



KOREA'S FTA DEVELOPMENTS: Experiences and Perspectives with Chile, Japan, and the U.S.

Chan-Hyun Sohn¹
(chsohn@kiep.go.kr)

INTRODUCTION: EVOLUTION OF KOREA'S TRADE POLICY

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

The period of 1980s is characterized by the increased pace of market opening and liberalization based on the multilateral framework. Korea undertook a fundamental shift in its industrial and trade policy from state intervention to deregulation and competition resulting in part by the severe trade disputes it faced with its main trading partners, such the U.S. and the EU. More importantly the shift came from its own need to modernize economic structure and increase competitiveness. Positive aspects of import liberalization were acknowledged. Preferential export credit was abolished and Fair Trade and Anti-monopoly act was enacted in order to stimulate the competition through market mechanism.

In the early 1990s, with the accelerated liberalization trend in international trade, Korea had to face international challenges that required further deregulation and liberalization of markets, as well as institutional and policy changes. To meet the challenges, Korea has undergone deeper liberalization process by undertaking trade-related economic reforms aimed at abolishing unnecessary regulations and restriction in trade and investment policy and reducing tariff barriers in line with the UR agreement. As a trade-oriented country and a member of WTO, Korea has become a strong supporter of multilateral trade liberalization. Also, active promotion of foreign

¹ Senior Fellow, Korea Institute for International Economic Policy



direct investment, deregulation and competition policy took place in this period as part of globalization process.

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

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

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

The financial crisis of 1997, however, clearly showed the structural weakness of Korean economy that has been historically characterized by illicit ties between the government and protected industries. Therefore, Korean government struggled to overcome the crisis and to modernize its economic structure by taking overall reforms in every



sector. With regard to foreign trade policy, in particular, Korea has established a new 'open trade nation' paradigm with the specific objectives of becoming a market-oriented, freer and fairer trading nation.

The discussion about Korea's FTA policy actually began in the late 1980s and became quite intense in the late 1990s. In this period, as the movement toward economic integration in North America became evident with the sudden reversal of the U.S. trade policy towards regionalism, Korea reviewed the possibility of a Korea-U.S. FTA, but without any government commitment.

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

THE MAIN QUESTION: WHY AN FTA?²

So far, Korea has always opted for preferred the multilateral framework to regional agreements and maintained its commitments to multilateral trade agreement because, due to its non-discriminatory and comprehensive coverage, it was considered to be the best way to achieve trade liberalization at the global level. As a result, of the world's major trading partners, only five economies- Korea, Japan, China, Taiwan and Hong-Kong- are currently not members of any regional economic arrangements.

However, the recent proliferation of regional trade arrangements and their successful performance have stimulated Korea to shift its trade policy toward FTAs. Although the basic position of Korea's trade policy is still focused on the strengthening the multilateral system, it now believes that regional trading arrangements (RTAs) could be a complementary force to multilateral trade initiatives in achieving world free trade system.

There are several factors that caused Korea to renew its interest in FTA. Some of these are external such as the increased importance of regional economic arrangements in world trade and changes in the international perception of regionalism. Other factors stem from Korea's own internal demand such as its high dependence on foreign trade, the need for securing of export markets and accelerated opening and restructuring of the Korean economy.

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



INCREASED IMPORTANCE OF RTAs IN WORLD TRADE

While the world economy is becoming more integrated on the basis of the multilateral system of the WTO, there is also the additional strengthening tendency of regionalism due to the widening and deepening of regional economic agreements. As seen from the number of regional economic agreements notified to GATT/WTO, the number of regional trade agreements rapidly expanded in the 1990s. And the share of world trade conducted within the framework of regional agreements grew steadily.

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

	1948 ~ 1954	1955 ~ 1959	1960 ~ 1964	1965 ~ 1969	1970 ~ 1974	1975 ~ 1979	1980 ~ 1984	1985 ~ 1989	1990 ~ 1994	1995 ~ 1999. 10
Number of notifications	2	3	12	9	21	19	6	5	47	85
Total notified	2	5	17	26	47	66	72	77	124	209

Source: WTO Secretariat (2000).

