The Developing Economies, XXXIX-1 (March 2001): 3–48

ASSESSING A JAPAN-KOREA FREE TRADE AGREEMENT

IPPEI YAMAZAWA

I. START OF JOINT STUDY ON A JAPAN-KOREA FREE TRADE AGREEMENT

TRADE between Japan and the Republic of Korea expanded dramatically after bilateral diplomatic relations were normalized in 1965. This happened in large part because the two countries were neighbors. Both lacked natural resources and they competed with each other in the manufacture of industrial goods, but they complemented one another in many ways. Along with growing trade, investments and personnel exchanges also increased. Friction between the two countries arose as a result. Korea's persistent trade deficits with Japan became a core issue, and Japan was called on to improve the situation. To curb imports of Japanese products, Korea introduced its Import Sources Diversification Program. In 1992 the then Prime Minister Kiichi Miyazawa and President Roh Tae Woo agreed on cooperation programs to promote exports of Korean products to Japan and Japanese investment in Korea. The aim of the program was to correct the trade imbalance. On the private-sector level, the Japan-Korea Industrial Technology Co-operation Foundation was established to implement cooperation programs to foster industrial technology among small businesses, develop human resources, and enhance productivity.

These industrial technology cooperative efforts have undoubtedly been effective over the long run. The trade imbalance between Japan and Korea has improved in terms of export-import ratio, and its absolute value has continued to expand. But this has taken place against a backdrop of increasing bilateral friction, and trade and investment between the two countries has shrank relative to that with other countries. Korea's exports to Japan accounted for around 20 per cent of all exports in the late 1980s; the share fell to around 10 per cent in the late 1990s. The share of Korean imports from Japan also fell from 30 per cent to 20 per cent during the same decade. During this time, Korea's trade deficit with Japan continued to increase. However, over the past five years Korea has increased its surplus in its trade in services with Japan which partially offsets its trade deficit. Concerning foreign in-

The views expressed in this paper do not represent the Institute of Developing Economies, the Japan External Trade Organization.

Fig. 1. Korea's Trade and Investment with Japan, 1980–99

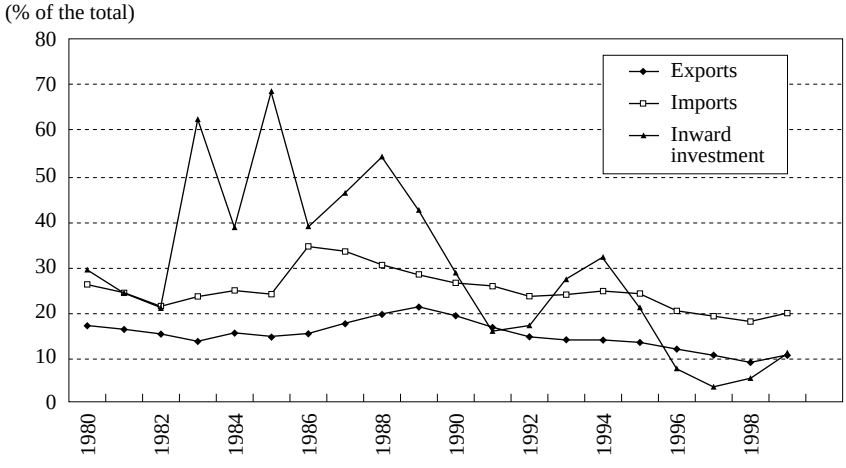
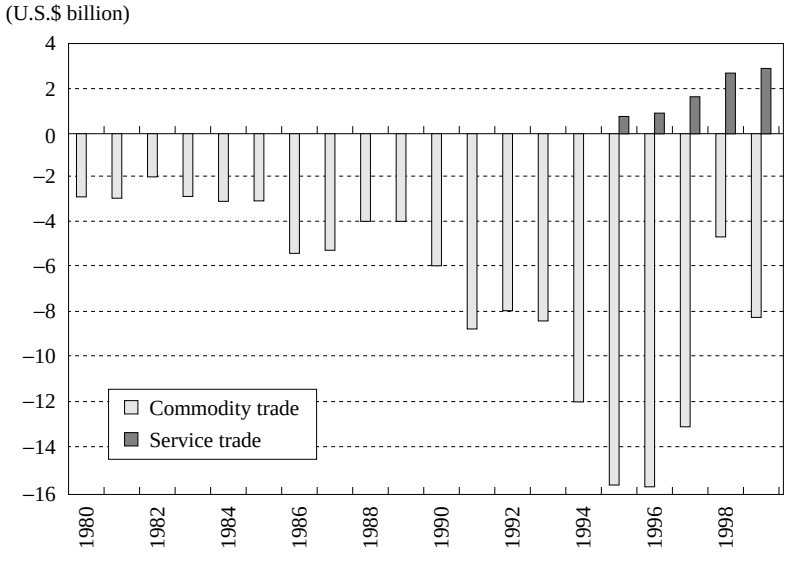


