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# **Economic Integration in Northeast Asia: Searching for a Feasible Approach**

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## Executive Summary

The need for economic cooperation in Northeast Asian region is increasing due to several factors. These are the deepening of the economic interdependence among the three countries; the need for the prevention of overlapping investment in major regional industries; as a response to the formation of economic blocs in the world economy and the growing number of fields requiring the coordination of common interests such as fishing activity rights and the problem of trans-boundary pollution. None of the Northeast Asian countries has joined any regional trade agreement so far, but Japan and Korea have recently renewed their interest in concluding some kind of regional trade agreement. Also, China has intensified its trade liberalization process and tried to modernize its institutions in order to become a member of the WTO. Thus, the possibility of establishing Northeast Asian economic cooperation is higher than ever before.

Economic cooperation should be pursued through a preferential trading bloc that is compatible with WTO rules and that can gain momentum in the process of implementation. One possibility is to conclude a close economic cooperation organization in the region. An alternative can be an FTA among the three. However, this option has so far not been under serious consideration, due to the socialist regime of China, the attitude of Northeast Asian countries suspicious toward Japan because of the history of the past, and the fear of the aggravation of existing economic gaps. But the need for economic cooperation among East Asian countries has been reemphasized after recent changes in the international economic environment, especially after the

East Asian financial crisis.

To examine the economic feasibility of Northeast Asian regional economic integration through the expansion of market approach, let us analyze the economic effects of trade liberalization between Korea and Japan, prior to exploring a simulation of economic integration of the three countries. If Korea and Japan eliminate tariff barriers on a preferential basis, Korea is projected to lose by USD 2.0 billion annually, and its trade balance with Japan will worsen by USD 7.1 billion. On the contrary, it appears that Japan will realize substantial gains. This result can be explained by the special conditions of both countries' economies. Korea's major industries overlap with Japan and thus are trade competitors, while Korea has weaker international competitiveness. Moreover, Korea's general tariff rates are higher than Japan's. Therefore, trade liberalization between the two countries will enhance Japanese price competitiveness over Korea's. Korea's dependence on high-tech industrial products from Japan will be higher, while Korea's industry structure will tend towards the development of low value-added industries such as textiles, clothing, shoes, etc, which will deteriorate the overall efficiency of resource allocation in Korea.

Next, a simulation was performed by adding China to the Japan-Korea FTA. Results similar to those in Korea-Japan FTA were obtained. The trade liberalization of the whole Northeast Asian region, however, would increase intraregional trade in a considerable way but at the same time, there is also a possibility that it would deteriorate the regional trade imbalance. This shows the importance of having a well-thought out strategy in achieving regional economic integration.

According to simulation results, the formation of an FTA would substantially improve Korea's and Japan's trade balances, while China would experience a sizeable increase in its trade deficit. This indicates

that simple enhancement of market access by removing tariffs and non-tariff barriers (NTBs) within a short period of time is not a feasible approach for economic integration in Northeast Asia. Therefore, in creating an FTA, measures to mitigate anticipated problems should be devised. In creating the Northeast Asian Free Trade Area, we need to implement a strategy that will gradually lead to regional economic integration while overcoming the aforementioned obstacles. This paper is aimed for suggesting feasible approaches for successful economic integration in the region.

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# Economic Integration in Northeast Asia: Searching for a Feasible Approach

Inkyo Cheong\*

## I. Introduction

Although Korea has achieved economic growth under the multilateral system of the GATT/WTO, response to a widening spread and deepening of regional trading blocs has been lukewarm, largely due to domestic opposition to the opening of market access under regional trading agreements. However, since the financial crisis began, the Korean government has been reevaluating the potential gains to be made by removing trade barriers on a preferential basis, and has decided to pursue the establishment of preferential trading blocs. Not only has a fear of being left out of the recent trend of growing regionalism been a motivating factor for Korea's change, but the outbreak of the Asian financial crisis has also played a large role in Korea's decision to pursue the establishment of FTAs. Korea has opened most of its financial sectors to foreign investors

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\* Any questions and comments may be directed to Inkyo Cheong(Tel: (822) 3460-1208, Fax: (822) 3460-1133, E-mail: ikcheong@kiep.go.kr). The working paper is an extension and elaboration of Cheong(1999b, c). The author wishes to express his appreciation for the constructive comments made by Professor Motoshoghe Itoh (Tokyo University), Professor Kimura Hukunari (Keio University), Mr. Toshihiko Kinoshita (Atkearney), Professor Sijoong Kim (Yeongnam University), and other participants, who attended at seminars held in Seoul and Osaka.



and has implemented unilateral trade liberalization measures. Albeit coerced, this liberalization has been viewed as beneficial by most Koreans, and there is a growing perception that the establishment of FTAs with major trading partners will bring greater welfare gains.

Moreover, Korea has recognized the importance of stable export markets; it is thought that the current account deficit that preceded the financial crisis resulted in worsening international confidence in the Korean economy. When Korea was considering to embrace regionalism as one of its major trade policies, the suggestion for the joint study on the economic feasibility of a Korea–Japan FTA by Japanese Ambassador Okura in Seoul, in September 1998, provided important momentum for Korea’s decision in moving towards regionalism. General rationale for the necessity of economic cooperation can be articulated as follows: 1) as a response to the growing regionalism in the world economy; 2) to stimulate growth in intraregional trade and to advance intraregional economic specialization; 3) the pursuit of common interests and goals; and 4) to attract foreign investment and assure a strategic position.

