

**Joint Report and Policy Recommendations on
the Possible Roadmaps of a Free Trade Agreement
between China, Japan and Korea**

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Trilateral Joint Research

by

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Executive Summary

In accordance with the common understanding reached during the historic Manila Summit by the leaders from China, Japan and Korea in November 1999, the joint research on “Strengthening the Economic Cooperation among China, Japan and Korea” was officially launched by the representative institutes from the three countries, namely the Development Research Center of the State Council (DRC) of China, the National Institute for Research Advancement (NIRA) of Japan, and the Korea Institute for International Economic Policy (KIEP) of Korea in 2000. Following the joint study on “Enhancing Trade and Investment between China, Japan and Korea,” the three institutes embarked upon the second phase of joint research in 2003 on “Long-term Economic Vision and Medium-term Policy Direction,” beginning with a project named, “Economic Effects of a Possible FTA (Free Trade Agreement) between China, Japan and Korea”.

The research in 2003 focused on the impact of a FTA between China, Japan and Korea (hereafter, CJK FTA) on the macro-economies of the three countries. Following an overall analysis of this subject, the three sides conducted joint research on the “Sectoral Implications of a CJK FTA” in 2004-06, covering agriculture, fishery, and major manufacturing and service sectors. In 2006 they also examined other important issues, including rules of origin and sensitive sectors in the FTAs concluded by China, Japan and Korea. After highlighting the rationales for a CJK FTA, including the positive macro-economic benefits for the three countries, the study in 2007 addressed the sectoral implications of a CJK FTA for major manufacturing and service industries, as well as the agriculture and fishery industries of the three countries, by analyzing their competitiveness and tariff structures, on the one hand, and the sensitive sectors reflected in the FTAs concluded by the three countries, on the other. In 2008, the joint research covered three aspects. First, it examined the three countries’ FTA policies, focusing on the relationship between the CJK FTA and each country’s bilateral FTAs already in effect or about to take effect. Second, it summarized the obstacles and expectations of a CJK FTA. Third, it analyzed the role of the three Northeast Asian countries and the CJK FTA for a region-wide FTA in East Asia. Overall, in the last six years, the joint research has touched upon almost all major issues concerning the CJK FTA to analyze a feasible roadmap for the establishment of a CJK FTA.

The joint research has received positive responses. During the fifth summit meeting among the three countries’ leaders in Bali, Indonesia in 2003, a *Joint Declaration on the Promotion of Tripartite Cooperation among the People's Republic*

of China, Japan and the Republic of Korea was issued, stating, “Appreciating the progress of the joint study on the economic impact of a free trade agreement (FTA) conducted by their respective research institutes, the three countries will explore, in a timely manner, the direction of a closer future economic partnership among the three countries.” During the first meeting of China-Japan-Korea Tripartite Committee held in 2004, the foreign ministers of the three countries appreciated the research of three-nation FTA carried out by research institutes of the three countries, indicating that they will continue to focus their attention on the research. The *Action Strategy on Trilateral Cooperation among the People's Republic of China, Japan and the Republic of Korea*, which was approved by the three countries’ leaders, was reiterated that “The three countries will facilitate the current joint study on the economic effects of possible free trade area among China, Japan and Korea by the three countries’ think tanks.” The theme of CJK FTA has become an important element of tripartite cooperation among the three countries.

In order to offer business circles a deeper understanding of the joint research on a CJK FTA, and to win their support, the organizers of the three countries tripartite business forum have been invited to participate in workshops and seminars of the joint research since 2006, and the scholars from the three research institutes have also attended the business forum to introduce the progress of the joint research on CJK FTA. Since 2007, government officials from China, Japan and Korea have participated in the joint research as observers. This is an important progress; however, it is still difficult to conduct face-to-face discussions among the three countries’ officials on some key issues.

A Review of Major Achievements

Through six years of joint research, the research institutes of the three countries have achieved some important results on the project of “Economic Effects of a Possible FTA between China, Japan and Korea”.

1. A CJK FTA Will Generate Positive Macro-economic Effects for All Members

The joint research project assessed the economic impacts of a CJK FTA by means of a computable general equilibrium (CGE) model. Three simulations were made in 2003, 2005 and 2007, respectively, adopting the static analysis approach with updated databases. The results of the three simulations generally indicated the same direction and similar magnitude of economic effects, confirming that an FTA among China, Japan and Korea will be a win-win-win strategy bringing about

macroeconomic benefits to all members.

