asian countries, and research-oriented officials of the IMF, World Bank, UN, and WTO have presented many of their views on Africa's challenges. Their analyses have provided useful insights into how policies can be improved at the national, regional, and international levels.

All of the chapters expose some cliché's of Africa's development. The book includes an interesting discussion about the development



model, the role of the state, and the role of the market that would best fit African realities, and the lessons that could be gleaned from experiences in Latin America and Asia. It also includes a timely analysis of the developmental role of emerging Asian investments into Africa.

The contributing authors are deeply concerned with Africa's fate. Their analyses and solutions are highly useful to those who want to contribute to improving the economic situation in Africa. Some of the issues discussed in this book are also of great relevance to development prospects not only for the African region, but for poor countries in general.

Global Imbalances and the US Debt Problem

Should Developing Countries Support the US Dollar?

KIEP · FONDAD (Dec. 2006)

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USD 7

The contributing authors to this book have provided highly interesting analyses and policy recommendations. Their analyses are geared toward both the functioning of the world economic system, as well as at the question of what individual countries and regions can do to resolve the US deficit and the problem of global imbalances. Several authors have reminded us of the need of more in-depth analysis on the causes of global imbalances. Barry Eichengreen and Yung Chul Park (Chapter 2) hold the United States primarily responsible for its large deficits and contribution to global imbalances. The authors argue that the US deficit is untenable, and they urge the US to reduce its current account deficit, preferably by saving more. The US could save more, they suggest, by reducing government expenditures, raising taxes, and reducing tax cuts. These measures sound reasonable and feasible, but the authors observe that there is no political will in the US to implement them. They stress that the US ought to address the domestic roots of its deficits, and warn emerging market countries that they cannot afford to wait for the US to act and should, instead, take their own measures. Barbara Stallings (Chapter 3) agrees with the policy recommendations by Eichengreen and Park, but stresses that

more discussion is needed regarding the lack of political will to carry them out. She observes that it is certain that the Bush Administration will not follow their advice and that the Democrats are unlikely to cut the deficit in a serious way either. Jane D'Arista and Stephany Griffith-Jones (Chapter 4) also share the notion that the US is to blame for its deficits. However, they stress that US deficits are not only the result of over-spending by the US, but also of an international monetary system that uses the dollar (and a few other national currencies) as an international store of value, thus generating debt in the key currency country, the US. Their analysis implies that the US could contribute to resolving problems with its debt and global imbalances by supporting international initiatives aimed at making countries, particularly developing countries, less dependent on the dollar as payments and investment currency. The initiatives they suggest include the promotion of GDP-linked bonds and local currency bonds. Fan Gang (Chapter 5) sees the international monetary system as the main cause of US deficits and global imbalances. The fundamental problem is not in US policies, he stresses, but in the global currency system which allows the US to run high deficits and print as much money as it needs. US policymakers do not see it as "their problem" that they run high deficits and print more money since the negative consequences generally becomes other people's problem, says Fan. In his view, the ideal system should be one that is independent of the self-interests of participating countries, and provides common benefits to all. "It should not be a currency of any particular country no matter how strong or dominant that country is in the world market." Jan Kregel (Chapter 9) presents an alternative explanation of global imbalances. In his view, they largely result from the fact that too many countries are using export-led growth strategies

(including Europe) and that firms are investing and producing transnationally while the balance of payments is national. Both Europe and Asia (as well as other countries) continue to finance US deficits, says Kregel, because this allows the US economy to absorb a large part of their exports and, equally important, to remain an attractive economy for investments by European and Asian transnational corporations. When the role of Asia in global imbalances is discussed, the focus (and blame) is often directed toward China. The authors in this book do not share this simplistic and critical view of china. Given the increasingly important role China is playing in the world economy, we asked several authors to respond to the “China question”. What policy recommendations do they suggest? Barry Eichengreen and Yung Chul Park (Chapter 2) say that China’s annual surplus is now roughly a third of the US deficit, which in their view suggests that China should do something to reduce its surplus. The authors argue that the best way for China to reduce its current account surplus would be to reduce its savings. while they observe that, in the long run, Chinese savings will go down in a natural way, they suggest that given the need for short-run measures, China’s government should increase spending on education, health care, social security, urban infrastructure, and modern housing. However, Eichengreen and Park stress that since the size of the Chinese economy is relatively small compared to that of the US, fiscal expansion in China could only offset a fraction of the fiscal contraction needed in the United States. Therefore, according to them, China is only a small part of the global adjustment story. Fan Gang (Chapter 5) does not think China saves too much or invests too little. He stresses that China invests up to or even more than 40 percent of its GDP in industrial capacities, housing, and public infrastructures. He also argues that China’s high saving

rate has little to do with the global imbalance problem. In fact, he observes that during 2003-2004, China even over-invested and registered trade deficits for almost 11 months. Moreover, China has not had large net national savings in recent years, says Fan, only about \$30-40 billion per year. Zdenk Drabek (Chapter 7) echoes repeated calls from US and Japanese authorities, as well as academics, for a substantial appreciation of the Chinese *renminbi*, even though he softens his argument by talking about the need for “some” revaluation of the Chinese currency. In his view, this would not only help to resolve global imbalances, but also slow down the inflow of speculative capital and help reduce inflationary pressures in China. Wing Thyee Woo (Chapter 6) disagrees with the recommendations by “foreign economists” that China should let its currency float. In his view, it misses the basic point that free-market tools can work only in a free market environment. Given China’s capital controls, a freely floating currency regime could result in a value that would be greatly over-appreciated compared to what its value would be under free capital flows, and would therefore reduce economic growth significantly. Freeing capital flows is not an option, says Woo. Regarding the role of Japan, Eichengreen and Park suggest that the most important thing Japan can do to help resolve the problem of global imbalances and contribute to a shift in demand from extra-regional exports to exports in the Asian region itself is to sustain its recovery. Yonghyup Oh (Chapter 8) also explicitly refers to Japan’s role in the issue of global imbalances. According to Oh, given Japan’s important position in East Asia and the world and the high macroeconomic interdependency across the region, East Asian monetary cooperation should be designed to include Japan (Eichengreen and Park make this point as well). Oh sees such cooperation as an important step toward to

resolving global imbalances since it would facilitate the creation of a regional capital market (implying that Asians would invest their capital in Asia rather than in the US). Moreover, it would facilitate coordinated exchange rate adjustments by each of the East Asian economies. What about the other Asian countries? Eichengreen and Park say that there is little disagreement that an across-the-board appreciation of East Asian currencies would constitute an important component of the resolution of global imbalances. However, if China sticks to limited flexibility, other East Asian countries are not likely to let their currencies appreciate vis-a-vis the renminbi since China has emerged as their export competitor in regional, as well as global, markets. This creates a problem of collective action and an argument for policy coordination, say Eichengreen and Park. East Asian monetary coordination is also an issue addressed by Fan Gang and Yonghyup Oh. Fan Gang reports on the possible establishment of an Asian Currency Unit (ACU), which would represent a weighted average of several key regional currencies. The ACU is not meant to be a real currency to replace the regional currencies, as is the case of the euro, explains Fan. It is meant to be a guide for the Asian countries to coordinate and manage their exchange rates. It could also become a viable “currency” for Asian countries to denominate their export prices, cross-border loans, and cross-border bond issuance; thus, weaning themselves away from their current total reliance on the US dollar. “This is no ivory tower academic exercise”, says Fan. “Both China and Japan are very serious about it”. Yonghyup Oh (Chapter 8) relates that around the time of the Asian Crisis in 1997-98, East Asian countries became capital exporters. Instead of investing in more risky assets at home or in the region, East Asian capital went to safer US treasury bonds and foreign reserves. Oh observes that even though it

is now less attractive to keep purchasing US government securities given the high level of foreign reserves in most East Asian economies, investing in East Asian securities is not yet attractive enough because of the underdeveloped nature of Asian capital markets. He stresses the need for creating East Asian financial markets to attract East Asian capital. Finally Jan Joost Teunissen, the chief editor of the book, acknowledges that several authors have reminded us of the need of more in-depth analysis of the causes of global imbalances. He further states that “experience tells us that in order to incite policy makers to action good analyses are a necessary but not a sufficient condition. Moreover, democratic decision making requires that more people are involved in designing and assessing economic strategies than just the academic and the policy maker.” He concludes by hoping that, in addition to the experts, non-experts will read this book as well and that the experts will help increase the understanding of the non-professionals and present the full range of policy choices that are available to resolve the problems of US debt and global imbalances. This book tells only a part of the story; the latter will be continued in the next volume, including additional policy suggestions.

Emerging Financial Risks in East Asia

Doo Yong Yang ed. (Dec. 2006)

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USD 7

The economic consequences of the Asian Crisis have been enormous. East Asia had experienced unprecedented economic slowdown, causing a sharp decline in living standards, rising unemployment, industrial breakdown, and social dislocation. After having realized the huge negative impacts from the system crisis in the region, there have been tremendous efforts to prevent future crises since 1997, including structural reforms at the country level and monetary and financial architecture at the regional level. Although these efforts have contributed to economic recovery, no one is convinced that the current economic conditions are strong enough to induce stable long-term growth; Financial risks in East Asia are continually emerging.