Fig. 2. Korea's Trade Balance with Japan, 1980–99



vestment in Korea, in the mid-1980s, 60 to 70 per cent came from Japan. However, this proportion shrank to 21 per cent in 1995, and to a meager 4 per cent in 1998. This indicates that Japan's importance to Korea has diminished. (Figures 1 and 2.)

The foreign currency crisis that broke out in Southeast Asia in the summer of 1997 spread to Korea, and because of the resulting tight monetary policy, the coun-

try suffered severe economic stagnation. Meanwhile Japan continued to be plagued by its prolonged recession that had begun in 1992, and both countries posted negative growth rates in 1998. As both countries endeavored to restore their economies, momentum grew in Japan and Korea to reexamine their bilateral relationship. During his visit to Japan in October 1998, President Kim Dae Jung struck a resonant chord with many Japanese when he proposed that the problems of this century be resolved within this century, and called for Japan's cooperation in building a partnership in the twenty-first century. Toward the end of the year, a number of ministerial meetings, cabinet-minister conferences, and meeting of the Japan-Korea Public-Private Joint Investment Promotion Council were held in the hope of finding ways to bring the Japan-Korea economic relationship closer. On the agenda proposed during these meetings was the suggestion that a Japan-Korea Free Trade Agreement (FTA) be studied in both countries. During his visit to Korea in March 1999, Japanese Prime Minister Keizo Obuchi proposed the strengthening of bilateral relations through the "Japan-Korea Economic Agenda 21" to go beyond existing economic cooperative frameworks. This program would include investment agreements, taxation treaties, standards certifications, intellectual property rights, cooperation in the next stage of World Trade Organization (WTO) negotiations, and other intergovernmental cooperative activities. It also laid out a path for the further strengthening of bilateral economic relations that would transcend all these inter-government cooperative activities and culminate in a free trade agreement.

These efforts will be the first attempt ever for either Japan or Korea to conclude a bilateral free trade agreement. Thus far both countries have traded with countries all over the world and have supported liberalization on a global scale. Today, however, many trading groups—most notably the European Union (EU) and North American Free Trade Agreement (NAFTA)—have adopted free trade agreements as a means of promoting economic integration with neighboring countries. Free trade agreements are increasingly being regarded as a realistic approach to achieving global liberalization. The free trade agreement between Japan and Korea does not aim merely at removing the tariff and nontariff barriers that still exist between them; they are expected to generate an array of effects, such as promoting investment, facilitating trade, and harmonizing both countries' economic systems and rules. Against the backdrop of increasing globalization, companies in both countries are engaged in drastic structural reforms. They are trying to move away from the conventional corporate group full-set production strategy and instead are working to discard unprofitable departments and boost their competitive edge through mergers and acquisitions that include foreign corporations. A Japan-Korea FTA, based on such matters as investment agreements and standards certifications, would aim at creating a dynamic synergy that encourages companies in both countries to aggressively seek close business cooperation. To survive globalization, both countries must emphasize that they need to increase business profits by further coordi-

nating their economic activities. They must set forth a new vision of bilateral relations in the twenty-first century that encourages the people of both countries to cooperate further. This, in fact, is the objective of the joint study program on a Japan-Korea FTA.