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

CHANGES IN THE INTERNATIONAL PERCEPTION OF REGIONALISM

In the past, regionalism, in the form of FTAs or customs unions, was regarded as a stumbling block to multilateralism due to its perceived undermining of the progress of the multilateral system of GATT/WTO. However, the WTO and the OECD, through their official reports, acknowledged the reality that the existence of FTAs as a reality of the world economy and accepted that regionalism could be a building block to multilateralism.³ In addition, with the launch of the US-Canada FTA in 1989, the U.S. abandoned its traditional anti-regionalism tendency and embraced regionalism by co-creating NAFTA and co-designing the FTAA. As a result, regionalism is no more regarded as a contradictory or damaging force to multilateralism, but as a complementary element to accelerate the progress of multilateralism in establishing a global free trade system.

³ WTO (1995). *Regionalism and the World Trading System*.

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



Securing export markets

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

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

Moreover, with the proliferation of RTAs, Korea's major trading partners are now diverting their trade more and more to their own members in order to take full advantage of their free trade areas. By joining a regional bloc and cooperating with other members, Korea can secure stable export markets and defend itself against discriminatory effects of other regional groups. In addition, if the potential FTA partner is a member of another type of RTA, it would be easier for Korea to gain access and diversify its exports to larger regional market.

The need for accelerating restructuring and opening of the Korean economy

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

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

Strengthening politico-economic ties

Regional integration has offered countries a way to resolve issues that would be more difficult to tackle in the wider multilateral context. For example, in the case of NAFTA,



the degree of economic integration called for a deeper and more comprehensive regime of rules than could have been achieved in the larger multilateral system.

In this new era of economic interdependence, Korea also needs to protect and maximize its national interest by joining or creating trading blocs. Economic cooperation is expected to spill over to political and diplomatic cooperation, covering a wide range of issues such as security, environment, labor and cultural exchanges. By forming an FTA with its major trading partners, Korea will strengthen its bargaining position and enhance its political influence and diplomatic weight in multilateral fora such as the WTO, OECD and IMF.

CURRENT STATUS OF KOREA'S REGIONAL TRADING ARRANGEMENTS

Regional Cooperation

APEC

Korea made a first attempt to join a regional agreement by participating in the Asia-Pacific Economic Cooperation (APEC). APEC was established in 1989 in response to growing interdependence among Asia-Pacific economies. In keeping with the spirit of international cooperation, APEC has recently become a major channel for promoting trade and economic cooperation among economies in the region. Its chief objective is trade liberalization, but while supportive of the GATT/WTO process of multilateral trade negotiations, it seeks to promote unilateral non-discriminatory (MFN basis) liberalization, rather than bilateral or multilateral trade negotiations. In November 1994, APEC members agreed on the ambitious goal of free trade and open investment to be realized by 2010 for developed countries and by 2020 for developing countries.

As envisioned by the Eminent Persons Group (EPG), APEC would not become neither a customs union like the EU nor a free trade area like that covered by NAFTA. APEC will support and complement every effort in GATT/WTO by emphasizing non-discrimination and defense of the open multilateral world trading system. In pursuit of "open regionalism," Korea agrees that APEC's role should be supplementary to and supportive of the multilateral trading system.

ASEM

Korea also hopes that the newly formed Asia-Europe Meeting (ASEM) will serve as another vehicle for promoting globalization of the world economy. ASEM, as a form of regional cooperation, accounts for almost 54% of world GDP. Korea's exports to ASEM members account for 45% of total exports, indicating they carry significant weight in the Korean economy.



Korea hosted the Third Asia-Europe Meeting (ASEMIII) in Seoul on October 20-21, 2000. Asia-Europe cooperation framework is particularly focused on the economic and financial fields, with clear goals of complementing and reinforcing efforts to strengthen the open and rules-based multilateral trading system embodied in the WTO, strengthening bilateral and investment flows between Asia and Europe, and promoting business dialogue, and industrial and technical cooperation between the two regions.