In order to make the econometric analysis more realistic, the simulation made in 2008 has been improved in two aspects. First, a dynamic approach was adopted, mainly introducing the factor of cross-border capital movement, since trade liberalization is bound to be accompanied by changes in capital gains and capital movements, whose macro-economic impacts far exceed those of tariff reductions. Second, comparisons were made among 16 scenarios of different combinations and orders of a CJK FTA and bilateral FTAs among the three countries. The simulation results indicated that the scenario of “trilateral FTA at once” would bring about the largest welfare gain to all three countries, under which China’s GDP will increase by 0.4%, Japan by 0.3%, and Korea by 2.8%. The order of FTAs will ultimately make no difference in the regional macroeconomic benefits and industrial sector structures. However, an earlier FTA with China would bring larger benefits for Japan and Korea.

The maximized macroeconomic benefits are also accompanied with the largest industrial adjustment with labor dislocation from the damaged sectors, bringing about social costs. The existing FTAs of the three countries were, in general, carefully designed to reduce such social costs by means of mitigating measures, including sector exclusion and grace periods. Nonetheless, sector exclusion would significantly reduce the potential benefits to everyone while mitigating the damages to some specific sectors.

2. The Establishment of a CJK FTA has Gained Broad-based Support from Enterprises in the Three Countries

The joint research team conducted a questionnaire survey of business enterprises from April to June 2003. A large proportion of the respondents supported the idea of establishing an FTA among China, Japan and Korea. Afterwards, the joint research team and media of the three countries continued to conduct numerous surveys, which all showed that most enterprises in the three countries maintained a positive attitude towards setting up a CJK FTA.

3. Implications of a CJK FTA on Manufacturing Industries

The results of an analysis on the competitiveness of the three countries’ major manufacturing industries showed different degrees of competitiveness among the major manufacturing industries in China, Japan and Korea. In general, China enjoyed low labor costs, large economies of scale, and large production capacities. Thus, its comparative advantages were concentrated in labor-intensive industries or processing links, such as textiles and electronics. By contrast, Japan and Korea boasted stronger technological abilities and research and development (R&D) capabilities, which

offered them stronger comparative advantage in capital-intensive and technology-intensive industries, such as automobiles and machinery for Japan, and electronics and petrochemicals for Korea.

All three Northeast Asian countries have become leading industrial economies in the world. Thus, trade liberalization in the manufacturing industry will be the biggest contributing factor to overall welfare gains by expanding the regional market, optimizing resource allocation, and creating a more competitive environment. In addition, it is also consistent with the willingness of most enterprises in the three countries. A delay in the establishment of the trilateral FTA would result in raising structural adjustment costs in the three countries, as well as overcapacity in some sectors, such as steel and petrochemical industries within the region.

4. Impacts of a CJK FTA on Agriculture

Unlike the manufacturing sector, agricultural and fishery industries in the three countries are relatively weak. The three countries are all major importers of agricultural and fishery products, and some of these products are protected by tariff and non-tariff barriers. Therefore, in the process of forming a CJK FTA, special attention will need to be paid to these sectors. A CJK FTA, however, could serve as a good opportunity to reform the agricultural sector and prepare the countries for global integration in agricultural trade. In order to alleviate adjustment burdens and facilitate structural adjustment, a clearly scheduled, gradual liberalization program should be devised with adequate specialization and compensation schemes for these industries.

5. Enhancing Service Industries at the World Level

China, Japan and Korea lag behind developed North American and European countries in trade in services. Although the three countries recorded in general trade surpluses, they usually have deficits vis-à-vis the world in trade in services. Liberalization of services would raise the competitiveness of service sectors by introducing competition and improving the quality of services. In addition, since many service products are used as intermediary processes in manufacturing goods, service liberalization would also contribute to making manufacturing industries more competitive. The trade in services among China, Japan and Korea is becoming increasingly important. Thus, a CJK FTA could be used as a means of raising competitiveness in the service industries of the three countries, as well as upgrading their economies.

6. Rationales for and Obstacles to a CJK FTA

The importance of intra-regional trade between China, Japan and Korea has

risen substantially since 1990: the share of intraregional trade among these countries increased from 12.7% in 1990 to 23.9% in 2005. In other words, trade interdependency among the three Northeast Asian countries has markedly strengthened in the past 15 years. This is mainly due to the increasingly closer supply chain relations among the three countries' manufacturing sectors and the fact that the three countries are important markets to each other. The establishment of a CJK FTA can eliminate trade barriers, expand intra-regional market and facilitate further economic integration among the three countries, and is therefore of great importance.