The Institute of Developing Economies, Japan External Trade Organization (IDE-JETRO) and the Korea Institute for International Economic Policy (KIEP) worked in close cooperation and completed separate studies addressed to their own nationals in 2000. However, they jointly proposed establishing a Japan-Korea FTA in their joint communiqué published at the same time. The two institutes jointly organized public seminars, one in Seoul in May and another in Tokyo in September, and presented individual reports to the Korean and Japanese audiences (IDE 2000, KIEP 2000).

Discussion on a Japan-Korea FTA has just started and it needs to be expanded and intensified to become more like the EEC and NAFTA. This paper seeks to provide economists and researchers with a foundation for future discussions on this issue. This paper is based on the Executive Summary of the IDE-JETRO study (IDE 2000) but augmented with statistical tables and references. It has also incorporated arguments for and against an FTA proposal which this author encountered at the joint symposia and on other numerous occasions.[1] It is also addressed to economists and researchers outside Japan and Korea who watch closely the discussion between the two countries.[2]

II. CONDITIONS FOR A FREE TRADE AGREEMENT THAT COMPLIES WITH WTO REQUIREMENTS

The General Agreement on Tariffs and Trade (GATT) opened the way to freer international trade. GATT adhered to the basic principle of nondiscriminatory treatment among its contracting parties (Article 1, GATT), and its work to eliminate trade barriers was applicable to all member nations. However, in Article 24, it also approved of Free Trade Agreements (FTAs) and other regional trade agreements as intermediate solutions toward freer globalized trade. Although such agreements, strictly speaking, violate GATT's nondiscriminatory principle, it was thought that

[1] The author is greatly indebted to the valuable contributions from Yorizumi Watanabe, Yukiko Fukagawa, Kōji Matsumoto, Keiji Ohga, Takehikio Kondō, and Shigeki Morinobu, all participants in the IDE study, as well as from the following IDE staff: Mitsuhiro Kagami, Junko Mizuno, Satoru Okuda, Kazuhiko Oyamada, Yasushi Ueki, and Madoka Nakanishi.

[2] The KIEP report and other Korean studies on a Korea-Japan FTA have focused on the CGE estimation of the static effects of tariff removed on Korean economy (KIE 2000). The IDE report covered a wider area including services trade, price differentials, industrial cooperation, and financial cooperation, even if they need further elaboration. The final decision should be made based on a total analysis.

such trade agreements would in the long run lead to global trade liberalization. On the basis of Article 24, the European Common Market was created which, more recently, has developed into the EU. Since then the NAFTA and many other FTAs have been concluded. GATT's efforts to promote global trade liberalization took the form of a series of multilateral trade negotiations, such as the Kennedy Round, the Tokyo Round, and the Uruguay Round. Although GATT evolved into the WTO in 1994, FTAs have continued to be formed in both industrialized and developing nations. Although the Asia-Pacific Economic Cooperation (APEC) forum, which comprises twenty-one participating countries and regions in the Asia Pacific, has yet to reach the FTA stage, the majority of its members, notably the United States, Canada, Australia, and the Southeast Asian countries, belong to some form of FTA. In contrast, neither Japan nor Korea has concluded an FTA with any other country, and the plan to formulate a Japan-Korea FTA was late in coming. However, since Japan and Korea are two of the world's major trading nations, an FTA formed between two such key players would naturally meet the FTA requirements set forth by the GATT/WTO.

GATT/WTO set forth the following five basic FTA requirements.