Bilateral/Trilateral FTAs

Korea expects that the formation of FTAs with major economies such as the U.S., Japan and China, which are Korea's main trading partners and present huge markets, will have greater impact on Korean economy. On the other hand, forming a strategic FTAs with relatively small but open economies such as Chile, New Zealand and Thailand will serve as a gateway to large regional markets in South America, Oceania and ASEAN.

Korea-Chile FTA

Background and Current Status⁴

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

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

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

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

⁴ Cheong (2000) and Yoon (1999).



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

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

During the four consecutive negotiations, the two sides elaborated and reviewed the draft text of the agreement and exchanged their preliminary tariff concession schedules. However, some disagreements were revealed over the tariff concession for sensitive sectors. Korea had proposed that exemption should be made on some sensitive sectors such as agriculture, but Chile insisted on no exceptions and if not, the exclusion of some manufacturing products from the tariff concession. Currently, the two countries are considering a detailed revision of their respective tariff schedules to narrow the gaps and tries to hold the final round of negotiations.

Analysis of Economic Effects

The assessment of the economic effects of a Korea-Chile FTA using the CGE model was conducted by KIEP in 1998.⁵ In assessing economic effects, three basic scenarios are presented. The first scenario is based on the complete tariff elimination by both countries across all sectors. The second scenario is based on complete tariff elimination in general sectors and partial tariff reduction for agricultural products and livestock. The last scenario assumes zero tariffs in all sectors except for agriculture and livestock.

⁵ The CGE model is a general equilibrium model that has the advantage of determining the reallocation effects of the resources caused by the cross-sectoral transfer of production factors.



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

(Unit: US\$ billion)

	Overall Tariff Liberalization	50% Tariff Reduction in Agriculture	With Agriculture Excluded
Welfare	0.96	0.96	0.95
GDP (%)	0.01	0.01	0.01
Exports ¹⁾	0.66	0.66	0.66
Imports ¹⁾	0.26	0.25	0.24
Trade Balance	0.4	0.41	0.42

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

Note: 1) Export and import value.

According to the Table 3, the three scenarios bring almost the same positive results to Korea's welfare level with an increase of about \$0.95-0.96 billion. On the other hand, Korea will see its GDP increase by 0.01 per cent in all three scenarios. Growth of Korea's exports to Chile (\$0.66 billion) will exceed that of imports (\$0.24-0.26 billion), thereby resulting in an additional trade surplus of \$0.4-0.42 billion in all three cases.

Future Challenges

The successful formation of an FTA with Chile will be of special importance for Korea's future FTA policy because other potential agreements will heavily depend on the first model. Particularly, it will bear an important symbolic meaning for other potential FTAs underconsideration with large economies. However, some obstacles and challenges still lay ahead in the course of the implementation of a Korea-Chile FTA.

Geographical distance

Frankel (1997), in his work *Regional Trading Blocs*, emphasized the importance of distance, using the concept of a gravity model. Based on this model, it is assumed that trade between countries depends positively on their size and inversely on distance. The effect of distance on trade is directly associated with three categories of costs which are: shipping costs, time-related costs and unfamiliarity costs. In order to reduce these costs and maximize the benefits of trade liberalization, it is desirable to form regional trade agreements between neighboring countries, that is, within a natural trading bloc.⁶

⁶ Frankel (1997) examines how the effect of the formation of free trade agreements on welfare depends on international transportation costs. According to him, the formation of natural trading blocs, where each country forms an FTA with its neighbor, will improve the welfare, while the formation of unnatural trade blocs has only lower welfare effects due to high intercontinental transport costs.



From this perspective, a Korea-Chile FTA is a unnatural trading bloc where a country forms a bloc with country on a different continent, with which it has relatively small volume of trade. The formation of such unnatural trading blocs is expected to have only negligible effects on welfare as intercontinental transport costs are very high. So, the economic feasibility of the formation of a Korea-Chile FTA can be seriously questioned.