The joint research in 2008 shows the establishment of free trade relations among the three countries is indeed faced with certain obstacles. First of all, some sensitive sectors exist in all three countries. Since they are likely to be harmed by trade liberalization, the interest groups are against the establishment of a CJK FTA. Secondly, some non-economic factors, such as unresolved historical issues and lack of Northeast Asia community spirit, also constitute major barriers to a CJK FTA. Since the barriers are more concrete and immediate while the economic benefits are potential and can be realized only in the long term, cautious or passive elements are predominant when the three countries government officials weigh the pros and cons.

7. The FTA Policies of the Three Countries and the Roadmaps of a CJK FTA

The three Northeast Asian countries display different characteristics in their FTA policies. The FTA partners of China are mainly composed of neighboring countries and developing countries, and China is seeking FTAs with countries with complementary industrial and trade structures. Satisfactory political and diplomatic relation and mutual intention for the FTA are other important prerequisites for the FTA.

Most of Japan's EPA partners are developing countries in the East Asian region as well. The EPAs are characterized by comprehensive coverage ranging from trade in services and investment to movement of natural persons in addition to trade in goods. Korea has the most active attitude, and it has conducted or completed FTA negotiations with major developed countries and trading partners. Korea's pursuit, meanwhile, focuses on the conclusion of comprehensive FTAs in services, investment, government procurement, IPR, and so on.

Judging from their FTA policies, all three countries view the trade partners who have supply chain relationships with them or those countries that are their major export markets as priority targets for setting up free trade relationship. All three countries are actively pursuing region-wide economic integration in East Asia. However, the free trade relations among China, Japan and Korea have progressed very slowly, although simulations results have irrefutably showed the superiority of a

CJK FTA over any other combination of bilateral FTAs.

In order to promote regional cooperation in East Asia, we should promote the CJK FTA process at the same time as we continue to consolidate the positive achievements of the current three “ASEAN+1” entities, so as to create conditions for the realization of trade liberalization among China, Japan, Korea and the ASEAN.

Policy Recommendations for Keeping the Momentum of the CJK FTA

Recommend three government officials to consider a possible CJK FTA and exchange views on it in a timely manner.

Through six years of joint academic research, the necessity of establishing a CJK FTA has been fully demonstrated. That is, the establishment of a free trade area among three countries with increasingly greater economic interdependency will not only generate huge economic benefits, but will also be conducive to strengthening the community spirit in Northeast Asia and improving political relations within the region. Nonetheless, the governments of the three countries will have to take into consideration the social costs brought about by the structural adjustments of the sensitive sectors as well as the improvements in such aspects as investment and rules of origin, which are necessary for the maximization of the potential benefits. Owing to the coexistence of foreseeable benefits and barriers, they have not achieved substantial progress on the issue of establishing a CJK FTA. Given the severity of the current global financial crisis, the need for closer economic cooperation among the three countries has never been more urgent. In order to create an atmosphere of mutual trust and win-win situation, the research institutes of the three countries recommend three government officials to consider a possible CJK FTA and exchange views on it in a timely manner so that they can probe into the feasible measures on how to overcome the obstacles and maximize the benefits.

CJK FTA should be one of the important agenda at future trilateral meetings among government officials

The governments of the three countries should give a serious thought on the importance of a CJK FTA in their bilateral and regional FTA policies. They should recognize that a region-wide East Asian FTA would not be easy unless there is a de facto CJK FTA. Furthermore, since the three ASEAN+1 FTAs were concluded, a CJK FTA would greatly facilitate the formation of an EAFTA.

To keep the dialogue mechanism on a CJK FTA

According to the plan agreed upon by the research institutes of the three countries, the six-year joint research project on “Economic Effects of a Possible CJK FTA” is to be concluded this year. Since a CJK FTA is an important element in the *Action Strategy on Trilateral Cooperation* among the three countries, the dialogue mechanism needs to be retained on this topic. In 2009, the research institutes of the three countries will continue their joint study on CJK FTA. The specific themes are to be determined by the three sides through consultation after the Japanese government designates a new representing institution.

I . Abstract of Joint Research in 2008

In 2008, the joint research covered three aspects. First, it examined the three countries' FTA policies, focusing on the relationship between CJK FTA and each country's bilateral FTAs already in effect or about to take effect. Second, it summarized the obstacles and expectations of a CJK FTA. Third, it analyzed the role of the three Northeast Asian countries and CJK FTA for a region-wide FTA in East Asia. The joint research team attempted to analyze a feasible roadmap for the establishment of a CJK FTA.