(a) When forming an FTA, member countries should not raise trade barriers against nonmember trading partners (Article 24, Clauses 4 and 5 [b]).
(b) If an intermediate treaty is concluded, it should include plans and schedules to establish an FTA within a reasonable period (Article 24, Clause 5 [c]). According to the interpretation of Article 24 agreed upon during the Uruguay Round, ten years has been determined as a "reasonable period."
(c) Countries participating in an FTA should immediately notify GATT/WTO members of this fact (Article 24, Clause 7).
(d) Within an FTA, customs tariffs and other restrictive trade rules and regulations should essentially be abolished for substantially all sectors (Article 24, Clause 8 [b]).
(e) An FTA that includes trade in services should satisfy requirements similar to (a), (b), and (c) above which pertain to the commodity trade (GATT Article 5, Clauses 1, 4, and 5–7).

Thus far, Japan and Korea have maintained the stance of approving FTAs only if they comply with global-scale liberalization. Any FTA formed by these two countries must meet the above conditions so that it agrees with what they have been contending all along. The requirement (d) above, meanwhile, demands that the agreement must "include substantially all sectors." We will have to explore a particular form of FTA which meets this requirement.

It should be noted that this section discusses only the lifting of tariff and nontariff barriers as well as service trade barriers, based on the GATT/WTO provisions. However, as will be stated repeatedly in this report, the FTAs that are being set up among a growing number of countries worldwide do more. The FTA planned be-

tween Japan and Korea, combined with investment promotion and facilitation measures, is designed to harmonize the two markets.

III. THE CURRENT BARRIERS TO JAPAN-KOREA TRADE AND INVESTMENTS

To predict the effects of establishing a free trade agreement between Japan and Korea, we must analyze the current state of bilateral commodity/service trade and investment, and gain an understanding of their basic characteristics. Then we must identify all tariff barriers and various nontariff measures, as well as investment measures to see how much those restrictive measures affect the current state of bilateral trade and investment. Only after adequately grasping the current state of trade and investment and the barriers to these can we proceed to estimate the effects of a free trade agreement.

A. *The Current State of the Commodity Trade*

First we will investigate the current state of Japan-Korea trade using a comprehensive set of data on the commodity trade between the two countries. We will identify its characteristics, categorized by major product groups, using the data of total exports and imports of both countries. Compared with the average shares of "total products," product group data reveals higher shares of some exports and imports in products and services between Japan and Korea, and these may be regarded as highly specialized forms of trade with Japan or with Korea. (annotated a, b, and c in Tables I and II)

Our investigation revealed the following characteristic patterns of Japan-Korea trade.

(1) The two countries follow a common import/export pattern with the world. They both export electrical machinery, general machinery, transport machinery, chemical products, metals, and other manufactured goods. They import fossil fuels and raw materials as well as manufactured goods other than transport machinery.

(2) Fossil fuels and raw materials including agricultural products are imported from third countries, and there is very little traded in these commodities between Japan and Korea.

(3) Electrical machinery, general machinery, chemical products, metals, and other manufactured goods are mutually imported and exported, reflecting an intra-industry division of labor between the two countries. In all these product groups, however, Japan has a huge surplus of exports.

(4) Generally speaking, Korea specializes more in importing and exporting with Japan than Japan does relative to Korea. Among Korea's major exports to Japan are metals, textiles and clothing, and other manufactured goods, and