First, capital flows in East Asia do not seem to be healthy. There have been significant structural changes in capital flows in East Asia; East Asia is no longer an import region due to huge current account surpluses followed by rapid accumulation of foreign reserves. Since foreign reserves should be invested in more liquid and safer financial assets, most foreign reserves in East Asia have moved to developed capital markets. Such capital flows have resulted in raising financial

vulnerability in the region. Investments from advanced economies in the region are concentrated in high risk assets, which can induce a sensitive response to even a slight increase of risk, regardless of large foreign reserves in the region. It also creates a vicious cycle. To reduce this risky, East Asia is accumulating more foreign reserves and importing more risky capital flows. It is worth noting that steady current account surpluses are critical to continue the growth of foreign reserves. However, it would further increase the overseas liabilities of the US. This, in turn, leads to bigger risks in the international financial market when the US. attempts to manage the increasing risk of global imbalances arising from the current account deficit by depreciating the US dollar or appreciating East Asian currencies.

Second, related to capital flows in the region, exchange rate management in East Asia faces a great challenge. It has been alleged that East Asia's prolonged, large-scale exchange rate intervention prevents East Asia's currencies from appreciating against the US dollar. The undervalued currencies are said to underpin an export-led economic strategy that produces economic and employment growth. Exchange rate management in the region is under great debate, as it is seen as one way to solve exchange rate risk exposure and reduce global imbalances. China recently announced that it is adopting a basket of currencies as a peg for its exchange rate, instead of the US dollar. This change raises questions of East Asian's exchange rate management or regime, and how it will to respond. However, it is not clear whether this will be an opportunity or a threat in East Asia.

Third, higher interest rates in the US. have also adversely affected East Asian economies. In general, upward movements in US interest rates triggered a number of emerging market crises in the 1980s and 1990s. Two risks factors are worth noting in this regard. First, higher

capital gains on US assets attract greater capital, thus reversing international capital flows. Increasing uncertainty combined with declining international liquidity and weakening currency conditions increase the volatility of capital in emerging markets. It also increases risk premiums and, therefore, the cost of capital. Second, higher interest rates on a global scale may decrease global consumption spending, hence reducing external demand for East Asian exports. Since investment and consumption in East Asia has been sluggish, such risks may accelerate financial vulnerability in the region.

Against this background, this year's joint project by the Korea Institute for International Economic Policy (KIEP) and the Policy Research Institute (PRI) has been trying to identify major financial risks in East Asia, as well as provide comprehensive analyses, policy implications, and recommendations.

The following are general descriptions for the joint project.

Theme 1: Current Capital Flows and Related Risks in East Asia

This theme will describe current capital flows in East Asia and identify and evaluate related risks from potential capital reversal. Current economic developments in regional or global capital markets should be addressed and potential risk factors should be identified.

Theme 2: China's New Exchange Rate Regime and its Implication to East Asia

China's current adoption of the BBC regime is the most important change in exchange rate management in East Asia. Questions on this issue are whether it is more beneficial for East Asia if the Chinese *renminbi* gradually increases its flexibility or implements one big

change in its value, and whether it would be advantageous to other East Asian countries if they were all to adopt a similar arrangement. In addition, it is worth mentioning how current changes in China's exchange rate regime have affected East Asian economies.

Theme 3: Too Much or Too Less: How to stimulate the private sector in East Asia

A hike in interest rates on a global scale could derail strong and broad-based recovery in East Asia. Despite strong growth, investment recovery has been sluggish, except in China, while a rebound in consumption remains vulnerable to a tightened monetary stance. In addition, diminishing external demand for East Asia's exports will also interrupt economic expansion. Under these circumstances, it is quite important to identify each country's macroeconomic policy stance and to analyze the consequences of these macroeconomic policy measures.

KIEP



Policy References (in Korean)

Economic Changes in Mexico after NAFTA and Implication

Chang-Soo Lee, Min Sung Kim, Chang-In Yoon, and Jin-O Kim (July 2006)

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USD 7

Since NAFTA was implemented in 1994, Mexico's main macroeconomic indicators, such as the economic growth rate, trade and FDI inflow, employment, and competitiveness, have been experiencing positive growth. NAFTA was pointed out to be a significant factor behind such positive changes.

Along with the implementation of NAFTA, however, Mexico has been undergoing declining real GDP, an increasing unemployment rate, and experienced damages to its subsistence farmers in the 1995-96 period. It also has been experiencing deepening income inequality and imbalances among industries and regions since trade liberalization in 1985.

It has been argued that NAFTA is a direct cause of these negative phenomena in Mexico. But this study shows that these negative phenomena stem from by various factors, from a sudden devaluation of the peso, sociopolitical instability, incompetence and corruption in local governments, economic structural problems, to an insufficient domestic settlement policy. These also helped to prevent the full realization of the potential benefits of trade liberalization. NAFTA was thus not the central reason behind the negative phenomena of the

mid-1990s.

According to survey responses from local governors, the idea that similarly negative effects in Korea due to FTAs is unfounded and irrational, in that Korea has been evaluated a more stable political, economic, and social environment, and has more advanced technology and institutions than Mexico. Unlike Mexico, Korea has retained relatively weakened income inequality, an absence of inefficient and non-competitive insolvent companies, global competitiveness of fundamental industries, and high levels of social cohesion, human resources, and R&D investment when compared with Mexico. Because of these characteristics, the potential positive effects of an FTA with the United States for Korea are expected to exceed Mexico's.

In light of Mexico's case, it is important to collect diverse public opinion and to make an effort to negotiate for maximum benefits in the process of FTA negotiations. It is necessary to prepare the proper countermeasures to the problems that developing countries undergo due to FTAs with developed countries, and formulate efficient policies for those who lose out from an FTA.

The Mongolian Economy and Directions for Economic Cooperation with Mongolia

Jae-Wan Cheong and Min-Woo Ryu (Aug. 2006)

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USD 5

The Mongolian economy, which began its transition to an open trade economy in the 1990s, has been in a period of stabilization since the 2000s. In particular, when excluding Eastern European countries such as the Czech Republic and Hungary from consideration, the Mongolian economy is evaluated having most successfully achieved the transition of its economy, with the fastest reorganization speed. According to the IMF, Mongolia suffered a relatively short time of economic turbulence compared to other countries in transition .

Since 2000, the successful post-transition Mongolian economy has experienced an increasing growth rate due to rich natural resources, the development of the private industry sector, foreign direct investment, and so forth. In 2004, Mongolia achieved an all-time high GDP growth rate of 10.7 percent, through the uniform development of all its industries and the sudden rise in international mineral prices.

In addition, the Mongolian economy is characterized by a small population compared to its vast territory, the economically advantageous geographical position of being an inland country, and

by being a resource-rich nation, a trade dependent economy, and a driftwood society.

Korea and Mongolia have rapidly developed cooperative relations in several fields such as culture and economy, facilitated by racial and cultural similarities, in spite of short period about 16 years. In particular, the Korean president's second visit to Mongolia helped to upgrade the two countries' relationship.

Mongolia traditionally recognizes South Korea as 'Solrongoseu's country', and recognizes Korea as its main partner in Northeast Asian economic cooperation. Because of its geographical position and historical experiences, the Mongolian people generally take strict precautions when dealing Russia and China, whose political and economic systems have subjugated Mongolia in the past, and prefer Korea to Japan, because of geographical proximity and amity between the two countries.

Mongolia looks to the South Korean experience as a model for its own economic development, and as such, the Mongolian government has established Korea as an important diplomacy target and is active in promoting relations with Korea. As a result, Korea is the first country with whom Mongolia established diplomatic relations after its transition to an open trade economy. In addition, hallyu (the Korean Wave) continues to exist in Mongolia, and South Korea is considered a land of opportunity and hope to Mongolians (seen in their enthusiasm for studying Korean and the popularity of studying abroad in Korean universities).

We can condense the directions of how best to extend economic cooperation between the two countries extending Korea's ODA support, participating in Mongolia's rich mineral resources development, participating in the extension of the infrastructure-

improvement business, and aid advances in agriculture and stock farming. More specific business prospects lie in cashmere, mining, energy, the Internet, communications, banking, and tourism.

Economic Development of Azerbaijan and Economic Cooperation between Korea and Azerbaijan

Hyeon-Joon Shin (Aug. 2006)

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USD 5

Azerbaijan is coming into the spotlight of world economy because of rapid economic growth, natural resource abundance and market-friendly investment environment. After President Noh's state visit to Azerbaijan in May 2006, Korea is showing more interest in Azerbaijan economy. Azerbaijan is worth being Korea's new trade partner. Many specialists in Azerbaijani economy forecast that the rapid economic growth of Azerbaijan will continue in the future. Azerbaijani government tries to reduce trade and investment barriers. Since Korea heavily depends on Middle East in the import of oil and gas, Azerbaijan holds a key post in alternatives in order to diversify import routes of oil and gas. Therefore Korean government should try to strengthen economic cooperation between Korea and Azerbaijan.

This study aims to analyze the current status of Azerbaijan's economic development and make a blueprint for strengthening economic cooperation between Korea and Azerbaijan. The development of trade relations between Korea and Azerbaijan has been unbalanced and Korea's direct investment to Azerbaijan has been few or no. Korea's trade surplus has significantly expanded and continued. As trade imbalance and few direct investment play a

restrictive role in consolidating and expanding economic cooperation between two countries, Korea needs to make a great effort to facilitate trade and direct investment in Azerbaijan. For a long-term economic cooperation, Korea should initiate Azerbaijan into experiences of Korea's economic development, provide Azerbaijan with credit assistance and grant aid and promote cultural exchange.