1. The FTA Policies of the Three Countries

In recent years, China, Japan and Korea have been actively promoting the FTA policy with other countries and regions. Studying the objectives and features of FTA policies of the three countries can shed light on the prospect of the potential CJK FTA in the future. Therefore, FTA policies of the three countries became the first topic for this year's joint research, which presented the rationales, objectives and progress for FTA policies, analyzed the contents and features of concluded FTA agreements, and discussed the implications for CJK FTA.

China's FTA Policy

The Chinese Government attaches great importance to the establishment of FTAs with other countries and regions. After its successful accession into the WTO, for China, FTA has become a new form of opening up to the outside world. In 2006, the Chinese Ministry of Commerce conceived of elevating FTA policy to the height of national strategy.

Therefore, China has been actively involved in the negotiations on the establishment of free trade areas in recent years. So far, China has signed Closer Economic Partnership Agreement (CEPA) with Hong Kong and Macao respectively, and has established FTAs with ASEAN, Pakistan, Chile, New Zealand, and Singapore. China has also initiated FTA negotiations with the Gulf Cooperation Council, Australia, Iceland, and Peru. Moreover, China has also completed joint research on the regional trade arrangement with India and joint FTA feasibility research with Norway and Costa Rica, and conducted joint FTA feasibility research with Korea.

China views neighboring countries and regions as a priority pool for FTA partners. The complementarity in trade and economic structure is also an important factor. The ease of negotiations also affects the choice and sequence of FTA partners as many FTAs were initiated by China's trade partners. Additionally, China's FTA

policy has long-term and global considerations; therefore, it will not restrict the FTAs to the neighboring regions, but will select some partners from various key areas in the world.

Normally China conducts the FTA policy through a gradual and progressive approach, for example, by first negotiating and concluding trade in goods agreement, followed by trade in services agreement and then investment. However, China's latest FTA with New Zealand in 2008 became China's first comprehensive agreement and is also the first FTA with a developed country.

Japan's FTA/EPA Policy

The Japanese government began supporting the conclusion of regional trade agreements (RTAs) in the late 1990s and since, it has been attempting to actively involve itself in the international trend towards the conclusion of Economic Partnership Agreements (EPAs). Japan has been negotiating bilateral and plurilateral EPAs, mainly with Asian countries, since it implemented its first EPA with Singapore in 2002. Japan so far concluded nine EPAs with such countries or regions as Singapore, Mexico, Malaysia, Chile, Thailand, Brunei, Indonesia, ASEAN, and the Philippines, and is now negotiating with six countries or regions: Vietnam, Switzerland, the GCC, India, Australia, and Korea.

In recent years, Japan has been advancing its EPA initiatives strategically in accordance with the Basic Policy towards the Further Promotion of EPAs, approved by the Council of Ministers on the Promotion of Economic Partnership on December 21, 2004, and revised on June 19, 2007, and the EPA work schedule, established in May 2006, and revised in May 2007, June 2007, and June 2008. The main objectives of Japan's EPA policy are: to compliment multilateral free trade system, to promote Japan and the partner countries' structural reforms, and to formulate a favorable international environment with respect to Japan's political and diplomatic strategies.

Japan's major points of focus in trade negotiations are to eliminate tariffs on materials and parts, to establish rules regarding investment and intellectual property rights, to liberalize trade in services, and to improve the business environment. The negotiations are characterized by their broad scope, focusing not only on trade in goods, but also covering a broad agenda including services, investment, government procurement, intellectual property, competition, movement of natural persons, improvement of the business environment, and cooperation.

Japan is currently making efforts to conclude economic agreements including bilateral investment agreements with resource-rich countries as well as countries in East Asia, a region that is deeply economically interdependent with the nation. In addition, Japan has been considering agreements with countries and regions that have

large markets and are major investment destinations, including the United States and the EU, as future options. Japan is expected to formulate a more active and bold roadmap in the future when circumstances allow.

Korea's FTA Policy

Korea turned its attention to FTAs after the 1997 Asian Financial Crisis, which provided the necessary momentum to promote regionalism in Korea. Korea has signed five FTAs so far with Chile, Singapore, EFTA, ASEAN, and the US, and is in the midst of conducting six FTA negotiations with Mexico, Canada, India, the EU, and the GCC. Negotiations with Japan have been suspended since November 2004. Joint studies with China, MERCOSUR, Australia, and New Zealand are also currently underway. By the end of 2010, more than ten FTAs are expected to come into effect in Korea.