However, economic integration between these two countries is overshadowed by undeniable regional realities. Firstly, one of the most compelling reasons for integration is the serious intraregional trade imbalance which currently exists. Though Korea records trade deficits with Japan, Japan also experiences deficits with China. Therefore, trade imbalances need to be addressed within a regional framework. Secondly, we can not neglect the growth potential of China’s domestic market. China has shown high growth rates in the 1990s and is expected to continue its growth trends in the future. A World Bank report projects that China’s per capita income will reach that of Portugal in the year 2020, and that its economy will be larger than the US economy by the midpoint of the 21<sup>st</sup> century. Thirdly, from a global perspective, Northeast Asia as an

integrated economic entity would be more influential than an economic bloc comprising just Korea and Japan would be. Fourthly, even after the collapse of the USSR, Northeast Asia is still in grip of cold war anxieties, especially on the Korean Peninsula. This instability leads to the continued maintenance of high levels of defense spending, which thereby impedes economic growth in the region. It is well known that in case of the EU, political stability through economic cooperation was one of main reasons for integration. Therefore, one of the foreseeable dividends of Northeast Asian economic integration would be the increase in regional political stability. Lastly, in any tripartite reality, any relationship between two of the countries, which, by its very nature, automatically excludes the third player, creates a large destabilizing influence on the region. Therefore, any examination of Northeast Asian free trade must be considered in the context of all three countries.

**Table 1. Mutual Complementarity of Northeast Asian Countries**

Region	Advantages	Disadvantages
Northeast China	Favorable agricultural conditions, adequate and varied agricultural products, some textile industrial products, oil, coal, building materials, medicinal herbs, excess labor	Lack of: capital, advanced equipment, technology and management experience. Comparative shortage of some mineral resources, advanced infrastructure
Korea	Capital, advanced technology and equipment ready to move out, leading industrial products	Shortage of energy and industrial resources. Lack of grains for stock raising. Insufficient labor
Japan	Surplus capital, advanced technology, plenty of superior equipment to move out, leading industrial products, management experience	Severe shortage of energy and industrial resources. Insufficient grains for animal husbandry and some agricultural products. Insufficient labor.

Source: UNDP, *UNDP Mission Report*, Oct. 1991.

Discussions on the subject of economic cooperation in Northeast Asia began in earnest in the late 1980s, in the wake of relaxation of political tensions in the region. As has previously been stated, despite the good possibility of economic cooperation in Northeast Asia, economic cooperation in the region is much behind that of other regions such as Europe and North America, because of different economic systems, the unfortunate history in the region, and lack of Japan's leadership. Nevertheless, since these three countries are in close proximity to each other and highly complementary in their economic activities, as well as the fact that they share Chinese culture, there is a strong potential for economic cooperation.

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## II. The Evaluation of the Possibility of Economic Integration through the Expansion of Market Access

### 1. Discussion on Northeast Asia Economic Integration

Economic cooperation among Korea, Japan and China can be pursued through various models. But according to the international criteria, the most desirable form of economic integration would be to create a preferential trading bloc among member countries by eliminating tariff and non-tariff barriers. The main goal of a trading bloc is to promote mutual sustainable economic growth and maximize economic welfare. The validity of the formation of a trading bloc is supported by the traditional theory of free trade. Under this theory, the elimination of trade barriers increases the efficiency in the allocation of the regional resources by market mechanism and thus improves the distorted structure of consumption and production patterns. In this way, it can accelerate economic growth and improve the level of economic welfare by enhancing the competitiveness of those industrial sectors possessing comparative advantage.

Apart from reasons relating to economic validity, there are several other motives for the creation of trading blocs. A trading bloc can minimize risk and uncertainty, and can reduce disadvantage accruing to countries outside regional trading blocs. Through the formation of a trading bloc, member countries can also seek solution of pending trade issues, and strengthen the political and diplomatic ties necessary for strengthening the international community. All this, in the long run, is expected to improve the economic situation of each country and contribute

to continued growth.

Economic cooperation should be pursued through a preferential trading bloc that is compatible with WTO rules and that can gain momentum in the process of implementation. One possibility is to conclude a close economic cooperation organization in the region. An alternative can be an FTA among the three. However, this option has so far not been under serious consideration, due to the socialist regime of China, the attitude of Northeast Asian countries suspicious toward Japan because of the history of the past, and the fear of the aggravation of existing economic gaps. But the need for economic cooperation among East Asian countries has been reemphasized after recent changes in the international economic environment, especially after the East Asian financial crisis. Recently, even Chinese scholars argue that the three countries should establish a Northeast Asia regional economic cooperation (NEAREC).<sup>1)</sup> To overcome the financial crisis, different forms of international economic cooperation can be utilized for stimulating internal demand, but the surest form would be to conclude a comprehensive FTA among the countries with large trade volumes.<sup>2)</sup> After then, the region can go further for the regional cooperation. Since the feasibility study of a Korea–Japan FTA was proposed by Okura, the Japanese ambassador to Korea in September of

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1) See Shi (1999) for detailed discussion on the necessity of the regional cooperation and the concept of NEAREC.

2) Viner (1950) provides several forms for economic cooperation such as an FTA, a customs union, economic union, etc. Among these, an FTA is the most simple form with preferential tariff treatment among member economies. However, his classification does not reflect the changes of the coverage of FTAs. For example, FTAs since 1980s tend to be comprehensive, covering trade regimes, investment, and services, in addition to tariff reductions.

last year, the discussion on the viability of an FTA between Korea and Japan has been vitalized. In addition, a feasibility study on an FTA among Japan, China and Korea was also suggested in the ministerial meeting between Korea and Japan in November last year.