Response of sensitive sector

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

While the manufacturing sector has generally shown a positive attitude toward a Korea-Chile FTA, the primary sector, in particular agricultural groups, have expressed deep concern. The fiercest opposition comes from fruit sector such as grapes, kiwis and apples, in which Chilean exports, both the natural and processed, are highly competitive and maintain a dominant position in the world market. Korean farmers and agricultural organizations fear that imports of grapes, kiwi and apples from Chile will dramatically increase as a result of tariff elimination, resulting in decreased sales and prices of domestic products and reduced income for farmers. Therefore, the basic position of the agricultural sector is to avoid the conclusion of a Korea-Chile FTA or at least to exclude agriculture from the tariff concession schedules. However, Chile does not accept the exclusion of agriculture where it places most interest. For its part, it hopes to exclude manufacturing sectors such as textiles, footwear, washing machines and refrigerators, which are considered sensitive areas due to comparative disadvantage.

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

The need for support and active participation of private sector

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

On the other hand, public promotional efforts about the ongoing process, and its possible benefits and challenges are needed so that general public does not suffer from



the fear that such economic opening will lead to a surge of foreign imports and massive unemployment. In fact, public concern is unavoidable as this is the first case of an FTA for Korea. Therefore, policymakers need to work in consistent and responsible way to gain public confidence and support for its FTA policy.

Compatibility with multilateral initiatives

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

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

As a Korea-Chile FTA also corresponds to such preferential and discriminatory trade agreements, the central concern is how to make the rules and procedures consistent with the multilateral rules of GATT/WTO. Korea and Chile have traditionally favored the multilateral approach as their basic policy option for fostering trade and investment liberalization and therefore, both countries committed themselves to faithfully abide by the rule-based requirements of GATT/WTO for forming an FTA, in order to not undermine the basic principle of non-discrimination and bring harm to third countries.

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

Korea-Japan FTA⁷

Background and Current Status

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

⁷ Sohn (2001).



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

In May 2000, a joint symposium on “Toward a Korea-Japan FTA: Assessments and Prospects” was held in Seoul where the two sides presented the results of their respective study and shared their views on ways to pursue an FTA. Although no official negotiations have yet been launched, the private sector is now taking the lead in the form of Business Forum where extensive exchanges of views are being made for pursuing an mutually beneficial FTA.

Economic Effects of a Korea-Japan FTA⁸

Effect of tariff elimination

Here we compare three different CGE analyses conducted by KIEP, KIET (Korea Institute for Industrial Economics and Trade) and IDE. The effects of a Korea-Japan FTA on the macroeconomic sector are summarized in Table 4.

Table 4. Economic Effects of a Korea-Japan FTA (Unit: US\$ billion)

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

Source: KIEP (2001) *The Economic Effects of and Policy Direction for a Korea- Japan FTA*.
KIET(1999) *Sectoral Effects of a Korea-Japan FTA and Policy Response*.
IDE (2000) *Toward Closer Japan-Korea Economic Relations in the 21st Century.*]

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



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

Although KIEP's estimates of export and import growth rates (2.32 per cent and 3.40 per cent) are greater than KIET's (0.43 per cent vs. 1.0 per cent), both studies equally expect that the growth rate of Korea's total imports will exceed that of total exports, thus aggravating the overall trade balance. In contrast, IDE estimated that the growth in Korea's total exports (2.8 per cent) will surpass total imports (2.47 per cent).

Korea's trade balance with Japan is expected to record an additional trade deficit of \$6.1 billion and \$3.4 billion, according to KIEP and KIET, respectively. IDE analysis also expects that Korea's trade deficit will grow additionally by \$3.88 billion. The increased trade deficit with Japan comes from the expansion of bilateral trade. This is due to Korea's inelastic structure of trade with Japan and trade diversion resulting in an additional shift to Japanese imports as well as Korea's worsening of terms of trade resulting from the elimination of its relatively higher tariff rates.⁹ However, both the KIEP and KIET studies estimate that trade balances with third countries will improve, recording a trade surplus of \$2.8–\$4.6 billion. Therefore, Korea's total trade balance will post deficit increase of only \$0.59 – \$1.5 billion.