TABLE I

JAPAN'S EXPORTS AND IMPORTS WITH THE WORLD AND KOREA

(U.S.$ million)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
0. All commodities								
World	441,536	411,209	421,010		335,411	349,268	338,509	
With Korea	31,127	29,347	26,062		17,246	15,953	14,569	
(%)	(7.05)	(7.14)	(6.19)		(5.14)	(4.57)	(4.30)	
1. Grains								
World	202	191	196		5,335	6,909	5,929	
With Korea	2.0	1.8	1.1		46.2	48.2	50.6	
(%)	(1.01)	(0.93)	(0.54)		(0.87)	(0.70)	(0.85)	
2. Fish products								
World	688	690	874		17,343	16,670	15,174	B
With Korea	35	43	50		1,158	1,118	928	b
(%)	(5.09)	(6.29)	(5.68)		(6.68)	(6.70)	(6.11)	
3. Raw materials								
World	1,761	1,801	1,838		32,758	30,221	29,251	B
With Korea	309	365	376		239	215	229	
(%)	(17.55)	(20.29)	(20.45)		(0.73)	(0.71)	(0.78)	
4. Mineral fuels								
World	2,517	1,971	1,972		53,401	60,560	62,339	A
With Korea	872	466	268		850	1,575	1,515	a
(%)	(34.65)	(23.66)	(13.59)		(1.59)	(2.60)	(2.43)	
5. Processed food								
World	1,234	1,100	1,140		28,131	27,182	24,991	B
With Korea	189	131	136		635	667	667	
(%)	(15.28)	(11.91)	(11.89)		(2.26)	(2.45)	(2.67)	
6. Textiles & clothing								
World	8,889	8,580	8,314		24,592	25,640	22,393	B
With Korea	768	690	608		2,496	1,954	1,376	a
(%)	(8.64)	(8.04)	(7.31)		(10.15)	(7.62)	(6.14)	
7. Chemicals								
World	30,093	28,887	29,981	B	24,576	23,448	23,617	B
With Korea	4,162	3,787	3,756	a	966	941	1,095	b
(%)	(13.83)	(13.11)	(12.53)		(3.93)	(4.01)	(4.64)	
8. Metals								
World	28,660	25,516	26,801	B	19,790	17,095	17,837	B
With Korea	3,438	3,161	3,016	a	2,425	1,989	1,985	a
(%)	(12.00)	(12.39)	(11.25)		(12.25)	(11.63)	(11.13)	
9. Nonmetal minerals								
World	5,455	5,486	5,164		6,197	5,978	5,124	
With Korea	711	722	543		254	208	177	
(%)	(13.03)	(13.16)	(10.52)		(4.10)	(3.48)	(3.45)	

TABLE I (Continued)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
10. General machinery								
World	106,461	101,622	100,308	A	27,701	32,666	32,985	B
With Korea	8,419	8,356	6,191	a	965	1,006	936	b
(%)	(7.91)	(8.22)	(6.17)		(3.48)	(3.08)	(2.84)	
11. Electric machinery								
World	113,185	100,010	99,511	A	34,799	39,249	38,493	A
With Korea	8,070	7,859	7,725	a	4,775	3,871	3,394	a
(%)	(7.13)	(7.86)	(7.76)		(13.72)	(9.86)	(8.82)	
12. Transport machinery								
World	89,575	83,973	90,628	A	15,516	15,924	14,692	
With Korea	785	696	530		112	116	110	
(%)	(0.88)	(0.83)	(0.58)		(0.72)	(0.73)	(0.75)	
13. Other manufactures								
World	43,409	51,383	54,283	A	37,887	47,563	45,517	A
With Korea	2,849	3,069	2,862	a	2,018	2,242	2,105	a
(%)	(6.56)	(5.97)	(5.27)		(5.33)	(4.71)	(4.63)	

Source: Japan, Ministry of International Trade and Industry, *Tsūshō hakusho* [*White paper on international trade*], various years.

Notes: 1. Converted in to U.S. dollars at annual average exchange rates. Reclassified according to the GTAP sector groupings.

2. Characteristics: (1) A and B indicate major export or import items of over 10% (A) or 5% (B) of the total trade with the world. (2) a and b indicate major export or import items of over 10% (a) or 5% (b) of the trade with Korea.

among its major imports from Japan are general machinery, electrical machinery, and other manufactured goods, all which are above Korea's average level for these imports. While small in terms of monetary value, exports of fishery products, foods, fossil fuels, and nonmetallic minerals are highly specialized in trade with Japan. Likewise, Japan's exports of chemical products, metals, and machinery and imports of electrical machinery, metals, and textiles and clothing are highly specialized in trade with Korea (standing far above Korea's average levels). Among minor items, Japan's exports of nonmetallic minerals, fossil fuels, and foods are also similarly highly specialized.

(5) While transport machinery constitutes a major export item for both countries, very little of this machinery is traded between the two countries.