There are two approaches to push forward Northeast Asian economic integration: one is to conclude a Korea–Japan FTA as a first step, with accession by China to follow; a second approach would be to proceed directly to the negotiation of a trilateral FTA.<sup>3)</sup> The first approach seems easier to achieve because of the similarity between Korea's and Japan's economic systems and development process. However, it would cause strong internal opposition from those who fear a worsening of Korea's trade balance and deepening dependency of the Korean economy on that of Japan. The second approach seems to have some merit, since none of the three countries would want to suffer serious trade diversion by being excluded from the FTA. However, a Korea–China–Japan FTA also presents some obstacles such as that posed by the different economic system of China and its present low level of interest in negotiating a regional integration agreement.

The rest of this paper will consider the first approach, which has benefits aside from being more feasible at present. The formation of an FTA requires a long-term deliberate process, as we have to consider not only the economic aspect but also political elements. In particular, it would be difficult to overcome the different political system of China in the short

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3) Because of diversity of economic and political backgrounds among the three countries, economic cooperation among subregions in the region (for example, Seoul, Peking, and Tokyo) can be preferred to institutional integration. However, preferential measures can not be installed in the former case under the international rules. Therefore, subregional approach may not produce substantial economic impacts.

term. In addition, generally, the conclusion of an FTA is more feasible when the number of countries participating is small. Thus we will examine the possibility of a Korea–Japan FTA, which could incorporate China at some later date after evaluating China's will towards trade liberalization and its progress in improving its institutions.

Besides, considering the scale of trade between Korea and Japan and their respective industrial structure, in the long term, it is desirable for both countries to form an FTA. As the degree of competition between the major industrial sectors of Korea and Japan is very high, both countries will competitively lower their product prices in export markets, which could result in serious trade disputes. The strengthening of economic cooperation between the two countries may attenuate this conflict but it would seem difficult for ordinary cooperation without the conclusion of an FTA to have practical effect. Hence we need an alternative to resolve potential conflict and competition and enhance the complementary nature of our two countries' industrial sectors.

Intuitively, a Korea–Japan FTA will enhance the complementary nature of their respective industries through structural adjustment, increase economic benefit as a result of specialization in each economy's competitive sectors, as well as economy of scale achieved through increased production oriented to the expanded regional market. Moreover, modernized institutions and increased transparency will upgrade international credit ratings, thereby attracting foreign investment. In spite of these theoretical advantages, in reality, any Korea–Japan FTA initiative faces large obstacles. Politically the historical antagonism between Korea and Japan is one issue, and the opposition of the United States is another. Economically, Korea fears a deepening degree of dependency on Japan and a trade imbalance which would favor Japan to the detriment of Korea.

Above all, the opposition of neighboring countries including China

would increase as a Korea–Japan FTA moves towards reality. The reaction of China could be interpreted as a negative attitude toward the formation of a regional trading bloc itself, but it could also be the manifestation of China’s position on the creation of an FTA excluding China. In the latter case, we need to assure China from the beginning of the Korea–Japan FTA negotiation that it can join the Korea–Japan FTA if it satisfies certain conditions of accession.

Currently, there are few opportunities for dialogue on a Korea–China–Japan FTA despite its great importance. However, it would be worth examining, considering China’s position and growth potential in the world economy. In 1990, the idea of East Asian Economic Cooperation was proposed by Prime Minister Mahatir of Malaysia but did not gain much support from Korea, Japan and China. However, the changes in the international trade environment after the Asian financial crisis made Korea and Japan reorient their trade policy toward regionalism. In that sense, the conclusion of a Korea–Japan FTA is far more feasible than before.

## **2. Northeast Asia Economic Integration: Empirical Results**

To examine the economic feasibility of Northeast Asian regional economic integration through the expansion of market approach, let us analyze the economic effects of trade liberalization between Korea and Japan, prior to exploring a simulation of economic integration of the three countries. In order to evaluate the economic feasibility of a trading bloc, first of all, it is necessary to predict the overall effect that economic integration would cause on the whole economy. If possible, it is desirable to make a general evaluation of expected economic effects with full consideration of the real economic situation. In judging the validity of the creation of a trading bloc, the most important criterion is to compare the



real income before and after its establishment. However, in order to measure exactly the variations in the real income, we need to construct an economic model that will take into account the effect of the formation of a trading bloc on the macroeconomic situation as well as across all industrial sectors, which requires a considerable number of academic researchers and great effort. This paper concentrates on analyzing the influence of trade liberalization on the Northeast Asian region using the model, data and parameters that enable us to estimate the economic effect of the elimination of tariff barriers.<sup>4)</sup>

As shown in Table 2, if Korea and Japan eliminate tariff barriers on a preferential basis, Korea is projected to lose by USD 2.0 billion annually, and its trade balance with Japan will worsen by USD 7.1 billion. On the contrary, it appears that Japan will realize substantial gains. International trade theory teaches that, in general, a small economy's trade liberalization will correct the distortion of resources allocation and intensify the specification of production and trade. As a result, trade liberalization will bring welfare gains to a small country. However, we observe the opposite result with a Korea–Japan FTA. This exceptional result can be explained by the special conditions of both countries' economies. Korea's major industries overlap with Japan and thus are trade competitors, while Korea has weaker international competitiveness. Moreover, Korea's general tariff rates are higher than Japan's. Therefore, trade liberalization between the two countries will enhance Japanese price competitiveness over Korea's. Korea's dependence on high-tech industrial products from Japan will be higher, while Korea's industry structure will tend towards the development of low value-added industries such as textiles, clothing, shoes, etc, which will deteriorate the overall efficiency of resource allocation in Korea.<sup>5) 6)</sup>

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4) Refer to Cheong (1998) for the model, data and parameters

**Table 2. Economic Effects of Removal of Tariffs between Korea and Japan**

Variables/Economies	Korea	Japan
Welfare(%)	-0.49	0.14
Equiv. Variation(bil. \$)	-1.982	6.057
Nominal Income (%)	0.48	0.27
Con. Price Index(%)	0.60	0.23
% Change of Exports <sup>1)</sup>	2.44	0.44
% Change of Imports <sup>1)</sup>	3.26	1.03
TOT(%)	-0.04	0.28
Overall Trade Balance (bil. \$)	-13.68	
Trade Balance with Japan (bil. \$)	-70.89	

Note: 1) Quantity basis

Source: Cheong (1998), "Economic Effects of the Korea-Japan FTA."