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

Overall economic effects (Tariff elimination + productivity enhancement)

The KIEP report extends its analysis by assuming that a Korea-Japan FTA will attract a yearly average of \$3 billion of FDI, mainly from Japan. If this is invested mainly in Korea's heavy and chemical industries, it is expected to increase Korea's factor productivity by 1% annually through the cross-sectoral reallocation of production resources. Based on this assumption, the KIEP study estimates the combined effects of tariff elimination and productivity enhancement under a Korea-Japan FTA.¹⁰

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

¹⁰ In order to estimate the overall effects of a Korea-Japan FTA, we also need to take into account other important factors such as investment expansion and productivity enhancement, in addition to the elimination of trade barriers. The formation of an FTA can stimulate the expansion of FDI from the FTA partner and third countries as firms move their production facilities from nonmember countries to member

**Table 5. Overall Economic Effects of a Korea-Japan FTA (Unit: US\$ billion, %)**

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

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

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

Future Challenges

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

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

countries in order to take advantage of zero tariffs within the free trade area. Also, the formation of a Korea-Japan FTA will attract FDI from nonmember countries trying to gain easy access to regional markets after tariff elimination. This increase in FDI, if efficiently reallocated between light industry and the heavy and chemical industries, is estimated to expand the level of output, thus enhancing the total factor productivity as a result of the economies of scale.

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

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



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

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

Stagnation of bilateral direct investment. Bilateral direct investment between the two countries has been relatively stagnant compared to the level of trade flows. During the period of 1994-1995, however, it reached a record high, showing a downward or stagnant trend since then. Of Korea's total FDI, Japan's share peaked at 34.85 per cent in 1994, but it has dropped drastically, accounting for only 7.6-8.0 per cent since 1997. Although FDI from Japan recently showed a growth rate of more than 200 per cent, recording \$2.4 billion in 2000, its share (15.6 per cent) is still below the level of Korea's other major trading partners such as the U.S. (18.6 per cent) and EU (29.3 per cent). Also, of Korea's total outward direct investment (ODI), Japan's share has stayed at a steady level of around 2 per cent, recording \$94 million in 2000. The share is very insignificant compared to Korea's ODI to the U.S. (24.5 per cent) and China (13.4 per cent). The stagnation of bilateral investment implies that there exist significant investment barriers between the two countries such as complex administration procedure, high wage costs, labor inflexibility, unfair business practices and strict investment regulation.

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

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

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



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

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

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

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

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

Korea-U.S. FTA

Background and Current Status

Though Korea and the U.S. have been important trading partners for four decades, their trade relationship has been often threatened by serious trade disputes. Talks on a Korea-U.S. FTA actually began in the late 1980s when both countries, in view of their growing economic interdependency, felt the strong need for deeper forms of bilateral cooperation, particularly in the trade sector. As Korean exports faced severe trade sanctions under the section 301 of the U.S. trade law, Korea's main interest lay in securing the U.S. market by avoiding future trade retaliation and discrimination. On



the other hand, the U.S. hoped that an FTA with Korea would reduce significant trade barriers, thereby facilitating access to the Korean market. With this growing interest in renewing the bilateral partnership, several academic studies have been conducted on the feasibility of a Korea-U.S. FTA.

Real progress, however, came in the late 1990s, when the two countries started to actively pursue FTA initiatives as a parallel approach to multilateral trade liberalization. Beyond NAFTA, the U.S. has initiated FTA talks with other strategic partners such as Chile, Singapore and Korea, for its part, officially announced an FTA as its main trade policy framework. As a preliminary step to a FTA, in June 1999, the two heads of state agreed to launch talks on a bilateral investment agreement. Although the negotiation reached stalemate due to screen quarter problems, deep review is currently being made at the working group level to find breakthrough.