During the initial stages, Korea pursued FTAs with countries with small economies, such as Chile and Singapore. This was to minimize the possible negative impacts on the Korean economy. Korea's FTA negotiations with Japan and the EU and the signing of the Korea-US FTA were rather bold initiatives, which reflected a drastic change in Korea's stance toward FTAs.

There are two major reasons for the radical change in Korea's trade policy. The first reason is that Korea started FTA negotiations to minimize disadvantage to its trade with the rest of the world in the face of mounting regionalism. Korea needed to avoid being secluded from the worldwide spread of regionalism and secure its trade share by hopping on the bandwagon. It adopted an FTA policy to maintain its market share on one hand, and move into new markets by forming FTAs with major trading partners on the other. The second reason is to strengthen its economic competitiveness and improve its national economic system through market opening and liberalization. Attempts to open its market have consistently faced severe protests from farmers and labor unions. Despite intense political opposition, Korea changed its trade policy to actively pursue high-quality FTAs with its trading partners, which can be regarded as a remarkable shift in Korea's trade policy.

Korea has adopted four strategies for pursuing FTAs with other countries. First, Korea is simultaneously negotiating FTAs with interested counterpart countries. Second, the Korean government is pursuing FTAs with large economies, such as the US, the EU, and Japan, and newly rising economies, such as MERCOSUR and India, with the expectation that forming FTAs with large economies or economic blocs will maximize the effects of market opening. Third, Korea seeks to establish comprehensive FTAs in terms of coverage and content; that is, it looks for substantial liberalization in other areas of trade, besides trade in goods: e.g., services, investment,

government procurement, intellectual property rights (IPR), and technical standards. Finally, the Korean government regards national consensus building and transparency as important factors to consider in promoting FTAs. Since market liberalization affects various interest groups differently, diverse opinions need to be heard in order to minimize the tensions and potential conflicts in the Korean society.

Comparison of FTA Policies of China, Japan and Korea

The three Northeast Asian countries display different characteristics in their FTA policies. The FTA partners of China are mainly neighboring countries and developing countries, and it has just completed an FTA negotiation with the first developed country. Most of Japan's EPA partners are developing countries in East Asia as well, but the EPAs are characterized by comprehensive coverage ranging from trade in services and investment to movement of natural persons in addition to trade in goods. Korea has the most active attitude, and it has conducted or completed FTA negotiations with major developed countries and trading partners.

In terms of areas of interest, each country has different priorities. China stresses neighboring countries and regions as the first choice of FTA partners and also wants FTA with countries with complementary industrial and trade structure. Satisfactory political and diplomatic relation and mutual intention for FTAs are other important prerequisites for China. Japan wants to achieve mutual prosperity with Asia by EPAs through incorporation of the dynamism in Asia and development of production networks of Asian companies. Moreover, Japan has been considering agreements with countries and regions that have large markets and are major investment destinations, including the US and the EU, as future options. Stable supply of natural resources and energy is another important factor to be achieved by EPAs. Korea's pursuit, meanwhile, focuses on the conclusion of comprehensive FTAs in services, investment, government procurement, IPR, and so on.

All three countries have been actively pursuing free trade agreements with Asian Pacific countries with great success. Given the trend towards closer regional economic integration by way of FTA, the joint research team believes that more concrete steps should be taken towards the establishment of CJK FTA.

2. Obstacles to and Expectations for a CJK FTA

Both economic theories and empirical experiences have shown that an FTA would bring about significant macroeconomic benefits to all the participating parties. The three major economic players in East Asia, China, Japan, and Korea have been actively engaging in negotiations for pursuing free trade agreements. However,

neither bilateral FTAs nor a trilateral FTA among the three countries is being actively pursued. This implies that there are many obstacles and skepticism to overcome before agreements can be realized. Therefore, it is highly necessary to explore the actual obstacles that each country faces and their expectations for the trilateral FTA, so that further efforts could be made to enable us to move towards the establishment of a CJK FTA.

A. Expectations for a CJK FTA

China

First of all, the signing of a CJK FTA will be a great boost to investors' confidence. It will show that China, Japan and Korea have determined political will to strengthen institutional cooperation, which would effectively disarm investors' suspicion and hence facilitate the booming of the intra-regional trade and investment.

As the world's second largest economy and one of the richest countries, Japan has a huge domestic market. China has already become Japan's number one import source. An FTA with Japan may further increase China's exports to Japan. More importantly, such institutional cooperation can help each country to understand non-tariff barriers in Japan and will create a predictable market for China's exports.