Next, a simulation was performed by adding China to the Japan-Korea FTA. Results similar to those shown in Table 2 were obtained. The trade liberalization of the whole Northeast Asian region, however, would increase intraregional trade in a considerable way but at the same time, there is also a possibility that it would deteriorate the regional trade

- 5) For more accurate evaluation of the impact of the formation of an FTA, the impacts of lowering non-tariff barriers should be considered. However, since it is not easy to collect data for non-tariff barriers, this study ignores the impacts of trade liberalization from lowering non-tariff barriers.
- 6) As two countries are integrated, intra-regional investment may be increased, especially, investment from Japan to Korea, with transferring technology to investment receiving country. Based on this inference, some may argue that Korea's welfare can be improved. Unfortunately, this study does not consider the transfer of technology. Thus, the estimations in this study may underestimate the impacts of economic integration.

imbalance. This shows the importance of having a well-thought out strategy in achieving regional economic integration.

Table 3 shows the expected increases in intraregional exports under a assumption where Korea, China and Japan eliminate tariff barriers. As for the trade creation effect, Korea, Japan and China are expected to increase their intraregional trade by USD 22.7 billion, USD 60.6 billion, and USD 24.0 billion respectively, amounting to USD 107 billion total trade creation effect. Japan, with its strong international competitiveness in the manufacturing sector, would enjoy the highest trade creation effect, which means it will obtain the greatest gains under a trilateral FTA. The expected increase in exports by region is, in Korea's case, USD 332 million, and USD 22.4 billion exported to Japan and China respectively. In China's case, its exports to Korea would increase by USD 4.7 billion and its exports to Japan would increase by USD 19.3 billion. With the highest trade creation effect predicted, Japan is expected to increase its exports to Korea and Japan by USD 8.5 billion and USD 52.1 billion respectively.

**Table 3. Impact of Removal of Tariffs in the Northeast Asian Region on Intraregional Exports**

(Unit: million dollars US)

Origin/Destination	Korea	Japan	China	Total
Korea	-	332.00	22,385.67	22,717.67
Japan	8,506.73	-	52,122.21	60,628.94
China	4,664.93	19,310.44	-	23,975.37
Total intraregional trade increase				107,321.98

\* This is an expected increase in export value (primary and manufacturing sectors) by country.

Based on Table 3, Table 4 presents the variations in trade balance of the three countries when tariffs are eliminated. While the formation of a

trading bloc is expected to increase the intraregional trade balances of Korea and Japan, that of China is likely to worsen by the exact amount of improved trade balance of Korea and Japan. Korea's trade balance with Japan will deteriorate by USD 8.2 billion, while that with China will improve by USD 17.7 billion. Japan will improve its trade balance with Korea and China by USD 8.2 billion and USD 32.8 billion respectively. This, in fact, means that China will experience a deterioration of its trade deficit in the amount of USD 50.5 billion in its trade balance with Korea and Japan.

If we relate the results shown in Table 4 to the relevant trade balances for a recent year, a trilateral FTA is expected to change the pattern of the intraregional trade balance. First of all, in Korea's case its trade deficit, which amounted to USD 9.7 billion in 1997, would be reversed to an equilibrium level. Also, the trade balance patterns of China and Japan would reverse. Japan would experience a trade surplus of USD 41 billion, which would be a reversal of its 1997 position; in 1997 it recorded a trade deficit of US 7.0 billion. In comparison, in 1997, China suffered a trade deficit of USD 3.5 billion with Korea but enjoyed a trade surplus of USD 20 billion with Japan, which resulted in a USD 16 billion trade

**Table 4. Impact of Removal of Tariffs on Trade Balances in Northeast Asia**  
(unit: million dollars US)

	Korea	Japan	China	Expected variation of Intraregional trade balance	Trade balance in 1997 <sup>1)</sup>
Korea		-8,173.73	17,720.74	9,546.01	-9,680
Japan	8,174.73		32,811.77	40,986.47	-6,999
China	-17,720.74	-32,811.77		-50,532.51	16,679

Note: 1) Intraregional trade balance among Korea, Japan and China.

2) Sources: KOTIS

surplus. In the simulation, China would experience a USD 50.5 trade deficit.

To sum up, the formation of an FTA would substantially improve Korea's and Japan's trade balances, while China would experience a sizeable increase in its trade deficit.<sup>7)</sup> This indicates that simple enhancement of market access by removing tariffs and non-tariff barriers (NTBs) within a short period of time is not a feasible approach for economic integration in Northeast Asia. Therefore, in creating an FTA, measures to mitigate anticipated problems should be devised.

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7) Table 4 shows only approximate variations of intraregional trade balance among the three prospective member countries of an FTA. Thus, the exact impact of tariff elimination on the trade balance of the three countries may be revealed through further work on this topic. The formation of an FTA among the three countries will lead to trade creation, but the huge increase in trade among the three might result in reduction of exports to non-member countries. Therefore, the net impact of an FTA can be analyzed through the investigation of its impact on trade balances with non-member countries.