The TV Broadcasting Industry and Regulations in China

Jina Yeo (Aug. 2006)

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USD 5

The business expansion of the Korean TV broadcasting industry represents a new engine of economic growth, as Korean soap operas and movies contribute to the “Korean Wave” that is currently sweeping across Asia and several Western countries. This report deals with the current status of the Chinese TV broadcasting industry and its regulations on the entry of foreign entities into the TV market. This study will contribute to establishing a market strategy for china’s TV industry and preparing for the Korea-China Free Trade Agreement (FTA) negotiations.

In accordance with China’s WTO commitments, the Chinese audiovisual service sector has been undergoing gradual market opening. In October 2004, the State Administration for Radio, Film, and TV (SARFT) and the Ministry of Commerce (MOFCOM) issued Provisional Rules on the Administration of China-Foreign Joint Venture and Cooperative TV Program Production Firms. These rules establish a minimum registered capital requirement for joint ventures and cooperative firms and mandate a share of no less than 51 percent for domestic partners. These changes opened the door for foreign investment into the Chinese TV industry, but only in the TV program

contents market, and not in the more profitable and sustainable markets of TV channel retransmission and program supply.

The Chinese TV industry is controlled by the government, and the Chinese Central Television (CCTV) dominates the media system in China. However, satellite TV stations in several provinces, such as Hunan, are now rising as main players in the Chinese TV market. Therefore, it is highly recommended that Korea take a specific and concrete, regional-based approach to establishing a market strategy for the Chinese TV market. This is why this study touches on the status of market competition between provincial satellite TV stations and municipal TV stations.

Japanese Safeguard Guidelines against Hostile M&As and its Implications for Korea

Sung Chun Jung and Hyong-Kun Lee (Sep. 2006)

ISBN 89-322-2101-4/ A5/110pp.

USD 7

Recently in Korean society, there has been an active expansion of discussions on the issue of hostile M&As. In Korea, the issue that is of most concern is the M&A of domestic enterprises by foreign capital. This paper introduces how the Japanese government has responded to hostile M&As as an example that can be referenced in Korea's efforts to solve this issue.

The ways in which the Japanese have responded to hostile M&As has caught Korea's attention. One of the first things that is noticed in Japan's response to hostile M&As is the recognition and attitude of its government. Japan's government, even after foreseeing the proliferation of hostile M&As, has focused more on associated positive effects than the negative effects. Another way in which Japan's response has differed is that in order to deal with hostile M&A takeovers, the government presented specific guides that give suggestions on effective ways that Japanese companies utilize to can respond to M&As.

The biggest lesson to be learned is the Japanese government's legal-oriented and rational response, which established specific guides to recommended conduct in response to M&As; the Korean

government must discuss the creation of similar guidelines. There is a need for rational and objective dialogue to take place between businessmen, M&A legal and economic experts, government officials, and other related parties to evaluate what the present condition of the M&A environment is, as well as to determine appropriate preventative measures that can be exercised by businesses.

We have reached the point where it has become necessary to promote rational discussions on preventative measures that can be taken against hostile M&As carried out by foreign capital. These discussions must look not only at the effects on corporate performance and business innovation, but also toward improving the contributions to the value of businesses in the long-term, discussing existing problems, as well as promoting the inflow and usage of foreign capital, which can improve Korea's economic competitiveness, while at the same time eliminating M&As, which impede such improvements.

In addition, it is necessary to engage in further in-depth case studies M&A market rules in developed countries, like the US, Europe, etc. In the UK, Australia, and New Zealand, the interests of shareholders are viewed as being of primary importance. As a result, the amount of government intervention in the M&A market is strictly limited. In contrast, although the US system at first glance seems to be open for M&A markets to form, if an M&A puts the strategic interests of the state in jeopardy, regulation is thoroughly exercised.

Similarly, states exercise various degrees of regulation in M&As, according to their respective situations. It follows that Korea should analyze and compare each of these advanced models and apply the one that is most appropriate to its conditions. Japan presents one such advanced model. However, because of the intervention by administrative authorities, it is uncertain whether the guide-based

model presented by Japan will be effective in fostering the formation of an M&A market in a consistent manner. Nevertheless, when we consider Korea's present condition, even though its M&A standards are insignificant in comparison, we can make the evaluation that it has sufficient merit to serve as benchmark in the short and middle-term.

Prospects for Regional Financial and Monetary Integration in East Asia (in English)

Yung Chul Park and Doo Yong Yang (Oct. 2006)

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USD 10

The financial crisis that erupted in 1997 changed the region's confidence in such a way that its consequence gave strong impetus to the search for a regional mechanism that could forestall future crises. This search has been gathering momentum and has opened the door to possibly significant policy-led integration in East Asia. The adoption and implementation of the CMI and ABMI could be counted as major steps toward strengthening financial and monetary cooperation in East Asia.

The CMI was initiated as a supplementary liquidity facility based on a bilateral swap arrangement. However, it has been criticized from the beginning as being too small in volume and too fragmented in its decision making process to deal with possible financial crises the region. The IMF conditionality and the lack of a regional surveillance mechanism are also a point of great concern for the effectiveness of the CMI. Reflecting on those concerns, the ASEAN+3 Financial Minister's Meeting has made some progress. The ministers agreed to increase the size of the bilateral swap arrangements from \$39.5 billion to \$79 billion. They also decided to increase the ceiling for liquidity support (without any IMF

supports) to 20% from the current 10%. Furthermore, the FMM reached the decision that the CMI would be developed as a multilateral decision-making process rather than a bilateral one. Despite current developments in the CMI, it is quite uncertain whether the CMI can fully handle a full-fledged crisis in the region.

One of important economic cooperations in the region is monetary cooperation, or a common exchange rate arrangement. It is, of course, a long-term perspective, and therefore it does not seem this issue will reach any short-term or medium term agreements. The discussion includes the choice of a common currency and a collective exchange rate regime during the transition period that could facilitate monetary integration in the region.

In promoting the ABMI, the priority of the ASEAN+3 members would be to resuscitate financial reforms enacted by most East Asian economies after the 1997-98 Financial Crisis. Deregulation and opening of the domestic capital market, with the construction of the requisite market support infrastructure, will overtime create domestic demand for foreign financial instruments and encourage domestic borrowers to seek the capital markets of other countries for financing. These developments - particularly deregulation of cross border trading and investment in financial instruments denominated in different currencies - which will establish the foundation of efficient regional capital markets, should precede the creation of regional capital markets.

East Asia enjoys the late comer's advantage in promoting financial and monetary integration as it can learn from the European experience. But the success of its integration efforts will in no small measure depend on the support of the US and EU. In

the end, the western countries will have to decide whether the regional financial arrangements in East Asia will contribute to global stability and welfare; the European experience suggests that they are likely to do so. It would, therefore, be in the US and European interest to support the expansion and consolidation of the CMI insofar as financial deepening and integration in East Asia supports orderly globalization of the world economy.

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Policy References I (in Korean)

Policy Directions for Mutual Recognition of Medical Professionals Comparing the Licensure System of Korea and the United States

Jeong Gon Kim (Dec. 2006)

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USD 5

Mutual recognition of professional licenses is crucial for the free international movement of people. Recently, both multilateral and bilateral trade negotiations have tended to deal with the issue of mutual recognition. One of the most mobile professions is in the medical field, generally from developing countries to developed countries. As the United States is a major importer of health professionals (including medical doctors and nurses), this study concentrates on the United States.

It is necessary to harmonize the licensure systems of member countries in order to enable mutual recognition. This study focuses on understanding the issues related to mutual recognition of medical licenses and derives future policy directions by comparing the licensure systems of Korea and the United States.

There are several differences between the licensure systems in the two countries. First, the central government manages the health-related licensure system in Korea, while state boards are in charge in the United States. Second, the US licensure exam for medical doctors, divided into three steps, formally includes clinical skills tests, while the Korean one does not, even though most candidates conduct clinical

exercises before applying for the national licensure exam. Third, regular license renewal is necessary in the US medical licensure system, while Korean medical professionals are allowed to maintain their licenses for life. Fourth, the United States manages a developed verification system for foreign medical professionals, which is somewhat differently applied by each state based on a uniform system controlled by a nation-wide commission; Korea does not have such a system, as it has not experienced considerable inflows of foreign professionals.

Based on the comparison above, this study suggests some domestic policy directions for the development of the Korean medical licensure system and for future negotiations on mutual recognition with the United States and other developed countries. First, sector-specific licensure boards are required in order to harmonize the system with the United States and other developed countries, as well as to advance public health. Second, the administration of currently licensed professionals is crucial. One of the related issues is license renewal, which would be essential for advancing public health as well as the harmonization of standards with developed countries. Third, a more elaborate examination process is needed. Introducing clinical skills tests is an important element to be considered. Additionally, Korea has to consider the establishment of a developed verification system for foreign medical professionals, whose significant inflow is expected in the near future. Fourth, to prevent the long term brain drain, it is of great importance to offer foreign-working medical professionals incentives to return.

Finally, this study suggests some external policy direction for promoting the freer movement of professionals. First, Korea needs to mention specific professional areas at future FTA negotiations and

create dialogue channels, such as working groups. Second, Korea has to actively participate in the international discussion on the harmonization of professional standards. Third, tools other than mutual recognition, such as a special visa quota system, may be useful for promoting the international movement of professionals.