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

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

Analysis of the Economic Effects

Here two important studies on the economic effects of a Korea-U.S. FTA made by KIEP and Institute for International Economics (IIE) in 1999 and 2001, respectively are to be quoted. The KIEP study is based on following different scenarios: a comprehensive liberalization, a partial liberalization with 50 per cent tariff reduction in agriculture and 100 per cent in all other sectors, a partial liberalization with 0% tariff reduction in agriculture.¹⁴ According to this analysis, greatest welfare increase (1.73 per cent) is expected in case of comprehensive liberalization. If agriculture is completely excluded from the liberalization scheme, the welfare benefit is estimated to reduce to \$3.3 billion.

¹³ Inside the US Trade (2001).

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



The real income is also expected to increase in all three cases, though in case of the exclusion of agriculture (0.78 per cent), the growth rate will be only half that for comprehensive liberalization (1.47 per cent).

Table 6. Economic Effects of a Korea-U.S. FTA on the Korean Economy (KIEP)
(Unit: US\$ billion, %)

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

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

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

Table 7. Economic Effects of a Korea-U.S. FTA on the Korean Economy (IIE)
(Unit: US\$ million, %)

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

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

Policy Analysis in International Economics. IIE.

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

2) Mean equivalent variation in millions of 1995 dollars. Percent of GDP in parentheses

3) Percent change.

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



billion.¹⁵ In terms of real income, it is estimated that comprehensive liberalization in the long run will result in a growth rate of 2.41 per cent, more than double that of the case of partial liberalization with agriculture excluded (1.09 per cent), which is similar to KIEP results.

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

Future Challenges

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

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

Another issue is the trade balance problem. As shown in the analysis of economic effects, Korea's trade balance with the U.S. is expected to deteriorate as a result of a Korea-U.S. FTA. Some may raise the question of the merit of a FTA with the U.S. if it will result in worsening, not improving, Korea's trade balance. However, the short-term negative effects could be offset in the long run by strengthening Korea's

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

¹⁶ Choi (2001).



competitiveness through FDI and technology transfer from the U.S. Moreover, Korea will enjoy a trade expansion effect by avoiding significant trade barriers in the form of antidumping and countervailing measures by the U.S.¹⁷

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

Korea-China-Japan FTA¹⁸

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

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

However, this approach seems difficult to achieve in the short term due to several reasons. First, as China still maintains a socialist regime, it is not easy to implement all trade rules and institutions required by a market economy. Moreover, China currently shows little interest in pursuing Northeast Asia economic integration. On the other hand, China and Korea fear that the economic integration will become another form of Japanese dominance, due to their deepening dependency on Japan and Japan's strong economic power.

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

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

¹⁸ Cheong (1999).



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

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

Other FTAs under Consideration

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

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

SELECTION CRITERIA FOR CHOOSING DESIRABLE FTA PARTNERS

Little theoretical literatures exist on providing clear and consistent criteria for choosing a desirable FTA partner. Empirical cases show that the selection of an FTA partner can be either economically-oriented or politically determined due to strategic purposes. Also in Korea's case, different factors are involved in determining different FTA



partners. Taking into account only purely economic elements, here we will consider five determinants in choosing a desirable FTA partner for Korea.¹⁹

The structure of comparative advantage

Comparative advantage reflects a country's industrial and trade structure and the traditional international trade theories claim that two countries will maximize gains of trade by specializing in production and exports of the products in which they have comparative advantage. An FTA between two countries that have complementary structures of comparative advantage will foster inter-industry trade based on an efficient system of specialization, bringing trade benefits in the form of economies of scale and efficient allocation of resources. Examples are U.S.-Mexico trade in NAFTA and a Korea-Chile FTA or Korea-U.S. FTA.

On the other hand, modern trade theories based on the differentiated products model argue that countries having similar structure of comparative advantage will trade more through product specialization based on intra-industry trade. This type of trade is typical among developed countries such as EU or U.S.-Canada FTA.