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### III. Searching for Feasible Approaches

NAFTA is purported to have had market access expansion effects. Based on the discussion in Chapter II, however, it appears difficult to create a Northeast Asian FTA which would be similar to the NAFTA. However, it cannot be concluded that establishing an FTA which is mutually beneficial is impossible. Rather, it can be said that the results imply the necessity for designing an FTA such that all member countries can benefit, as opposed to simple trade liberalization. The simulation results have been derived based on the assumption of simple trade liberalization, which assumes complete elimination of tariffs between member economies at the same time. Therefore, the following can be one appropriate approach for the formation of an FTA, which meets the needs of the current situation of the Northeast Asian region.

Basically, an alternative approach could be the introduction of flexible market access. To relieve the problems relating to the extension of market access, we should consider the international competitiveness of the countries in addition to the tariff rate system. The simple average applied tariff rates of Japan, Korea and China for 1998 are 4.9%, 7.9% and 16.9% respectively. Table 5 summarizes tariff structures of the three countries. The overall tariff structures of Korea and Japan have not changed since 1995 and thus, the base years of tariff rates in Table 5 are 1995.<sup>8)</sup> However, since China has liberalized trade substantially since 1995 as a part of China's progress toward membership in the WTO, Table 5 reports China's tariff structures for 1995 as well as 1999. According to the table, 87%–89%

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8) Refer to APEC (1996–1999) Individual Action Plan for marginal modifications of tariff rates after 1995.

Table 5. Tariff Structures of Korea, Japan and China

(Unit: %)

Simple average MFN Tariff Rates	Korea	China		Japan
		1995	1999	
0%	1.5	1.7	3.1	43.9
0.1~10%	86.6	8.5	28.5	45.4
10~20%	4.6	16.5	37.7	8.5
20~30%	2.2	24.3	18.2	1.9
30~40%	3.2	10.6	9.6	0.2
40~50%	0.7	8.5	1.1	0.1
50~60%	1.2	11.3	0.5	0
60~70%	0	4.0	0.5	0
70~80%	0	5.4	0.5	0
80~90%	0	7.6	0.1	0
90~100%	0	0.7	0.5	0
Higher than 100%	0	0.9	0.2	0
Total	100	100	100	100

Note: 1) Tariff structures for Korea, Japan and China(1995) are based on UNCTAD's *Trade Analysis and Information System*, Winter 98/99, whose base year is 1995.

2) Tariff structure for China (1999) was calculated from data from APEC tariff database.

3) The numbers of tariff lines(HS 6) for Korea, Japan and China are 5,016, 4,959 and 4,945('95)- 5,116('99) respectively.

of total tariff lines of Japan and Korea have tariff rates which are lower than 10%, while China charges higher than 10% tariff rates for more than 68% of all tariff lines.

Table 5 displays the importance of trade liberalization scenarios when the three countries try to establish a trading bloc. Trade liberalization with equal rates of reduction will definitely increase exports of Japan to the

other two countries and Korea's exports to China. The impact on trade will be further affected by the relative level of each nation's international competitiveness. According to the IMD(1999) report, Japan's competitiveness ranking is 8<sup>th</sup>, while China and Korea rank as 26<sup>th</sup> and 31<sup>st</sup>, respectively. This can explain the underlying reasons for China's huge deterioration of trade balance under the FTA of the three countries, shown in Table 4.

Of the three countries, Japan has the lowest tariff rates: the country charges no tariff at all for 44% of its tariff lines, and another 45.4% of its tariff rates are lower than 10%. Even though Japan maintains the lowest tariff rate system, especially in industries where Japan is competitive, it maintains high tariff rates on items such as textiles, clothing and shoes, in which both China and Korea have a great deal of interest (Refer to Table 6). For example, Japan charges 27% tariff rates for footwear, which is more than double Korea's tariff rate for the same item.

Considering tariff structures of the three countries and degree of international competitiveness, it would be possible to apply tariff reductions with different lengths of implementation periods, depending on the strength of the industry, or the country. For example, let us consider asymmetric trade liberalization, which would allow Korea and China to have a longer implementation period for tariff reductions. Also, another possible alternative would be to ease the conditions for invoking the safeguard mechanism, in order to reduce injury to weak industries which might occur during the implementation period, and to secure the necessary time for restructuring.

The introduction of institutional devices for maximizing intraregional trade creation between the member countries could also be considered. An example would be making preferential rules of origin (ROO) more favorable to member economies. The study by Cheong (1999a) shows that



Table 6. Examples of Japanese Tariff Peaks on Items of Concern

HS Code	Description	Tariff Rates	
		General	WTO
420292010	Trunks or suit-cases, with outer surface of plastic sheeting	10	8.8
420292090	Trunks or suit-cases, with outer surface of textile materials	10	8.8
420310100	Articles of apparel and clothing accessories, of leather or of composition leather	40	17.5
420310200	Other articles of apparel and clothing	12.5	10.9
500720032	Silk goods	20	10
610610012	Women's or girl's blouses, shirts and shirt-blouses, knitted or crocheted	14	11.6
610620011	Blouses, shirt-blouses, open shirts of man-made fibres	16.8	13.9
610711000	Men's or boys' underpants, briefs of cotton	11.2	9.3
611020029	Jerseys, pullovers, cardigans of cotton	11.6	11.1
611030022	Jerseys, pullovers, cardigans of acryl	11.6	11.1
620213200	Women's or girls' overcoats, carcoats of man-made fibres	11.2	11.6
640299010	Shoes	20	8.8
	Sandals	20	10
640391011	Footwear with outer soles of rubber or composition leather for gymnastics, athletics or similar activities	27	27
640399011	Other footwear with outer soles of rubber or composition leather	27	27
640411010	Tennis shoes, canvas shoes	10	8.8

Source: UNCTAD (1999), *Trade Analysis and Information System*.

preferential ROO will increase intraregional trade substantially.