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Working Papers

Investment Stagnation in East Asia and Policy Implications for Sustainable Growth

Hak K. Pyo (July 2006)

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USD 7

The overall assessment of the macroeconomic performance by Asian crisis countries is that the rebound of growth over the period of 1999-2000 has slowed in the subsequent period of 2001-2003 mainly because of stagnant demand for domestic investment across all crisis-inflicted economies. In particular, domestic investment in Machinery and Equipment has been very disappointing. For example, in the case of Korea, its average annual growth rate was 17 percent during the pre-crisis period of 1994-1996 and became negative during the crisis-years in 1997 (-9.6%) and 1998 (-42.3%). Since then, the average annual growth rate exploded in 1999 (36.8%) and 2000 (33.6%), but suddenly dropped in 2001 (-9.0%), maintaining relatively low figures throughout 2002 (7.5%), 2003 (-1.2%) , and 2004 (3.8%).

There are two main issues at hand in examining the investment trend in the post-recovery period of Asian crisis countries. One issue is whether the stagnation in investment is a permanent phenomenon and, therefore, the period of “East Asian Miracle” is over. The other issue is why the volatility of investment has been so large during the post-crisis period of 1999-2004. The present paper

addresses these two issues and examines the determinants of investment in crisis-inflicted economies during the post-crisis recovery period.

A two-sector growth model shows that institutional rigidity, for example strong union activity for minimum employment guarantees in conventional non-IT sectors can cause investments to stagnate and prolong the slowdown of productivity and growth of the economy. In addition to the basic framework of a two-sector growth model with structural rigidity, we can add the following theoretical dimensions to explain the continuing investment stagnation in East Asia.

The standard baseline model of investment with adjustment costs known as the q theory model of investment holds expectations of lower output in the future reduces current demand for investment. It also predicts that a permanent increase in the interest rate produces a temporary setback in investment as the industry moves to a permanently lower capital stock supporting the standard view that long-term interest rates are important to investment.

However, the standard baseline model alone cannot explain continuing investment stagnation in East Asia, because even though output has recovered and interest rates have been reduced to the pre-crisis levels, investment still has not recovered yet. The reason is because the East Asian Crisis has increased uncertainty of future profitability and aggravated investment irreversibility :adjustment costs of reducing capital have become greater than that of increasing capital. In addition, financial market imperfections persist even after the crisis as financial reforms in many crisis inflicted economies either failed or took much longer than expected

so that asymmetric information continues to create agency problems increasing the cost of external finance and therefore discouraging investment.

Empirical results indicate that East Asian countries' investments are very sensitive to output growth; thus, the acceleration hypothesis is accepted. It also implies that current output growth is a reliable signal for sustainable growth and future output growth, which is a rational expectation.

This implies that the current stagnation in East Asian investment may not be a reflection of a permanent erosion of investment potential in these countries. Rather the volatility of output growth in the post-crisis period seems to have increased the cost of adjustment associated with investment irreversibility and uncertainty of discount factors. In addition, as outlined in the theoretical section, the institutional rigidities inherent in the East Asian economies, which deterred institutional and structural reforms and transformations including financial-market imperfections, have depressed investment demand.

in the empirical study of Korea we paid special attention to the IT sector to examine its investment potential and productivity growth. IT capital stock in Korea had accumulated very slowly until the first half of the 1990's, along with small decreases in certain years of the early 1980s. Since the second half of the 1990's, IT capital has accumulated at a very high rate, which is common in industrialized countries. However, IT capital has accumulated only in restricted sectors, i.e. IT-producing sectors and some IT-using service sectors.

Our findings from value-added growth accounting are as follows :

(1) productivity in the IT sector is much higher than that in the non-IT sector. Even though there are significant differences in IT capital intensities across industries, we could not find labor movement from lower IT capital intensity sectors to higher ones, compared to non-IT capital. This may lead to a decrease in the return to IT capital in the future.

(2) The growth rates of TFP in IT-industries are higher than those in non-IT industries. However, their contribution to labor productivity growth is only half of the contribution by the capital accumulation. Therefore, the Korean economy had followed a pattern of input-led economic growth up until the mid-1990s. However, this gap started to shrink from the second half of the 1990s, as IT capital started accumulating.

A productivity paradox, in which there is no improvement in productivity even though IT technology is widely used, can occur because there is a large difference in the usage of IT capital between sectors and there is a time lag in adopting and diffusing IT technology. In addition, as Jorgenson (2004) has emphasized, national accounts in many countries do not account for quality growth in IT capital assets by appropriate price adjustments and neglect accounting for software. So, if IT capital is used in more and more sectors, this paradox could disappear in the near future. The IT capital-using effect contains factors (which are difficult to measure) other than those mentioned above. In fact, IT technology has made changes to the entire economy and is expected to continue doing so in the future. Therefore, if all these factors are

included, we may be able to solve the productivity paradox in the near future.

Based on both yearly and quarterly investment functions for Korea, we can argue that Korea's investment is very sensitive to output growth and the acceleration hypothesis is accepted. It also implies that current output growth is a good signal for sustainable growth and future output growth, which is a rational expectation.

This implies that the current stagnation in Korea's investment may not be a reflection of a permanent erosion of investment potential. Rather the volatility of output growth in Korea's post-crisis period seems to have increased the cost of adjustment associated with investment irreversibility and uncertainty of discount factors. In addition, as outlined in the theoretical section, the institutional rigidities such as strong labor unions, which deterred institutional and structural reforms and transformations and its financial-market imperfections, have depressed investment demand.

In this context, the policy implications for Korea are straightforward. First, it should design and implement a macroeconomic stabilization program in favor of enhanced investments by reducing government expenditure and corporate taxes and, at the same time, increasing investment tax credits and R&D expenditure, rather than wasting the fiscal budget on rampant development projects, such as the creation of a new capital and relocating the main offices of public institutions from the Seoul area to remote rural areas.

In other words, a supply-oriented policy in favor of investment demand in sector with incremental comparative advantage, such as advanced electronics, needs to be implemented. In this process, political stability and a social environment encouraging

entrepreneurship and discouraging political corruption and cronyism are crucial elements for Korea to resume a sustainable growth.

Does FDI Mode of Entry Matter for Economic Performance? The Case of Korea

Seong-Bong Lee and Mikyung Yun (Aug. 2006)

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USD 2

This paper has attempted to empirically test the proposition that contrary to typical concerns M&A, the mode of FDI entry has little difference influence on firm performance. If this is the case, there is no reason to prefer other modes of entry over M&As. The major contribution of this paper is that it calls into question the current classification scheme of FDI entry modes, on which government tax incentives are based. This paper corrects for this, reclassifying the modes of entry through a detailed analysis of each investment case to reflect as much as possible the actual complexity of cross border investment deals.

Empirical results obtain after reclassifying the mode of entry into three groups confirm that there are indeed no significant differences between greenfield, M&A and P&A in terms of corporate performance (using various profitability measures) and subsequent investment behavior (measured by changes in total assets). As shown in the case studies, the main reason behind this result is that at the time of entry, investing multinationals and target domestic companies employ complex deals, mixing various modes within a single investment case. Therefore, when the impact analysis is made at the firm level, which is

a common approach, it is not surprising to find that there are no differences between the various modes. Further, sequential investment may take a different form from the original mode of entry, making it difficult to isolate the economic impacts of different parts of an investment deal over time.

An important policy implication of this result is that There is no logical foundation to provide tax incentives on the basis of FDI entry modes, which assumes that different modes of entry will have differential economic impacts on the host country. therefore, tax incentives for FDI, which are granted to FDI used to acquire newly issued stocks, should change. The tax incentives for the FDI in the mode of P&A should especially be abolished, because there is no difference between the modes of P&A and M&A in terms of economic substance.

Regional Currency Unit in Asia

Property and Perspective

Woosik Moon, Yeongseop Rhee and Deokryong Yoon (Oct. 2006)

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USD 2

This paper examines different properties of the regional currency unit (RCU) in Asia and estimates the value of the RCU as a weighted average of East Asian currencies according to the method used to calculate the ECU under the EMS. The basket feature of the RCU yields both benefits and costs. First, the use of the RCU central rate can make the intervention burden of a central bank less onerous than bilateral exchange rate. Also, for any given band of margins, a basket unit offers more flexibility than a bilateral exchange rate. Another advantage of using the RCU is that the variance of RCU exchange rates is smaller than the variance of exchange rates of component countries. However, the usefulness of the RCU as a unit of accounts for domestic transactions and contracts will be very limited, because of information costs and uncertainty on the value of the RCU. Also, the introduction of the RCU raises the important problem of asymmetry for foreign exchange market intervention. Once such a problem is solved, the RCU can be then used as a divergence indicator to monitor the exchange rates of Asian currencies between themselves and against the US dollar or the euro. The creation of the RCU is a good way to coordinate policies and assure exchange rate stability between Asian countries.

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APEC Study Series

Cooperation among APEC Member Economies

An Interdisciplinary Approach of Economic and Cultural Perspectives

Hwy-Chang Moon and Min-Young Kim (Nov. 2006)

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USD 5

APEC Member Economies have devoted themselves to achieving sustainable economic development in the region by reconciling heterogeneity in economic and cultural aspects. However, comprehensive studies encompassing both economic and cultural perspectives that suggest a way of mutually beneficial development are difficult to find. Therefore, for a more accurate analysis on cooperation among APEC Member Economies, we need a more comprehensive framework that deals with important variables in various areas, including cultural factors. For this purpose, this article studies the relationship and cooperation among APEC Member Economies in the following three stages. In the first stage, national competitiveness of Member Economies will be measured with a comprehensive model developed through exhaustive literature reviews on national competitiveness from both economic and cultural perspectives. In the second stage, the national competitiveness structures of Member Economies are analyzed by classifying them into four country groups depending on their national competitiveness structures. In the final stage, a mutually beneficial way of cooperation among Member Economies will be suggested with an in-depth consideration of the

characteristics of each country group.