It should be noted that, although (3) above indicates the presence of an intra-industry division of labor, individual product groups include intermediate goods and components as well as finished goods, and that finished goods include those used for different purposes as well as both high- and low-end products. Also, much of (4) can be accounted for by trade with neighboring countries, and this may be reinforcing the intra-industry division of labor mentioned above.

TABLE II

KOREA'S EXPORTS AND IMPORTS WITH THE WORLD AND JAPAN

(U.S.$ million)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
0. All commodities								
World	125,058	129,715	136,164		135,119	150,339	144,616	
With Japan	17,049	15,767	14,771		32,606	31,449	27,907	
(%)	(13.63)	(12.15)	(10.85)		(24.13)	(20.92)	(19.30)	
1. Grains								
World	219	273	311		1,983	2,689	1,996	
With Japan	49	48	45		2	2	1	
(%)	(22.13)	(17.45)	(14.43)		(0.11)	(0.07)	(0.07)	
2. Fish products								
World	1,551	1,494	1,362		784	1,009	984	
With Japan	1,143	1,111	920	b, c	40	49	64	
(%)	(73.73)	(74.38)	(67.58)		(5.08)	(4.84)	(6.48)	
3. Raw materials								
World	5,176	5,438	5,303		15,173	14,493	13,446	A
With Japan	609	520	420		497	457	405	
(%)	(11.78)	(9.57)	(7.93)		(3.28)	(3.15)	(3.01)	
4. Mineral fuels								
World	2,423	3,845	5,331		18,918	24,125	27,153	A
With Japan	903	1,718	1,695	a, c	655	557	310	
(%)	(37.26)	(44.67)	(31.80)		(3.46)	(2.31)	(1.14)	
5. Processed food								
World	1,032	1,164	1,196		3,714	4,238	4,197	
With Japan	531	581	604	c	205	140	148	
(%)	(51.46)	(49.90)	(50.52)		(5.51)	(3.30)	(3.53)	
6. Textiles & clothing								
World	17,747	17,135	17,799	A	3,980	4,253	4,052	
With Japan	2,600	2,033	1,448	a	723	662	598	
(%)	(14.65)	(11.86)	(8.14)		(18.17)	(15.56)	(14.76)	
7. Chemicals								
World	9,720	9,897	11,450	B	13,599	13,988	13,901	A
With Japan	1,078	1,027	1,188	b	4,328	4,164	4,132	a
(%)	(11.09)	(10.38)	(10.37)		(31.83)	(29.77)	(29.73)	
8. Metals								
World	12,667	14,184	16,486	A	15,588	18,174	18,310	A
With Japan	2,780	2,401	2,534	a	3,697	3,623	3,421	a
(%)	(21.94)	(16.93)	(15.37)		(23.71)	(19.93)	(18.68)	
9. Nonmetal minerals								
World	728	705	656		1,709	1,812	1,667	
With Japan	260	222	197	c	676	701	565	c
(%)	(35.69)	(31.46)	(30.10)		(39.58)	(38.70)	(33.87)	

TABLE II (Continued)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
10. General machinery								
World	12,384	13,474	14,585	A	23,982	25,960	20,442	A
With Japan	895	786	771	b	9,056	8,942	6,671	a, c
(%)	(7.23)	(5.84)	(5.28)		(37.76)	(34.44)	(32.63)	
11. Electric machinery								
World	38,075	35,085	34,048	A	19,316	21,871	24,322	A
With Japan	4,669	3,906	3,514	a	7,716	7,486	7,438	a
(%)	(12.26)	(11.13)	(10.32)		(39.95)	(34.23)	(30.58)	
12. Transport machinery								
World	16,058	19,990	20,234	A	6,228	7,008	4,342	
With Japan	178	180	262		1,041	981	689	
(%)	(1.11)	(0.90)	(1.29)		(16.72)	(13.99)	(15.87)	
13. Other manufactures								
World	7,278	7,031	7,403	B	10,145	10,720	9,804	B
With Japan	1,355	1,233	1,173	b	3,970	3,687	3,464	a, c
(%)	(18.62)	(17.54)	(15.84)		(39.14)	(34.39)	(35.33)	

Source: Korea Customs Research Institute, *Statistical Yearbook of Foreign Trade*, various years.