Cheong investigated the economic effects of an FTA between Japan and Korea with two scenarios, the first with preferential ROO taken into consideration, the second without. Under the assumption of no preferential ROO, Korean imports from Japan are expected to increase by 171.45% in agricultural products and by 39.64% in industrial products. When preferential ROO was considered, Korean imports of agricultural products would rise by 230.81% while imports of industrial products would be reduced to 34.73%. However, the huge increase in the percentage of agricultural products imports would not be significant in overall quantitative terms because the trade volume of agricultural products between Japan and Korea is rather small.<sup>9)</sup>

Preferential ROO would affect Korea's exports to Japan more than

**Table 7. The effects of rules of origin on exports and imports**  
(Unit: % variation in volume)

		Without consideration of ROO		With consideration of ROO	
Korean imports	Industry/Region	Japan	Other Regions	Japan	Other region
	Agricultural goods	171.45	-0.94	230.81	-9.45
	Industrial goods	39.64	-8.98	34.73	-6.77
Japanese Import	Industry/Region	Korea	Other region	Korea	Other region
	Agricultural goods	59.81	-0.13	52.06	1.48
	Industrial goods	13.00	0.67	35.36	-11.79

Source: Cheong (1999a), "The Impact of Preferential Rules of Origin on Trade Deflection in the Regional Trading Blocs".

9) The reason for the larger increase in agricultural imports from Japan where

Korea's imports from Japan. Korean exports of industrial products and agricultural products to Japan would increase by 59.81% and 13% respectively without preferential ROO. However, when ROO are taken into consideration, Korean exports of agricultural products would have a growth rate of 52.06%, while exports of industrial products would expand to 35.36%. Investigating the effects on the trade of industrial products between Korea and Japan, we find that Korean imports of industrial products will decrease by 4.9% while Korean exports to Japan will rise by 22.4%. According to the above estimation, preferential ROO can contribute considerably in creating intraregional trade (at least between Korea and Japan) and therefore, will be a very important issue in negotiating an FTA in the region.

The paper also considers several approaches, such as the linkage of trade liberalization and investment, in order to realize a feasible FTA for the region. In case of the Korea-Japan FTA, one way to compensate Korea's losses would be to arrange for specific Japanese investment commitments into those sectors in Korea which would be most seriously affected by a worsening sectoral trade balance. This can be considered a serious component of the Korea-Japan FTA. The economic growth pattern of Korea follows that of Japan, which has caused Korea to form a special economic relationship with Japan. As a result, Korea has imported intermediate goods and machinery from Japan and assembled export

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preferential ROO was considered, as opposed to where it was not considered is that Korea's tariff rates would decrease through the adoption of a common external tariff (CET) on agricultural products (this is too technical. See the author for detailed explanation). However, Korean tariff rates are currently higher than those of Japan. Thus, Korean importers would change the source of their imports of agricultural products from other regions to Japan.

products. Specifically, Korea's import dependence on machinery from Japan is as high as 31.5–33.1% for 1995 to 1997, and commands 38–41% of Korean imports from Japan for the period from 1995 to 1997. According to Cheong's study (1998), when Korea liberalizes trade with Japan, most of its manufacturing sectors are expected to experience a deterioration in trade balances with Japan. Among these sectors, it was predicted that the machinery sector would experience the highest level of deterioration. Therefore, it can be suggested that the most seriously damaged sectors, such as machinery, can be compensated with special industrial cooperation, such as Japanese commitments for FDI in the sector or through the provision of technology.

Finally, we can take a long-term perspective in propelling economic integration of the Northeast Asian countries. First of all, trade regimes in the respective countries should be harmonized through strengthened cooperation, which can serve as frameworks for economic integration for the medium and short term.<sup>10)</sup> Then, based on unified trade regimes, elimination of tariff and non-tariff barriers through gradual and asymmetric approaches can be followed for the purpose of expanding market access. Following these steps, we can temporarily mitigate the negative side effects which may be incurred through simply expanding market access by securing time in advance for enterprises in the region to acclimatize themselves to the new trade environment.

Some examples of feasible approaches towards cooperation in trade regimes could take the following suggested forms. Firstly, differences in

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10) Strongly preferential modifications of trade regimes without the formation of a trading bloc consistent with the WTO could cause trade disputes with other countries. Thus, for the time being, it is necessary to coordinate trade rules in an MFN-consistent manner.

customs procedures are regarded as a significant trade barrier because it can shrink intraregional trade by delaying customs clearance. Therefore, coordinating the customs procedures of the three countries and resolving problems in customs procedures are a prerequisite to enlarging intraregional trade among the three countries. Cooperation related to customs procedure should be directed towards simplifying the customs clearance process in order to improve promptness of clearance. It should be also coordinated in a way consistent with the International Customs Clearance process. Concerning the rules of origin, we could consider admitting the accumulated value-added of goods where the production process takes place in two or more countries of the region, or extending the exemption period of the ROO certificate on the same products.

In the case of government procurement, it would be possible to apply a lower threshold for government procurement contracts than are presently applied, and to establish mechanisms to share information and data related to a bid or procurement issues. Also, a "Mutual Recognition System" in which a bidder satisfies one country's criteria and then is automatically recognized by the other member countries could be considered. In addition, it is necessary to establish a common bidding qualification procedure among the three countries. The following are other ways in which cooperation among Korea, Japan and China could be furthered in this area: standardization of registration forms for open bids, establishment of trilateral supply networks and after service systems, cooperation to investigate the credit ratings of foreign companies, and facilitating contract formation.