Thanks to the large volume of direct investment flow into China from Japan and Korea, a close industrial chain has been formed among the three countries. As a result, a big part of Japan and Korea's trade surplus with the US and the EU has been transformed to Japan and Korea's trade surplus with China, and China's trade surplus with the US and the EU. A CJK FTA will further facilitate the development of intra-industry trade between China, Japan and Korea, and strengthen the competitiveness of the transnational production network among the three countries.

Both Japan and Korea have leading manufacturing industries and China is implementing import substitution policy in such industries as petrochemical, machinery and automobiles. Judging from the current development trend, competition between the heavy chemical industries among the three countries will become increasingly intense in the future and the problem of excess capacity will become more and more outstanding. The cost of structural adjustment will increase instead of dropping. For this reason, early initiation of an FTA progress will give clear price signals to the three countries' enterprises and facilitate the industrial relocation among the three countries. Part of the cost of the structural adjustment may be offset through the improvement of the resource allocation efficiency.

Currently, there are still some restrictions in Japan and Korea over technology transfer to China, which hinders the normal development of the technological trade among the three countries. It is expected that a CJK FTA can help reduce or eliminate

such restrictions so that China can have the opportunity to fully tap the late-starting advantages and accelerate technological advances and industrial upgrading.

Japan

Political relationships between China and Japan have recently improved, with the leaders of the two countries each making visits to the other country. It is hoped that increasing mutual cooperation between China and Japan will contribute to the future establishment of a bilateral EPA between them, in addition to plurilateral FTAs involving both countries. Forging future-oriented cooperative relations is the most important for both countries.

Forming a trilateral FTA would be very appealing for Korea as Korea is expected to receive the greatest benefit. Under a CJK FTA, industrial structure and competitiveness of Japan and Korea are relatively similar. They actually belong to the same group under WTO negotiations on agriculture. Therefore, it is possible that Japan and Korea can cooperate in sensitive sectors under a CJK FTA. Cooperation in certain fields like environment, education and culture are effective means of deepening mutual understanding.

Korea

According to the joint study on the Korea-China FTA, Korea's GDP may increase by 2.4–3.2% if the Korea-China FTA becomes effective. The trade volume of both countries is also expected to grow. The capital accumulation model, which captures the static and medium-run growth gains, expects a greater increase in the total volume of exports.

In line with the country's impressive economic growth, China's domestic market for mass consumer goods has been expanding in the past decades and is expected to grow continuously. A Korea-China FTA may create more favorable environment for Korean companies to succeed in the growing Chinese consumer markets. Similarly, Korea's export to China, which already faces fierce competition with other countries, may take an advantageous position in Chinese market.

Korea and China are important partners in foreign direct investment (FDI). A Korea-China FTA will favorably affect a large number of Korean subsidiaries through zero tariffs on input supplies imported from Korea, zero tariffs on final sales to Korea, or both. It may also enhance investment between the two countries and lead to a greater investment-induced trade.

China, Japan and Korea have relatively restricted service markets and their roles in world's trade in services are not significant. However, since the three countries have comparative advantages in different sectors, Korea may expect to gain

some economic gains from the liberalization of the service markets in China and Japan when forming an FTA with the two countries.

B. Obstacles to a CJK FTA

China

In terms of competitiveness, the chemical, automobiles, and machinery industries of China are in disadvantaged positions compared to Japan and Korea. These sensitive industries are the main obstacles faced by China in establishing FTAs with Japan and Korea.

China's petrochemical industry has maintained great trade deficits with both Japan and Korea and the volume of the deficit is rising rapidly. In order to implement import substitution strategy, China has made great investments on petrochemical industry in recent years and tried to enhance the production capabilities of high-technology and high value-added products. The establishment of an FTA will result in further accelerated increase of import from Japan and Korea and the newly built capacities of China's domestic enterprises might not be fully utilized. In particular, the market space for high-end products will be squeezed, and some enterprises might suffer losses for failing to reach the economy of scale.

Among China's manufacturing industries, automobiles might have the largest gap compared to Japan and Korea in terms of competitiveness. China has maintained a large amount of trade deficit of automobiles products to Japan and Korea and the deficit volume has been increasing rapidly. As major automobiles manufacturers from Europe, USA, Japan, and Korea have all set up manufacturing bases in China and joint venture companies has become the main force of China's automobiles industry, a CJK FTA will not bring overall negative impacts over China's automobiles industry. However, local automakers who occupy 25% of China's market will be faced with greater competition pressure. Due to the high degree of product similarity, Korean automakers might pose a greater threat to local automakers in China.