The results of the empirical analyses regarding the relationship among the 19 Member Economies in the economic and cultural perspectives suggest methods of inter-group cooperation and intra-group cooperation, based on the complementarity of the national competitiveness structure and the complexity of factors comprising national competitiveness. Inter-group cooperation, which is based on the complementarity of the national competitiveness structure, refers to a cooperative relationship among economies in different country groups. Economies have competitive relationships with economies in the same country group, while the portion of upstream and downstream cooperation increases compared to economies in other country groups. Therefore, Member Economies can enjoy cooperative relationships with economies outside their own country group. On the other hand, intra-group cooperation, which is based on the complexity of the factors comprising national competitiveness, represents the cooperative relationship among the economies within the same country group. Although competition prevails in the majority of economies in the same country group, there is room for cooperation among other factors that are not in a competitive relationship. This is because countries can also benefit from similarities. Together with the similarity in many factors, the dissimilarity in other factors enables countries to reap further competitiveness.

Cooperation among APEC Member Economies, therefore, can be fostered with the integration of inter-group cooperation and intra-group cooperation with consideration of both economic and cultural factors comprising national competitiveness. The complementarity of the national competitiveness structure and the complexity of factors comprising national competitiveness should be two corner stones for

the establishment and implementation of effective policies with which all APEC Member Economies can enjoy the benefits of cooperation.

When considering ways to spur cooperation among Member Economies, we can draw several implications from this study. Firstly, macro level policies to enhance the cooperation among the country groups analyzed in this paper should be appropriately derived with a full consideration of the unique characteristics of the economies in each group. Secondly, micro level policies to increase cooperation among Member Economies within the same country group should be more carefully considered by taking into account both the similarity and dissimilarity of the sub-variables of competitiveness. Thirdly, each Member Economy should take an appropriate strategic position between macro and micro policies in accordance with the unique status of its competitiveness structure. Lastly, in the process of establishing and implementing policies, balanced attention must be paid to the factors comprising national competitiveness from both economic and cultural perspectives.

Based on these implications, more detailed suggestions can be derived as follows. Firstly, the results of this study can be employed as a rationale for the feasibility of cooperation among APEC Member Economies and the *raison d'être* of APEC. Secondly, governments should implement more active and favorable policies to enhance both inbound and outbound FDI. Thirdly, each Member Economy should establish its unique strategy to enhance national competitiveness through cooperation with other Member Economies. Lastly, some Korea-specific implications can also be derived.

Evaluation of Investment Liberalization Efforts by APEC Economies

Taeho Bark (Nov. 2006)

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USD 5

Foreign investment liberalization among member economies has been a main objective for the Asia-Pacific Economic Cooperation (APEC). The Committee on Trade and Investment (CTI) has made efforts to improve the openness of investment through various approaches. The main objective of this study is to explore a strategy for the APEC economies to achieve further liberalization of investment by evaluating the general performances of the two investment instruments: Non-Binding Investment Principles (NBIPs) and Individual Action Plans (IAPs). In this paper, we have shown that there are various degrees to which the twelve NBIPs were adopted in bilateral investment and trade agreements. Some provisions were properly incorporated, while others were not fully adopted. When we evaluate the cumulative improvements that appeared in the IAPs, the overall impression was disappointing; the performance of the individual economies looked even more disappointing. These may imply that the APEC's overall efforts to provide a more liberal investment environment were neither effective nor sufficient. In this paper, several policy recommendations for enhancing the effectiveness of the APEC investment liberalization process have been provided: the NBIPs must be improved, the menu of

options needs drastic improvement, and the process to evaluate progress needs substantial improvement.

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CNAEC Research Series

Korea-China-Japan FTA and Korean Fisheries (in Korean)

Namdoo Kim (April 2006)

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USD7

This volume aims to analyze the potential effects of a possible Korea-China-Japan free trade agreement, KCJ FTA, on the fisheries industry of the three countries, and draw some policy recommendations for the Korean fisheries industry. For this research objective, we are to evaluate the domestic and external situations of fisheries in Korea, China, and Japan. To assess their competitiveness in the world market, we utilize the trade specialization index, TSI, market shares, and export and import unit price indices for the specific items under HS 6 digit product classifications.

Korean fisheries reversed long-term export specialization to import specialization in 2001. Since then, the import specialization of the Korean fisheries sector has intensified. Its TSI has fallen to -0.29 in 2004 from 0.04 in 2000. The number of Korean fishery products specialized in export has decreased from 34 in 2002 to 24 in 2004, while products specialized in import have increased from 37 items to 54 items. For import specialization, the number of products close to complete import-specialization with an index between -0.80 and -1.00 increased sharply. In the trade between Korea and Japan, the TSI of the Korea's fisheries sector was 0.64 in 2004, showing considerable

degree of export specialization. Korea's major export-specialized products in the Japanese market are frozen big-eye tuna, seaweed and other algae, yellow-fin tuna in the highly export-specialized group, and some live fish and mollusca in export specialization group. In Korean-Chinese trade, the trade specialization index of Korea's fisheries was -0.76 in 2004, indicating a high degree of import specialization. This is the opposite of Korean-Japanese trade of fisheries products, but with a higher degree of trade specialization.

The effect of a KCJ FTA on Korean fisheries is anticipated to be negative rather than positive. Removal of tariff and non-tariff trade barriers through the FTA will bring more expansion of imports than of exports, followed by a decrease in domestic production and a negative effect on the trade balance of Korean fisheries. On the other hand, consumer surplus is expected to grow, as people can have the choice of purchasing fishery products of lower price. The negative effects on Korea's fisheries would reflect current trade situations and productive capabilities, such as aging fishermen, reduction of fishing capacity, and a rapid decline of fisheries resource stocks. In Korea's fisheries trade, the degree of import specialization with respect to China outweighs that of export specialization with respect to Japan. And, even in the Japanese fisheries market, Korean fisheries products fall behind Chinese ones in terms of market share and price competitiveness. Thus, even if Japanese demand for Korean fishery products rise subsequent to the conclusion of the FTA, the Korean fisheries industry might not be able to increase its production and export fast enough.

Under such suffering of the fisheries sector and the potential effects of the KCJ FTA, the Korean government faces some policy challenges, such as restructuring the fisheries industry, minimizing the negative

effects, and utilizing the potential opportunities. First of all, the government has to establish some principles for scheduling future tariff concessions of fisheries products in the FTA. In this process, we need to maintain policy consistency across various trade negotiations with the long-term success of the Korean fisheries industry in mind. In addition to supply-side policy considerations, the government has to pay more attention to consumer' welfare under more open trading environments. Government authorities are called upon to improve the provision of fresh and secure foods with lower prices. Also, business firms must try to find new opportunities through the FTA. Korean firms in aquaculture and fish processing should capitalize on the better environments for overseas direct investment, as well as larger export markets for Korea's marine products.

Regional Trade in Northeast Asia

Why Do Trade Costs Matter?

Prabir DE (July 2006)

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USD 5

Trade costs are often cited as an important determinant of trade volume. This paper provides sufficient evidence to ascertain that today's trade issues in Northeast Asia go beyond the traditional mechanisms of tariffs, and include "behind-the-border" issues. We find that variations in transaction costs, along with trade mobility infrastructure facilities, have significant influence on regional trade flows in Northeast Asia. This paper concludes that if tariffs were to become lower in Northeast Asia, the economies in that region could benefit substantially from higher trade, provided that trade facilitation measures were greatly strengthened.

Bankruptcy Procedures and the Efficiency of Corporate Debt Restructurings in Korea and Japan

Kenya Fujiwara (Nov. 2006)

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USD 2

Both Korea and Japan experienced massive corporate debt restructuring after the late 1990s. Although the apparent factors that gave rise to corporate sector distress seem to differ between the two countries, i.e. Korea faced the financial crisis of 1997 and Japan suffered from a bad loan problem after the burst of the bubble economy in the 1990s, there are several similarities. First, in both countries, formal legal bankruptcy procedures were relatively weak and instead informal bankruptcy procedures, such as workout schemes, played an important role in corporate debt restructuring. However, regarding the use of informal bankruptcy procedures, there has been criticism that facile debt forgiveness and additional lending to distressed firms cause the “too big to fail” problem and put off the early exit of nonviable firms. Responding to this criticism, both countries recently set about introducing legal bankruptcy reforms (1998, 1999, and 2001 in Korea; 2000 and 2002 in Japan). These legal reforms are for massive corporate bankruptcies in both countries and are related to the encouragement of a market-based mechanism for restructuring. It is worth examining how efficient debt restructuring is and whether there are any differences in both countries. So, in this

paper, the efficiency of debt restructuring is empirically examined by using the qualitative response model and data on bankrupt firms from both countries. The conclusions of this paper are as follows. For the Japanese case, overall tendencies toward under-liquidation and excess-legal bankruptcy are observed. However, for sub-samples, or samples after 2000, when the Civil Rehabilitation Act was introduced, under-liquidation disappears and the efficiency of legal bankruptcy procedures increases. But, on the other hand, under-legal bankruptcy or excess-reorganization in a workout program seems, to occur. This may reflect weaknesses of workout schemes and reduced intervention by the government. In contrast to the Japanese case, excess-legal bankruptcy is not observed in Korea. Instead, there was a tendency for under-legal bankruptcy or excess-reorganization in workout programs before 2000. This result may be interpreted to mean that before the introduction of the Corporate Restructuring Promotion Act, workout programs were relatively weak and included firms that should have gone legally bankrupt.