As regards conformity and standards issues, Korea, China and Japan could make a Mutual Recognition Agreement (MRA) and cooperate to establish a technological infrastructure for conformity and standardization. In the service sector, reduction of existing regulations and expansion of

the scope of concessions are appropriate ways of cooperation. Korea, China and Japan show considerable differences in dealing with foreign direct investment. Investment liberalization is a very significant factor in encouraging productive and market-oriented cooperation in the Northeast Asia region and in motivating technology transfer, which is an indispensable element for continuous growth. Thus, reaching an agreement on investment liberalization is an essential prerequisite for economic development in Northeast Asia. An agreement ought to be made in such a way as to prohibit member countries from establishing new obligatory clauses or investment conditions. It should contain as principal elements such provisions as transparency, nondiscrimination, a right of establishment as well as national treatment.

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## IV. Conclusion

In light of their interdependent economic and industrial structures, there exists high potential for economic cooperation among Korea, China and Japan. However, the potential for disputes due to different economic interests is also high. Moreover, this paper shows that trade liberalization can deepen the current imbalance in intraregional trade. A country experiencing trade deficits cannot help being negative to liberalized trade. Therefore, feasible mechanisms to resolve trade conflicts or distrust among the three countries are indispensable if any initiative is to lead to successful conclusion of a trading bloc in the region. Based on the results analyzed so far, the following approach can be conservatively presented.

Firstly, the need for economic cooperation between Northeast Asian countries is increasing due to several factors. These are the deepening of the economic interdependence among the three countries; the need for the prevention of overlapping investment in major regional industries; as a response to the formation of economic blocs in the world economy and the growing number of fields requiring the coordination of common interests such as fishing activity rights and the problem of trans-boundary pollution.

None of the Northeast Asian countries has joined any regional trade agreement so far but Japan and Korea have recently renewed their interest in concluding some kind of regional trade agreement. Also, China has intensified its trade liberalization process and tried to modernize its institutions in order to become a member of the WTO. Thus, the possibility of establishing Northeast Asian economic cooperation is higher than ever before.

However, we still face some obstacles in achieving any kind of

economic integration in the form of a Free Trade Area because of widening intraregional trade imbalance, deterioration of the overall efficiency of resource allocation, the economic differences between members, China's adherence to its socialist regime and also a lingering and bitter history in the region.

Therefore, in creating the Northeast Asian Free Trade Area, we need to implement a strategy that will gradually lead to regional economic integration while overcoming the aforementioned obstacles.

Based on the research, we suggest the following initiatives for the creation of the "Northeast Asian Free Trade Area" (See Table 8).

Due to the special characteristics of the Northeast Asian economy, it seems difficult to realize economic integration centered on the expansion of market access, as in the case of NAFTA, at the start of integration.

**Table 8. A Scenario for Economic Integration in the Northeast Asia Region**

MFN Basis	Preferential Approach(Regionalism)
	<b>Stage IV</b> - Tariff reduction by Korea and China
	<b>Stage III</b> - Tariff reduction by Japan
	<b>Stage II</b> - Easing of Japanese tariff peaks - Reduction of tariffs of concern by all 3 countries
<b>Stage I</b>	- Improvement and harmonization of trade regimes such as customs procedures, rules of origin, etc. - Incentive policy for regional industrial adjustment
2000	2005
	2010
	2015
	2020



The current industrial and trade structure and tariff system of the region will prevent China from adopting the expansion of market access because it will result in a large trade surplus for Japan and a significant trade deficit for China. In the case of Korea–Japan FTA, Korea is expected to suffer a serious trade imbalance with Japan but in the case of Korea–China–Japan FTA, Korea appears to achieve trade balance in the intraregional trade.

Therefore, the Northeast Asian Free Trade Area should be pursued with a long–term perspective and it is essential for the three countries to actively pursue coordination for the successful launch of regional economic integration.

In the short–term, we need to standardize and modernize the differing trade norms of each country, such as customs procedures, anti–dumping rules, the unification of product classification, rules of origin, etc, in order to lay the groundwork for economic integration and we should implement a common incentive policy to accelerate the restructuring and cooperation of regional industries.

In the mid–term, we should facilitate intra–regional trade by reducing tariff rates of items of concern for the three countries as well as for Japanese tariff rates with high customs duties. In the long–term, we should create the “Northeast Asian Free Trade Area” by achieving mutually preferential trade liberalization based on a liberalization scenario designed to solve the regional trade imbalance. In that all three countries are members of APEC and APEC declared the goal of 2010/2020 trade liberalization, it can be pointed out that Japan’s trade liberalization from 2010 may be meaningless. However, APEC’s 2010/2020 goal is just a declaration, not a binding commitment at this point of time. If APEC trade liberalization does not show substantial progress, and economic integration in other regions is further developed, the three economies in

the Northeast region will suffer serious trade diversion from preferential economic integration outside the Northeast Asia. Therefore, the three countries in the region should prepare the long-term strategy for economic integration.

The liberalization scenario consists of the differential liberalization based on the early trade liberalization of Japan and the subsequent liberalization Korea and China at the midpoint of Japan's liberalization process. In addition to tariff reduction, deliberate measures for promoting intraregional trade, such as preferential ROO, will be needed.

In order to carry out this long-term economic integration program successfully, we need to create the Northeast Asian Economic Integration Promoting Commission composed of high level officials and professionals from each country, which will occur when there exists a favorable environment within each of the three countries for integration. The commission will be responsible for preparing long-term plan for integrating the three economies and for overseeing the integration process into a single free market.