Notes: 1. Reclassified according to the GTAP sector groupings.
2. Caracteristics: (1) A, B indicate major export or import items of over 10% (A) or 5% (B) of the total trade with the world. (2) a and b indicate major export or import items of over 10% (a) or 5% (b) of the trade with Japan. (3) c indicates major items of high Japanese specialization.

Characteristics (1) and (2) can easily be explained by the two countries' reliance on resources and their comparative advantages. However, (3) through (5) need to be studied further to identify their causes. To what degree can the causes be explained by each country's trade barriers? Korea's decreased dependence on Japanese export, import, and investment over the past decade, as indicated in Figure 1, needs to be analyzed in detail.

Looking at the trade barriers that exist between Japan and Korea, Japan enforces quantity restrictions on some imports of fishery products. However, it imposes only tariffs on manufactured goods, most of which are low rates of between 0 to 5 per cent. These are all "most favored nation" (MFN) tariffs applied in a nondiscriminatory manner to all import sources, which means that Korean products are not discriminated against. Moreover, the generalized system of preferences (GSP) has been applied to Korea since 1973, and all products made in Korea have entered Japan either duty free or at lower tariffs than those applied to imports from developed nations.

Nevertheless, in its "Concrete Action Plan to Correct the Imbalance in Japan-

Korea Trade" announced in June 1992, Korea cited sixteen high-tariff items and demanded that they be lowered. These included the following sensitive items: leather clothing (17.5 per cent) and sports shoes with leather backs (27 per cent), ladies' blouses and shirts (11.6 per cent and 13.9 per cent), sweaters and cardigans (11.6 per cent), travel bags (8.8 per cent) and high-density polypropylene (22 per cent ad valorem equivalent) (all tariffs effective as of 1999). In 1998 Korea cited the following as factors that inhibited exports to Japan: quantity restrictions on imports of fishery products and silk fabrics; standards on additives to processed foods; regulations on components of cosmetic products; and automotive certification/permit systems.

The import restrictions and high tariffs that still remain for certain items may have inhibited Korean exports of these items to Japan. They are some of Korea's items specialized for export to Japan mentioned in (4) above, which explains the country's strong interest in them. These, however, are in no way connected with Japan's trade surplus in exports of machinery, chemical products, and metals mentioned in (3), which are a result of Japan's strong competitive edge, and which is evident in Japan's exports to other countries as well. But Korea is becoming increasingly competitive in these sectors, and its exports to the world and to Japan are on a steady rise. This is what the intra-industry division of labor is actually about. However, the mutual export and import of differentiated products has not taken place as much between Japan and Korea as among European countries. The general pattern goes like this: Korea exports general-purpose products, technically standardized products, and low-priced items, while Japan exports special processed items, components, and intermediate products that cannot be procured within Korea, and high-priced famous brand items.

Meanwhile, Korea imposes higher tariffs than those imposed by Japan. High tariffs are placed on manufactured products, such as 17.6 per cent for some chemical products, and 15.4 per cent for glass valves and tubes. An 8 per cent tariff rate is imposed on many of Korea's major imports from Japan, such as steel plates, storage batteries, thermal electron tubes, liquid crystal devices, switchboards, printing circuits, camera components, automotive parts, and caprolactam.

The insufficient development of intra-industry trade between Japan and Korea has resulted in the decreased dependence depicted in Figure 1 and the continued trade imbalance indicated in Figure 2, which cannot be attributed directly to the trade impediments examined above.[3]

B. *The Effects of Abolishing the Import Sources Diversification Program*

In 1978 Korea introduced the Import Sources Diversification Program. Together with the country of origin certification system and country of origin management

[3] This point is seldom discussed in Korean studies on a Japan-Korea FTA. Satoru Okuda's recent study (Okuda 2000) of Japan-Korea trade focuses on this aspect and suggests a way out.