Analysis on the Issues of and Prospects for a China-Korea FTA

Zhang Jianping (2006. 11)

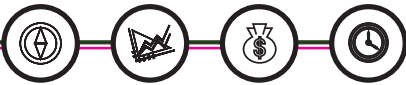
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China and Korea are the two most vigorous economies in East Asia and both are accelerating the FTA process. A China-Korea FTA would be a key leverage point from which to move forward multilateral institutional economic cooperation in Northeast Asia, as well as a major move to strengthen economic and trade interactions between China and Korea. The strong growth in economic and trade relations and industrial complementariness (revealed comparative advantage index and trade specialization coefficient calculations) between both sides have laid solid foundations for an FTA. Partial equilibrium model calculations reveal that a China-Korea FTA would have remarkable economic effects on both sides and bring much more benefits to Korea than a Korea-US FTA. The so-called barriers (agriculture, hollowing-out, SMEs) are not the major issues of a China-Korea FTA. The real problem blocking the process of a China-Korea FTA is geopolitical. Deciding on a China-Korea FTA is dependent on the Korean government and experts in different fields changing their concerned perceptions of China. We suggest that China and Korea complete feasibility studies and enter into negotiations for the purpose of enjoying mutual benefits from an FTA at the earliest

possible time. Should Japan's political position remain substantially unchanged, a China-Korea FTA is likely to be signed before a Korea-Japan FTA.

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(in Korean)**

Conditions for the Successful Establishment of East Asian Economic Integration

An Institutional Approach

Cae-One Kim, Myung Ho Park, and Heungchong Kim (Dec. 2006)

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USD 7

1. Economic Integration in East Asia and ‘Institutionalization’

The subject of this research is to find out the methods of how to promote market integration in East Asia considering the experiences of the European Union. In its 56 year old history from the Schuman Declaration in May of 1950, the EU has been the most successful, and, in a sense, the only successful example of regional economic integration.

It is as a matter of fact that the case of European economic integration cannot be transplanted into East Asian soil as it is. Europe and East Asia have very different historical, cultural, political, and economic conditions. Nevertheless, closely examining the historical process of European economic integration, several principles of commonly approaches to other regions of the world can be discovered. The only caveat is that it takes wisdom and the will to modify these principles so that they can be altered to fit the particular conditions in East Asia.

It is important to note J. Monnet’s famous words that “Nothing is lasting without institutions.” The incipient discussion on European

integration dates far back to Dante in the Medieval Ages. In more modern times, it was in the interwar period that the idea of the United States of Europe was proposed and the establishment of a European Customs and Economic Union was discussed. Despite a series of discussions and their contributions to raising public awareness in Europe on this matter, however, the ideas remained mostly unrealized. In pursuit of practical actions, the Schuman Declaration gave birth to the European Coal and Steel Community (1952) and European integration finally began got underway. The most fundamental reason for continuous progress in European integration afterward is that the EU was equipped with complex but systematic institutions.

Meanwhile, in the case of East Asia, ever since Malaysian Prime Minister Mahathir proposed the EAEC (East Asian Economic Caucus) in the early 1990s there have been various academic meetings aimed at establishing organizations for the purpose of economic cooperation among East Asian countries. Recently, the East Asian financial crisis and the worldwide spread of FTAs have caused regional states to proceed with more tangible ideas and proposals: leading to the birth of the CMI (Chiang Mai Initiative) and discussions on an EAFTA (East Asian Free Trade Area). In the financial-monetary field, considerably concrete discussions, including the CMI, are being conducted among East Asian countries at the governmental level. However, with respect to the establishment of an EAFTA, not much progress has been made.

At the government level, the participating countries in the ASEAN+3 summit conference in 2002 have already agreed to pursue the establishment of an EAFTA on the basis of a report submitted by the East Asian Study Group (EASG). They also agreed to move toward the creation of an East Asian Community (EAC) in the long run.

Nevertheless, ongoing discussions on the proposal for an EAFTA have not resulted in any concrete alternatives for its materialization. East Asian countries have taken ambiguous positions that neither oppose nor unequivocally support the proposal. No country in the region has taken the initiative to establish the EAFTA, nor are there official contacts or discussions among the regional governments. East Asia cannot but feel a sense of vagueness regarding the substantial contents of the EAFTA, i.e. its process, methods, and purpose and form of FTA (Free Trade Agreement).

2. Merits of a Pragmatic Approach

It goes without saying that, the reason that most countries in East Asia do not play positive roles in materializing the proposal of an EAFTA is that they do not feel an urgent necessity for it. For East Asian economic integration to be persuasive the possible benefits to concerned states should be clearly stated. This issue is related to the ultimate purpose of an EAFTA.

In this respect, the purpose of the EU is very suggestive to East Asia. The EU should not be misunderstood as ‘a group of countries that seek to realize benefits through economic integration’, as it is commonly perceived. If the European countries had intended to pursue economic benefits alone, we would not have been able to witness the developed state of the EU as it stands today. In a nutshell, the single greatest achievement of the EU is its contribution to peace, which has taken root in Europe and in the rest of the world.

European countries embarked on European integration by proceeding first with economic integration in order to realize the supreme value of peace. By promoting tolerance and reconciliation

within this framework, they gradually reduced various conflicts stemming from nationalistic emotionalism, conflicting interests, and past history of disputes, etc. Economic integration was the first step towards European integration and brought economic benefits at the same time. If the European countries had planned to take up integration only after overcoming all the obstacles, the EU would not have established as is seen today. In this sense, the European integration is based on the ideas of rational realism and future-oriented pragmatism.

Compared with this European experience, there is a widespread view in East Asia that regional countries should first clear away the stumbling blocks in the way of economic integration, such as excessive nationalism, insecurity, legacies of historical conflicts, and the hegemonic competition between China and Japan. Although these obstacles by their own nature cannot be easily overcome once and for all, it is true that they are becoming incrementally meaningless in the larger context of regional 'peace and stability'. Therefore, focusing on realizing 'peace and stability' the pursuit of economic integration itself will be an efficient approach for achieving this goal. A stable and peaceful environment is a prerequisite for economic integration. Moreover, as is seen in the EU case, the pursuit of economic integration provides an institutional framework within which the member states can continue to discuss their concerns.

East Asia and Europe differ greatly in terms of history, culture, geo-politics, geo-economics, and in other aspects. Therefore, East Asia will need different methods for integration. Economic benefits are the most significant 'necessity' for the pursuit of economic integration in East Asia together with the establishment of peace. More than anything else, the expected economic gains of forming a free trade

area in East Asia should be the top priority.

3. The Benefits and Costs of Economic Integration

There have been many studies on the possible static and dynamic benefits of East Asian economic integration. It is a fact that, intra regionally, the East Asian region is composed of economies that have big gaps. This can be a negative factor; but, it can also be a positive factor in the sense that there is greater room for various types of economic cooperation, including capital investment and technology transfer within the region. The important thing is to set up an appropriate economic cooperation system that benefits all participants. Most East Asian states are adopting outward-oriented economic liberalism. Thus, they have the potential to take advantage of these benefits.

Moreover, East Asian countries already constitute a natural economic area. For example, the intra-regional trade of intermediate goods, including parts and components, is an essential factor that activates inter-country production networks. Intra-regional production fragmentation is based on the logic of comparative advantages according to differences in factor endowment, including technology, management skills, between countries in the region.

The establishment of an East Asian free trade area could purportedly provide stable conditions to boost trade liberalization by institutionalizing on-going ‘de facto’ market integration which entails more benefits to all.

It is very encouraging for East Asia that regional financial monetary cooperation is advancing, unlike in other regions (except for the EU). For instance, the Chiang Mai Initiative has expanded to a

multilateral currency swap. Recently, there has also been discussion on creating an Asian Currency Unit. Stabilizing the currency value will contribute to advancing stable regional transactions.

Meanwhile, one of the most important advantages that East Asian economic integration will bring intra-regional countries is the increase in international negotiating leverage with other states outside the region, as can be seen in the EU. Without the backdrop of the EU, the European states, along with the United States, could not have led the international economic order. Enhanced negotiating power would mean that East Asia could conduct international economic negotiations in more favorable terms, which would increase the interests of member states. Considering the weight East Asia occupies in the international economy, the East Asian free trade area, if formed, will constitute one of the three growth-poles of international economy, together with the EU and NAFTA.

With respect to the ensuing costs of East Asian market integration, this research argues that the most important cost to the participating states is the resultant limitations to their economic sovereignty. Such a constraint would be most palpable when the member states form one 'internal market' like in case of EU. For example, the EU conducts a common policy on behalf of the member states on monetary, trade, and agricultural policies. The degree of limitation to economic sovereignty is directly in proportion to that of economic integration.

One sure thing is that without acceptance of a certain degree of limitations to economic sovereignty, economic integration will not be possible. In East Asia, sovereignty is a very sensitive issue. Therefore, in the early stages of economic integration, an approach to the expansion of economic cooperation that respects the member states' sovereignty as much as possible is desirable. For example, in the

process of realizing the AFTA, the members of ASEAN accepted a common binding measure within the boundaries of policy coordination that required trade liberalization.

Next, this research points out the costs of adjusting industrial structures. Seen from a long-term perspective, however, this cost can be considered to be more of a benefit for economic integration. This is because intra-regional competition speeds up the adjustment of industrial structures. Another important condition for promoting a successful EAFTA is the introduction of a multilateral assistance system that accelerates structural adjustments through close economic cooperation among member states.