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## 國文要約

한·중·일 3국간 경제의 상호의존성 심화, 역내 산업내 중복투자의 해소, 세계경제의 블록화 추세에 대비, 어업권, 국경간 공해 문제 등 역내국간 공동 이해 조정 필요 분야의 증가 등의 이유로 동북아 경제협력체 설립의 필요성은 증가하고 있다. 동북아 국가들이 모두 어떤 지역무역협정에도 가입하지 않고 있는 가운데, 최근 한국과 일본 정부가 지역무역협정의 체결에 적극성을 보이고 있다는 점과, WTO 가입을 위해 중국의 무역자유화가 확대되고, 제도상의 선진화가 이루어지고 있어 동북아 지역의 경제통합체 추진 전망은 과거 어느 때보다도 높아지고 있다. 그러나 역내 경제격차 확대, 무역수지불균형의 고착, 중국의 사회주의 체제 고수, 역사적 잔재 등으로 인해 동북아 경제통합체 실현에 대한 장애요인도 상존하고 있다.

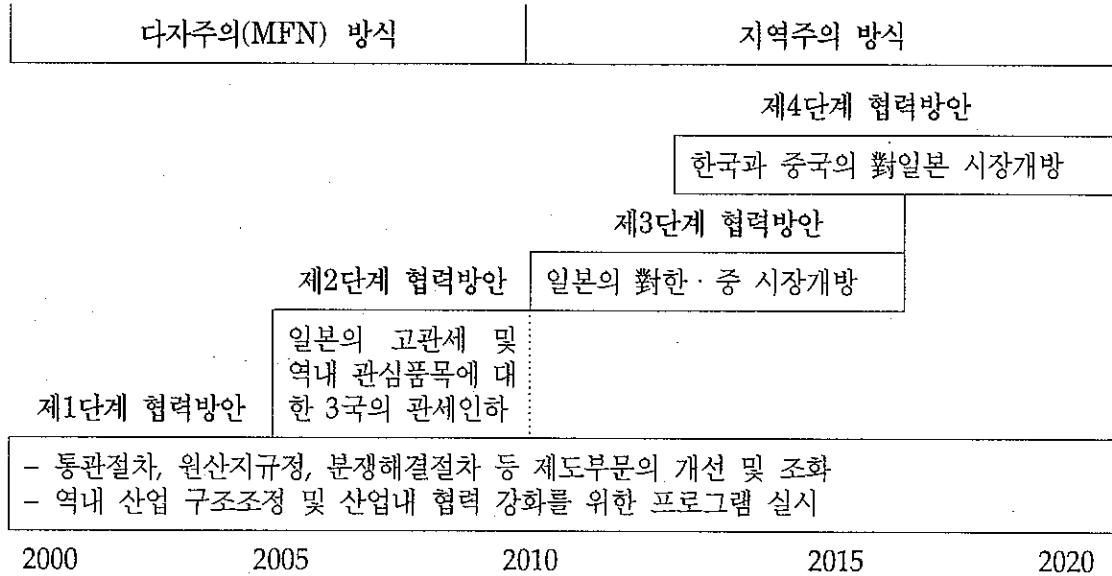
본 연구결과에 따르면, 동북아 지역경제 특성상 NAFTA와 같이 단기적 시장접근 확대 중심의 경제통합은 실현되기 어려울 것으로 보인다. 역내 3국간 산업 및 교역구조, 상이한 관세체계 등의 이유로 단순한 역내 시장접근이 확대될 경우 일본은 제조업에 대한 시장접근 확대 및 막대한 무역수지 개선을 기대할 수 있으나, 한국과 중국은 무역수지 악화외에 산업구조가 역행될 것으로 예상되므로 받아들이기 어려울 것으로 전망된다. 그렇다고 본 연구의 결과가 동북아 경제통합을 시도하지 말아야 함을 의미하지는 않으며, 오히려 전략적인 접근이 필요함을 강조하고 있다.

즉, 동 지역의 경제협력체는 NAFTA와 같은 단기적 시장접근 확대보다는 중장기적으로 무역제도 부문의 개선과 조화를 기하고, 역내 무역불균형 심화를 방지할 수 있는 3국간 공동 정책을 실행함으로써 경제통합의 토대를 마련한 후, 장기적으로 상호호혜적 시장접근 확대를 추구하는 전략의 수립이 필요하다. 본 연구가 제시하는 경제통합 시나리오는 다자간 체제하의 통합작업(2010년까지)과 상호호혜적 지역주의 방식 통합(2010년 이후)으로 크게 나눌 수 있다.

먼저 단기(1단계)적으로는 통관절차, 반덤핑, 원산지규정, 위생·검역 등의 무역규범을 개선·통일하고, 역내 산업의 구조조정 및 산업내협력을 가속화시키기 위한 3국 공동의 인센티브 정책을 고안·실시한다.

중기(2단계)적으로는 일본의 고관세 품목의 관세를 인하하고, 역내 3국간 관심 품목에 대한 관세를 인하함으로써 역내교역을 활성화시키고 역내 국제분업의 효율성을 제고시킨다. 장기((3·4단계)적으로 역내 교역불균형을 해소하도록 고안된

## 동북아 경제통합 시나리오



자유화 시나리오에 따른 상호특혜적 시장접근을 확대함으로써 ‘동북아 경제협력체’를 창설한다. 경제협력체는 다양한 형태로 추구될 수 있으나, 우선 농업, 투자, 서비스 등이 포함된 포괄적인 형태의 자유무역협정이 바람직할 것으로 보인다. 자유화 시나리오는 전반적인 관세율은 낮더라도 산업의 국제경쟁력이 높은 일본이 자유화 초기에 가속적인 무역자유화를 먼저 달성하고, 일본의 자유화 이행중간시기에 한국과 중국이 자유화를 단행하는 것이다.

이러한 장기적 경제통합 프로그램을 차질없이 수행하기 위해서는 각국의 고위급 관리 및 관련분야 전문가들로 구성된 “동북아 경제통합추진위” 및 “동북아 경제통합추진사무국”을 만들어 프로그램의 설정 및 이행을 감독하도록 해야 한다.

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