Also, as Korea and Japan share similar industrial and trade structures, a Korea-Japan FTA, if properly designed, has the possibility to develop into an advanced form of intra-industry trade, mitigating competition and increasing efficiency.

Economic level

It is generally known that an FTA between countries at different economic levels will deepen the economic dependency of the lower income country as the higher income country will monopolize the benefits of free trade by means of abundant capital, efficient markets and advanced technology.

However, Sohn (2000) in his empirical analysis of the EU, AFTA and ANZER, showed that an FTA will certainly produce economic convergence among its members. The convergence of income means that the benefits of an FTA with developed countries are realized not only through the increased trade benefit from the elimination of tariff and non-tariff barriers but also through technology transfers, increased capital productivity and savings rates.

This implies that Korea, by forming an FTA with developed countries such as Japan or the U.S, is expected to enjoy income convergence in addition to the potential trade gains from liberalization.

¹⁹ For more detailed explanation, see Sohn (2001). *The Economic Effects of and policy Direction for a Korea-Japan FTA*. pp 18-26.



Geographical proximity

While traditional international trade theories emphasize the importance of purely economic factors such as comparative advantage and factor endowment in determining bilateral trade volumes, modern theories, in particular, the gravity model²⁰ pay more attention to the role of geographic elements such as distance, adjacency, population and language.

Some fundamental reasons can be mentioned why distance can act as a determinant factor in international trade.²¹ First, short distances will reduce shipping costs and transport times. This, in turn, will lead to regional agglomeration of specific industries across borders, thereby expanding bilateral trade. In addition, countries close to each other have a strong policy preference to increase not only regional welfare benefit but also their market power in the world economy by forming a natural trading bloc.

In reality, the importance of distance is also evidenced by existing RTAs such as NAFTA, EU, MERCOSUR, ANZCER, whose members are all closely situated. As for Korea, distance was also found to be an important factor, explaining 17 per cent of its bilateral trade volume. Therefore, from the perspective of the gravity model, it would be desirable for Korea to conclude a FTA with countries in geographical proximity such as Japan or China

Market size

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

One of the main objectives of Korea's FTA policy is to secure export markets. To maximize the benefits of market integration and trade expansion, it would be desirable for Korea to pursue an FTA with large economies such as Japan, China or the U.S.

The existence of missing trade

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

²⁰ The gravity model aims at explaining the bilateral trade flows and patterns between two economies by regarding them as an organic bodies that attract each other in proportion to their economic size (GDP) and inversely to their distance.

²¹ Frankel (1997)



The existence of “missing trade” can be a determinant factor in choosing a desirable FTA partner for Korea. Wider gap between actual and predicted trade volume, the greater trade expansion effect that will take place through the elimination of the trade restrictive factors. Sohn and Yoon, in their empirical analysis (2000) based on gravity model, point out that Korea’s trade with Japan and China, in particular, having all the favorable factors to expand bilateral trade, such as large economic size and close distance, fall short of the normative value by 33 per cent and 15 per cent, respectively, implying the presence of considerable missing trade.

Through an FTA with those countries, Korea is therefore expected to expand the bilateral trade flows not only in the form of the trade creation effect but also through the recovery of the missing trade caused by significant trade restrictive factors.

CONCLUSIONS: KOREA’S GLOBAL FTA POLICY

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

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

Korea’s global FTA strategy, in this regard, can be promoted in several directions. First of all, in order to maximize the benefits of trade and investment liberalization, secure export market and modernize its economic structure, Korea will need to design FTAs with large economies such as Japan, China and U.S. An FTA with those countries will not be feasible in the short term as various conflicting issues such as trade imbalance problem, opposition from sensitive sectors and different economic system remain unsolved. Therefore, they should be pursued in the long term with a deliberate and sophisticated approach. In the short term, it will be necessary for Korea to restructure its economy and accumulate more experience in operating under a free trade regime.