4. Inefficiency of a Complicated FTA Map in the Region

East Asian countries are familiar with multilateralism but they began to take an interest in regionalism only in the mid-1990s when the second wave of regionalism arose. Furthermore, although ASEAN has a long history of economic cooperation, it was only after the early 1990s that they began to push forward with the AFTA.

Although East Asian countries were late in their pursuit of full-scale regionalism, they set a new record in that they concluded more FTAs than any other region within the shortest amount of time. The six member states of ASEAN have not yet completed a free trade area. However, they constitute some of the most complicated preferential areas together with the newly joined four states (CLMV). Each of the six ASEAN states also has concluded many FTAs with other states outside the ASEAN region or is in the middle of pushing forward with FTAs.

Meanwhile, the Northeast Asian states, comprised of Korea,

China, and Japan, had formed in ten years an exceptional area not engaged in any type of regionalism. However, these three states recently started to aggressively expand their FTA policies. These states are now competing to conclude FTAs with ASEAN as a whole or with individual ASEAN member states. They have concluded or are in the process of negotiating similar agreements with countries outside the region.

Related to this situation, a fundamental reservation is whether these agreements that have the appearance of FTAs really contribute to the expansion of trade. More than anything else, East Asian countries have to keep in mind that the original purpose of an FTA is to establish a free trade area. Nevertheless, in reality the contents of most FTAs are not sufficient for materializing free trade among the parties concerned, and can only be regarded as preferential agreements at best. More precisely speaking, nearly all of them take the form of a WTO-plus. Although basically intended to be a step-by-step abolishment of tariffs, these agreements not only lack binding force, but also contain numerous escape clauses. Examining the details of the free trade agreements, most of them simply reaffirm the regulations in WTO-related agreements or somewhat broaden the application of those regulations.

In this light, it can be said that many of the FTAs prevalent in East Asia are the outcome of the concerned states' political interests or strategic considerations in diplomacy, rather than the reflections of the states' will for trade liberalization.

Of course, compared to the other regional trading arrangements, e.g. a common market, it is true when seen pragmatically that FTAs contain many merits. However, it is important to note that the expansion of FTAs can be a negative factor in reality that hinders the

development of transnational transactions. It is possible that a complicated FTA map of East Asia would rather delay the smooth advancement of the international division of labor.

The greatest weakness of FTAs concerns the management of ‘rules of origin.’ Each FTA has different contents regarding rules of origin; in East Asia each FTA has a different type of exception to trade liberalization. This phenomenon, together with differential treatment, results in trade segmentation in each subregion and, ultimately, market distortion. It cannot be denied that the implementation of complex and various rules of origin is accompanied by trade transaction costs and management costs.

If each country in the region respectively pursues a number of different FTAs with a view to expanding trade, it can bring about in the region as a whole the unintended consequence of dwindling transnational transactions. This is called the FTA paradox. As the ‘second-best theory’ in international trade theory implies, compared with the multilateralism of the WTO system, the spread of FTAs could instead result in the reduction of welfare in all states concerned. It is almost needless to say that the reason for such a paradoxical result is the ‘trade diversion effect’ arising from a complex web of differential treatments.

Of course, pursuing trade liberalization based on multilateralism that purports to implement the principle of non-discrimination can theoretically neutralize such a negative consequence. As J. Bhagwati aptly points out, expansion of the liberal ‘good blocs’ could speed up liberalization of international transactions more effectively than multilateralism.

5. The Evolutionary Characteristics of Market Integration

It is worth summarizing the views as to how to push forward market integration in East Asia. First of all, it would not be very meaningful to categorize market integration into a free trade area, a customs union, a common market, and an economic union according to B. Balassa's textbook-style typology. These are not independent forms of market integration. Rather, they should be seen in the long run as appearing in the 'continuous process' of market integration. A so-called 'evolutionary approach' is required. For instance, successful operation of a free trade area inevitably leads to a common market in the long term. Namely, by continuing to pursue a free trade area as a form of market integration, East Asia will ultimately face the task of reaching a higher level of market integration, such a common market. It is difficult to stay in the middle, and unless East Asia continues to deepen market integration through a free trade area, East Asia will be forced by situation to give up on integration altogether.

Empirically speaking, nobody in the 1950s predicted that the EU would succeed in creating either an 'internal market' or the 'euro' as seen today. Although the EU aimed for economic union in theory only, it was achieved because the Europeans had deepened market integration by persistently solving each of the tasks they faced in reality. From a different perspective, it was the result of appropriate management of a free trade area that allowed the EFTA to develop into the EEA (European Economic Area).

On the other hand, NAFTA is in the early stage of a free trade area. However, once it passed the transitional period, scholars started to talk over the necessity for strengthening policy coordination among the three countries, including the adoption of a common tariff policy.

They also cited the case of the AFTA (ASEAN Free Trade Area) that concerned states should accept 'institutionalization' for the completion of a free trade area.

6. Desirable Direction for Market Integration in East Asia

In terms of pursuing an EAFTA, East Asia can only set up an appropriate long-term direction of development when the evolutionary characteristics of market integration based on the present conditions in East Asia are taken into account. Otherwise, efforts for market integration will endlessly be a repetition of trials and errors.

In this regard, two principles of direction need to be addressed. First of all, East Asia needs a certain period of preparation before the states in the region can push forward with the EAFTA on a full scale. Here a 'true EAFTA' means a free trade area that contributes to liberalization of trade in the region in a practical manner, rather than a PTA or WTO-plus. This free trade area must be pursued on the premise that it will move toward an East Asian common market in the long run.

East Asia needs five years or so for this preparation period during which emphasis should be put on strengthening the dimensions of multilateral economic cooperation. The important thing to note is that without 'institutionalization', it will be difficult to continue systematic economic cooperation among the East Asian countries. That is to say, East Asia needs to establish an East Asian Economic Cooperation Organization (EAECO, tentatively named) to conduct continuous multilateral economic cooperation. Market integration can be also developed within this framework.

East Asia has two purposes in pursuing regional economic

cooperation. One is to raise the level of policy coordination among member states. Comparable to the function of the ex-OEEC or the present OECD, East Asian Economic Cooperation Organization could provide a forum where 'like-minded nations' get together to discuss the matter of intensive economic cooperation. Only after East Asian countries bridge the gap in their respective institutions and policies through this kind of cooperation, can the efforts for market integration be expected to bear fruit.

The most significant achievement of the ex-OEEC is that, it was conducive to creating conditions for economic integration, like the EEC and EFTA in the 1950s, by inducing close policy coordination among the European countries. Market integration is literally premised on the participating states' market economies at full work. The fundamental reason for the failures in economic integration among developing countries is that in these countries, market economies have not been firmly established. There needs to be a systematic effort to ensure that a market economy firmly takes root in these countries.

The other purpose for an East Asian Economic Cooperation Organization would be to introduce a multilateral assistance system in the region, replacing the diverse bilateral economic cooperation system that currently exists. East Asia particularly needs to systematically assist underdeveloped regions by setting up development banks and various structural adjustment funds. The introduction of a multilateral assistance system will, to a certain extent, contribute to narrowing the socio-economic gap between countries in the region. It will also be helpful to transition many countries in the region into market economies through structural adjustments. In this respect, East Asia can obtain many suggestions

from the policy efforts of the EU, especially in its process of admitting Central and East European countries experiencing regime transition as new members.

Next, it must be emphasized that East Asia can only push forward with full-scale market integration in a practical manner when the atmosphere is such that the East Asian countries feel closer to each other. Therefore, it is desirable to simplify the FTA map that is confusingly entangled in East Asia these days and turn toward a new direction.

Here, two directions can be suggested. One is that East Asia can conclude a multilateral FTA among regional countries including three Northeast Asian states and ten ASEAN states within the framework of an East Asian Economic Cooperation Organization, if the latter functions properly and a certain period of time has elapsed.

Above all, related to the EAFTA, the focus of the discussion should be on membership, specifically the matter as to whether it should be a way to expand the so-called ASEAN+1 FTA: ASEAN on the one side and Korea, China, and Japan, respectively, on the other; or whether it should be an initial measure for the three Northeast Asian states to conclude an FTA and then negotiate with ASEAN countries. In this research, it is argued that the second method is not only technically easier for negotiations, but also it provides the opportunity to organize the complicated FTA structure in East Asia. It can also reduce the management-transaction costs that the high number of FTAs bring and it can considerably eliminate distortions of international trade as well.

East Asian countries can limit the prospective EAFTA states to thirteen in the early stages, and expand after market integration proceeds to a certain degree. East Asian countries can also allow

certain unqualified countries to hold the status of associate members for a certain period taking into consideration their particular situations. In addition, in a multilateral setting, the EAFTA could conclude different types of FTAs with other regions, such as the United States and the EU.

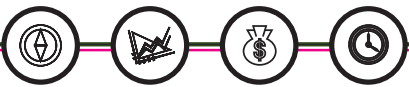
Next, it is believed that for the EAFTA to be effective, it should aspire to move toward being a 'market integrative' FTA. That is to say, the EAFTA should be equipped with the institutional and organizational structures essential for proper functioning. For instance, East Asian countries will inevitably need to establish a Council of Ministers as a supreme decision-making entity. The Council can make 'binding' decisions intended for phase-by-phase elimination of practical trade barriers in the region throughout policy coordination among member states, as well as other measures. East Asian countries can also make the necessary steps to create other organs of East Asian Economic Cooperation Organization as the need arises.