China's machinery industry also has maintained great trade deficit to both Japan and Korea, with a great magnitude. China is currently implementing the policy of reviving the equipment manufacturing industry. The establishment of an FTA with Japan or Korea may bring great negative impact on domestic enterprises, especially those in the process of upgrading the manufacture of high-end products. Due to more remarkable technological advantages, Japan poses a greater threat to China's domestic enterprises.

Japan

A joint study between Japan and Korea was launched in December 1998. This

study was Japan's first joint research project examining the possibility of a bilateral FTA that had been established at the initiative of the government.¹ Following several stages of joint research, the leaders of Japan and Korea agreed during the October 2003 summit meeting to commence FTA negotiations within the same year, hoping to conclude the agreement by 2005.

FTA negotiations were initiated in December 2003 but have been suspended since November 2004. Although Japan is willing to restart the FTA talks with Korea and working-level talks were initiated on June 25, 2008, there is still no conspicuous sign of resumption. During the negotiations on Japan-Korea FTA, both sides had sensitive sectors. Korea's expected lower economic returns generated by a FTA between Japan and Korea in the short time and its huge trade deficit against Japan are the other obstacles to a bilateral FTA in addition to the argument over their sensitive sectors.

Should an FTA with China be considered, agriculture and fisheries would be some of the sensitive sectors for Japan. Other labor-intensive sectors in manufacturing such as textiles are also less competitive in Japan. Because the volume of trade between China and Japan is extremely large, the effects of a Japan-China FTA are considered to be enormous and uncertain. The scale of the effects and the lack of certainty are convenient focuses for the opponents of a Japan-China FTA and generate anxiety concerning such sectors.

Japan pays considerable attention to the level of comprehensiveness and quality of its FTAs. Japan's FTAs normally encompass a broad range of issues including investment, services, and other trade and investment-related rules and regulations. Since there still remains a gap between Japan and China in terms of economic systems and the level of the economy, Japan's level of conditions for trade and investment is much higher than China can currently provide.

Korea

Korea's biggest concern in a Korea-China FTA is the agricultural and fishery sectors. China has higher price competitiveness than does Korea. In most cases, Korean farmers and fishermen are likely to take the biggest blow when an FTA is concluded, since Chinese agricultural and fishery products cost only one-fifth of the Korean equivalents.

Since processing trade accounts for almost 70% of Korea's exports to China and these exports are already receiving tariff exemption or returns, the estimated

¹ The joint research conducted by the Institute of Developing Economies (IDE), the Japan External Trade Organization (JETRO), and the Korean Institute for International Economic Policy (KIEP) examined the effects of a Japan-Korea FTA and set the establishment of an FTA between Japan and Korea as an ultimate goal.

increase in Korea's exports in manufacturing sectors may be overstated in previous bilateral FTA related studies, and therefore may not meet general expectations.

Korea exports intermediate products toward China with relatively low tariff burden, while China exports primary goods and consumption goods toward Korea that have higher tariff rates. Thus, from Korea's perspective, there are concerns over restricted positive effects of tariff reduction from a Korea-China FTA.

Many Koreans fear that Korea's chronic trade deficits against Japan would worsen through a Korea-Japan FTA. Korea's dependency on imports from Japan has been high, particularly for intermediate products and capital goods. A Korea-Japan FTA may not change this scheme and the situation is likely to deteriorate in the short term.

Korea sensitive sectors toward Japan are concentrated in manufacturing sectors, especially in general machinery, electronics, automobiles, and petrochemical, as trade imbalance in these sectors have continuously increased even with highly protective tariff rates.

Furthermore, it has been emphasized that Korea's overall economic gains from tariff elimination would not be significant since Japan already imposes low tariff rates on majority share of imports from Korea. In 2007, zero-tariff items already account for 77.1% of Japan's imports from Korea. In addition, there is some argument that Japan's pervasive non-tariff barriers limit Korea's export increase after the establishment of a Korea-Japan FTA, although those are issues that have more to do with private sectors.

C. Summary

Although all three countries have high expectations for the possible benefits from a CJK FTA, some important obstacles cannot be ignored. From the economic perspective, the major obstacle is the existence of some sectors in each country that are sensitive to competition from imported products. While the beneficiaries of a CJK FTA are quite scattered and lack political influence in trade policy, the expected benefits of the CJK FTA can only be realized in the long-term, which seems to be vague and less tangible when compared with the more concrete and immediate cost of structural adjustment of domestic industries.

Some non-economic factors also constitute major barriers to a CJK FTA. In essence, signing a FTA is a political decision and therefore appropriate political atmosphere is needed. However, there still remain unresolved historical issues between China and Japan, and between Korea and Japan. Lack of community spirit among the three countries is another obstacle.