Secondly, Korea can consider strategic FTAs with economic and cultural similarities such as ASEAN countries. This kind of FTA will minimize the adjustment costs of liberalization and consolidate a strong foundation for large-scale FTAs. Moreover, by incorporating Japan and China, it could later be developed into a East Asian regional trading bloc that could serve as a countervailing force to other major trading blocs such as the EU or NAFTA.



REGIONAL TRADING ARRANGEMENTS: Stocktake and Next Steps

Trade Policy Forum

Bangkok, June 12-13, 2001

Thirdly, with a view to gaining easier access to larger regional markets within other continental trading blocs, Korea can pursue FTAs with countries in strategic locations such as New Zealand (Oceania) or South Africa (Africa).

After all, Korea tries to ensure that RTA initiatives will be consistent with the multilateral trade rules so that both multilateral and regional approaches can contribute to the progress of the world free trade system in mutually supportive ways.



REFERENCES

Cheong, Inkyo and Yunjong Wang. 1999. *Korea-U.S. FTA: Prospect and Analysis*. KIEP Working Paper 99-03.

_____ 1999. *A New Strategy for Northeast Asian Economic Cooperation: Regional Economic Cooperation for Trade Issues*. KIEP Working Paper 99-25.

Kyounghee Lee. 2000. *Korea-Chile FTA: Background, Economic Effects and Policy Implications*. KIEP Policy Analysis 00-07.

Choi, Inbom and Jeffrey J. Schott. 2001. *Free Trade between Korea and the United States? Policy Analyses in International Economics*. Washington, D.C.: Institute for International Economics.

DIRECON of Chile. 2000. *Current Status of Progress in FTA Negotiation with Korea*. Various background materials. <http://www.direcon.cl/acuerdos/index.htm>.

Frankel, Jeffrey A. 1997. *Regional Trading Blocs in the World Economy System*. Washington DC: Institute for International Economics.

IDE. 2000. "Toward Closer Japan-Korea Economic Relations in the 21st Century." paper presented on May 24, 2000 at the Joint symposium, *Toward a Korea-Japan FTA: Assessments and Prospects*. Seoul.

Inside the US Trade. "Baucus Introduces Bills Authorizing FTA Talks with Korea, New Zealand, Australia." May 23, 2001. <http://www.insidetrade.com>.

KIET. 1999. *Sectoral Effects of a Korea-Japan FTA and Policy Response*. KIET Policy Discussion Paper.

Ministry of Foreign Affairs and Trade. 1999. *Korea's Mid and Long Term Trade Policy*. www.mofat.go.kr.

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

Sohn, Chan-Hyun. 1989. "U.S. FTA Policy: Background and Korea's Position." *Monthly Korea Trade Focus*. February: pp.12-19. Seoul: Korea International Trade Association.

Yang, Junsuk·Yim, Hyo Sung. 1998. *Korea's Trade and Industrial Policies: 1948-1998*. KIEP Working Paper 98-05.



Yim, Hyo Sung. 2000. "Free Trade Agreements and the Income Convergence of Member Countries: Lessons from the EU, NAFTA and ANZCER." *Journal of International Economic Policy Studies*. Volume 4. no 1: pp.3-39. Seoul: KIEP.

Yoon, Jinna. 2001. *Does the Gravity Model Fit Korea's Trade Patterns?* KIEP Working Paper 01-01.

_____ ed. 2001. *Analysis of the Economic Effects of Korea's FTAs with Japan, the U.S. and China, Japan*. KIEP Policy Reference 01-01.

_____ 2001. *The Economic Effects of and Policy Direction for a Korea-Japan FTA*. KIEP Policy Reference 01-03.

WTO. 1995. *Regionalism and the World Trading System*.

_____ 2000. "Regionalism in the World."
http://www.wto.org/english/tratop_e/region_e/region_e.htm

Yoon, Jinna. 1999. *A Korea-Chile FTA: Economic Effects and Policy Implications*. A Master thesis (unpublished), Korea University.