Of course, given the economic gap among countries in the region, it would be taxing to ask all members to proceed with trade liberalization at the same speed and with the same conditions. In other words, given that the EAFTA would be comprised of developing countries, it would be desirable to not only allow exceptions for a certain group of states according to a different schedule appropriate to their situation, as well as taking a multi-layered approach. Only when these countries subsequently join advanced economies, can we say the EAFTA has been successfully completed.

It is almost needless to say that in reality non-economic factors, such as politics and diplomacy, work to complicate the process. What is important is the judgment and discretion of the East Asian countries with respect to the general costs and benefits that market integration

will bring about. Ultimately, the realization of East Asian market integration depends on the concerned states' political judgment and their will.

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Regional Report (in Korean)

The Directions of Economic Cooperation between Korea and Emerging African Countries

Bokyeong Park, Jooseong Hwang, and Chul Hyung Park (May 2006)

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USD 7

Egypt, Algeria, and Nigeria, which were all visited by Korean President Roh in March 2006, are politically and economically important countries in Africa. They all have relatively large populations and economies, and are richly endowed with energy resources. Therefore, there are various economic areas in which Korea can cooperate with these countries, the most feasible and mutually beneficial of which are identified in this report. The African countries' own economic features, such as market size, resource endowment, economic policy, and so forth are taken into account.

This report suggests that Korean overseas direct investment in Egypt would be an effective channel through which to enhance economic cooperation between Korea and Egypt. Egypt achieved noteworthy progress in its recent reforms to promote foreign investment. It established the Ministry of Investment to create the institutional framework and infrastructure required to attract foreign investment. It reduced the amount of red-tape involved with doing business, revised laws to make the labor market more flexible, and strengthened its intellectual property rights. Its location interlinking the Middle East, Africa, and Europe is a merit for foreign investors.

Algeria has a relatively large population and domestic market compared to other African countries. It also has immense energy reserves, especially crude oil and natural gas. Korea, therefore, can strengthen economic ties with Algeria through export promotion and participation in energy development projects. The products for which Korea can rapidly increase its exports are automobiles, IT products, industrial machinery, steel, and iron. On the other hand, Algeria has kept open its domestic energy exploration market, and recently restructured its oil industry by lifting the regulatory rights of its national oil company. The restructuring is intended to accelerate the participation of foreign companies in the development of its energy resources. Korean oil companies and the government need to make an effort to seize these energy exploration opportunities in Algeria. Because of a long-lasting civil war, Algeria's infrastructure, such as electricity and transportation, is in ruins or is under-developed. Therefore, linking energy exploration and infrastructure construction could be an effective strategy.

Nigeria also has a great amount of oil and gas, and allows foreign companies to participate in its exploration. Its recent policy on energy development is oriented toward inducing more foreign investor participation. However, there are a few risks associated with energy exploration by a foreign company in Nigeria. Most of the oil fields to be explored in Nigeria are offshore, which requires large-scale capital and advanced technology. In addition, the requirements of localization tend to be more stringent, and there still remain political risks such as ethnic insurgencies and abrupt policy changes.

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Regional Study Series

The Success Story of Switzerland

How could Switzerland's specific political institutions contribute to the country's political stability and economic wealth?

Won-hwa Park, Heungchong Kim, and Linda MADUZ (July 2006)

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Switzerland is known as one of the most prosperous and wealthiest countries in the world. Switzerland ranks 3rd in terms of income in the world. Furthermore, it maintains stable political regime and high level of security. This research tries to illuminate on the success of Switzerland by examining its political background and the specific features of the Swiss political system.

Switzerland is a country marked by strong pluralism, facing the challenge of integrating a multiplicity of different interests: different regional interests, different cultures, different languages, and different religions. This heterogeneity has shaped the political institutions of the country, which in turn have influenced political processes and structures in Switzerland. In the paper, “federalism,” “representation system,” and “direct democracy” are defined as the main institutional determinants of Switzerland’s particular political system. They guide the political, as well as the economic actors, towards finding common solutions; the constant search for a consensus is the distinctive feature of the Swiss political system, known as “consensus democracy”. Chapters 3 and 4 show to what extent the political institutions has contributed to the country’s positive political and economic

development. Today, they are still responsible for Switzerland's strong performance in these areas.

The major characteristics of Switzerland's political system are also highlighted. First, continuous political stability derives from the consensus-based system; through its institutions, the Swiss political system balances different interests and focuses on finding consensus. Second, a characteristic of Switzerland's political system is its political integration. The existence of a referendum allows the largest possible number of political parties and interest groups to be included in the opinion-forming and decision making process. The system assures that losers are not excluded from the decision-making process. It thereby contributes to a politically stable environment. Third, in the Swiss political system, the people have the final say. The institution of direct democratic tools gives them the control of last resort. The people assume the function of a real opposition force with the power and responsibility to check and balance the government's policy. Fourth, Switzerland's federalist and direct democratic structure pushes the political actors to negotiate and find compromises that are likely to be supported by the majority. Three to four times a year the Swiss citizens are called to vote on specific and concrete issues. Fifth, political success and failure of individual actors and parties are generalized. The Swiss political system is constructed in a way that the responsibility for failures and successes is shared also among the various actors involved in the decision-making process. Political failures and successes are less attributed to individual political parties or people. Parties and politicians are less affected by tensions in politics; this, again, has a stabilizing effect on the political system as a whole. Sixth, there is large autonomy of the cantons, which restricts the power of the central government. As a result of historical

developments, the cantons enjoy large autonomy and are the main competent authorities in certain areas, such as education and health, as well as the police and justice systems. The institution of federalism allows the cantons to assume an important role in the power-sharing and influence the decision-making process at the national level. Seventh, Switzerland has a bicameral parliamentary system. The two chambers are elected on different bases: the majority representation system is used for the Senate (Council of States) and the proportional representation system for the House of Representatives (National Council). The two chambers are equally weighted, giving the Senate, which represent the cantons, real power relative to the House of Representatives, representing the overall population; thus, the federalist principle is as important as the democratic principle. Eighth, Swiss Members of the Parliament are part-time officials. This system, characteristic of Switzerland, is called the “militia system.” It refers not only to the federal parliament, but to most of the mandates and offices in the Swiss political system. The existence of the militia system creates inter-dependency: on one hand, the semi-professional parliament is dependent on the information and knowledge of other social actors; on the other hand, the parliamentarians bring in important knowledge and contacts from other sectors of society. Ninth, multiplicity of relatively weak political parties in an otherwise stable system is important. Federalism and direct democratic tools open the doors to a large number of political actors and parties, which provide an explanation for the historically weak and fragmented Swiss political party system. Tenth, the Swiss government is a multi-party collective and has a collegial head of state with a long term in office. Eleventh, the executive power is shared in a broad coalition of the four most important parties. A stable political environment is essential for

a prosperous economy. Trade and investment benefit from political stability and continuity. Not only does the consensus system contribute to preventing major interruptions in domestic politics; the referendum forces the political actors and economic actors to co-operate, and it also furthers the cooperation among the social partners.

The review of the major points in this paper provides a brief summary of how the Swiss political system works; the key word is “consensus.” In general, mutual agreements are easier to achieve in periods of prosperity and economic growth. Consensus finding becomes more difficult in times of political or economic crises, when the actors try to make each other responsible for failures and losses; the tendency of the system to polarize is the consequence. Consensus reaching becomes difficult and the system may become paralyzed. The feasibility of a consensus-based system depends also on the issue at hand: consensus finding is challenging when it comes to emotional issues, such as the restriction of farmers’ rights, abortion, authorization of genetically modified organisms, etc.

Despite difficulties that a consensus system can reveal, the pattern of compromise-seeking carries on. “Concordance” has become an immutable part of the Swiss system that cannot be changed, unless the institutions are changed. As most of these institutional devices are part of the constitutional law, they have become robust elements of the Swiss political system, contributing to its stability. The attribute of the consensus system that may be the most noteworthy is its extensive capacity for political integration; not only do political parties integrate into a system of cooperation and power-sharing, but also economic and social groups.

From an economic perspective, the consensus system is in a better

position to cope with the increasingly important role of economic actors than a majoritarian system. Through processes of economic internationalization, economic actors, such as transnational companies, are gaining political weight. The tension between the interests of “globalized” economic groups and political parties with national interests is rising. In the competitive majoritarian system, it is possible that the competition between these economic interest groups on one hand and the political parties on the other hand hinders the political system. The risk of a blocked political system does not only emanate from winners of economic globalization opposing policies of national political parties, but also from the losers, e.g. trade unions losing jobs who could oppose political decisions in an unfruitful way.

From a political point of view, the consensus democracy with its potential for political integration of multi-cultural societies is a future-oriented model. Today, a large majority of the 190 countries, considered sovereign states, constitute multicultural societies. Moreover, South-South or South-North migrations are important aspects of national economic and political life today. Cultural differences also continue to be a political problem in many industrialized countries. Conflicts between ethnic groups are a main factor for national disintegration or war in Africa and in the Far and Middle East. The former countries of the Soviet Union are, today, facing the problem of integrating once strongly repressed minorities.

In all these situations greater political integration is needed for a peaceful multicultural coexistence. It is difficult to say to what extent the Swiss solutions of power-sharing and consensus-finding would be appropriate to solve these problems. No matter how the challenges are tackled in the future, the importance of political institutions, especially in the long run, should be taken into account. This is what the Swiss experience shows us.