3. The Roadmaps of the Free Trade Agreement

The wave of the FTA proliferation in the world has extended to East Asia. The countries in ASEAN, particularly the original five members (ASEAN5), have actively taken the opportunities to establish FTAs with their trade partners and among themselves. In Northeast Asia, China, Japan and Korea each has also actively joined this FTA trend. With the greater presence of the three countries in terms of large population, aggregate incomes and production, and higher technological levels in East Asia, the existing FTAs related to these countries brought about greater influence on all the parties.

The joint research team decided this year to study the possible roadmap of CJK FTA and its implications for East Asian economic integration through simulation and empirical methods with specific interest in the effects of the orders and timings of different FTAs among the three countries. In general, the trade theory suggests that such FTAs result in economic impacts, both benefits and loss to various parties concerned. The trilateral joint research report last year confirmed the result. The joint research this year steps further to more strategic consideration on the time dimension.

Our simulation confirms other implications obtained by the existing studies. Most importantly, “trilateral FTA at once” will bring about the largest gains among all the combinations to all the three countries. The trilateral FTA will be a win-win-win strategy. The earlier the trilateral FTA is established, the larger the welfare gain will be. If two countries out of the three make an FTA, the remaining country may receive no or small negative impact from the FTA due to trade diversion effect.

The order of the FTAs will ultimately make no difference in the regional macroeconomic benefits and industrial sector structures. As for timing, the benefit will generally become larger by making an FTA earlier with the partners of higher economic growth in the future. In the case of the three countries in Northeast Asia, earlier FTAs with China would bring about larger benefit for Japan and Korea. The transitional loss from delay in making FTAs with such high-growth countries would be large in sum.

In order to promote regional cooperation in East Asia, we should promote the CJK FTA process at the same time as we continue to consolidate the positive achievements of the current three “ASEAN+1” entities, so as to create conditions for the realization of trade liberalization among China, Japan, Korea and the ASEAN.

4. Concluding Remarks

All three countries have been pursuing FTA policies very actively in recent

years and have focused their attention on their trade partners in the East Asian Region. Yet, no formal FTA agreement has been reached among the three countries. Progress towards establishing a potential CJK FTA has been moving at a glacial pace, despite the close and growing trade and investment relationship among the three countries, the stated and demonstrated FTA objectives, the desire of the general business community of the three countries, and the simulations results irrefutably showing the superiority of a CJK FTA over any other combination of bilateral FTAs.

II. Policy Recommendations for Keeping the Momentum of the CJK FTA

Recommend three government officials to consider a possible CJK FTA and exchange views on it in a timely manner.

Through six years of joint academic research, the necessity of establishing a CJK FTA has been fully demonstrated. That is, the establishment of a free trade area among three countries with increasingly greater economic interdependency will not only generate huge economic benefits, but will also be conducive to strengthening the community spirit in Northeast Asia and improving political relations within the region. Nonetheless, the governments of the three countries will have to take into consideration the social costs brought about by the structural adjustments of the sensitive sectors as well as the improvements in such aspects as investment and rules of origin, which are necessary for the maximization of the potential benefits. Owing to the coexistence of foreseeable benefits and barriers, they have not achieved substantial progress on the issue of establishing a CJK FTA. Given the severity of the current global financial crisis, the need for closer economic cooperation among the three countries has never been more urgent. In order to create an atmosphere of mutual trust and win-win situation, the research institutes of the three countries recommend three government officials to consider a possible CJK FTA and exchange views on it in a timely manner so that they can probe into the feasible measures on how to overcome the obstacles and maximize the benefits.

CJK FTA should be one of the important agenda at future trilateral meetings among government officials

The governments of the three countries should give a serious thought on the importance of a CJK FTA in their bilateral and regional FTA policies. They should recognize that a region-wide East Asian FTA would not be easy unless there is a de facto CJK FTA. Furthermore, since the three ASEAN+1 FTAs were concluded, a CJK FTA would greatly facilitate the formation of an EAFTA.

To keep the dialogue mechanism on a CJK FTA

According to the plan agreed upon by the research institutes of the three countries, the six-year joint research project on “Economic Effects of a Possible CJK FTA” is to be concluded this year. Since a CJK FTA is an important element in the *Action Strategy on Trilateral Cooperation* among the three countries, the dialogue mechanism needs to be retained on this topic. In 2009, the research institutes of the three countries will continue their joint study on CJK FTA. The specific themes are to be determined by the three sides through consultation after the Japanese government designates a new representing institution.



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