regulation imposed beginning 1991, the country has essentially curbed imports of Japanese products in a rigorous manner. This primarily relates to product groups featured in (3) which have active intra-industry division of labor setups. In response to demands from Japan to lift these restrictive systems and criticism from third countries, Korea abolished them in stages throughout the 1990s. All the systems were completely eliminated as of June 30, 1999. Imports from Japan of some items for which restrictions had been lifted at the end of 1998 rose sharply during the first half of 1999, which reportedly caused a public outcry in Korea and cast doubt on the political advisability of any further liberalization of trade with Japan. At this time Korea was experiencing a surge in demand as result of the country's recovery from the financial crisis. A more in-depth analysis will be provided in the next section.

Restrictions on imports from Japan imposed by the import diversification program were lifted on thirty-two items at the end of 1998, and on another sixteen items on June 30, 1999. Thus, all restrictions now have been lifted. The fact that imports from Japan soared immediately thereafter was used politically to warn of the effects of continued liberalization that would result from the proposed Japan-Korea FTA. It is now being used as an argument against its formation. But is this argument correct? Let us investigate this in an unbiased way.

The Japanese government has refrained from resorting to bringing the Import Sources Diversification Program before the WTO. Instead, it has conducted repeated bilateral negotiations to abolish the system. Meanwhile, the Kim Young Sam administration informed the Japanese government in 1994 of its policy to gradually reduce targeted items every six months, and completely abolish all such items by the end of 1999. The purpose was to attain OECD membership which was set forth as the administration's policy goal. At the end of 1997, as Korea was being bailed out by the IMF, the administration promised to abolish the system six months earlier than planned. The system was virtually abolished on June 30, 1999.

According to information provided by the Korea International Trade Association, the thirty-two items removed from restrictions at the end of 1998 accounted for 23.8 per cent of all products imported from Japan in 1997, and 23.4 per cent in 1998. However, their share rose to 32.4 per cent between January and July of 1999. Imports of single-lens reflex cameras and ceramic products increased particularly sharply. Total imports of the thirty-two items from Japan rose by 92.5 per cent in the January–July 1999 period when compared with the same period in 1998. These data have been used as to show that the abolition of the system of categorizing countries from which Korea imported goods resulted in even more Japanese exports to Korea. Meanwhile, the country registered a 26.4 per cent drop in imports overall in 1999 when compared with the January–July 1997 period, which was before the country was caught up in the Asian foreign currency crisis. Imports of the thirty-two items from Japan also decreased by 16.6 per cent; and while the rate of reduction was small compared with the total drop in imports from Japan, it nev-

ertheless was lower than the January–July 1997 level when imports were being regulated.

The reason for this, in addition to macroeconomic factors, may be that (1) Korea has began producing similar items domestically and is becoming increasingly competitive; (2) Korea has less need to import from Japan due to changes in its industrial structure; (3) Korea imports from other countries products that are more competitive than those made in Japan; and (4) Korea imports products which Japanese companies produced in other countries and regions.

Korea's lifting of the system of categorizing countries from which it imports goods has overlapped with the process of recovery from Asia's financial crisis, so it is incorrect to make judgments simply by looking at increases in imports of regulated items. Imports of specified items from Japan surged after the import diversification system was lifted. This occurred because the market for highly competitive Japanese products (which already had substantial import demand in Korea but which had been artificially closed by powerful regulatory measures that restricted volume was liberalized with the lifting of regulations. This is a unique case, and cannot be compared with the effects of ordinary liberalization measures such as the phased lifting of tariffs.[4]

Korea's import diversification system violated GATT/WTO nondiscriminatory principles as it discriminated against Japan. The lifting of this system should be regarded merely as the nondiscriminatory principle finally being applied to Japan. In view of past Japan-Korea relations, however, the fact that both countries have finally become "normal trade partners" is of great significance. In the development of bilateral economic relations, it was an important milestone and also a starting point. It is expected to bring about new business opportunities for both countries. It is also worth noting that positive effects for both countries have already become evident, such as a series of announcements that Japanese and Korean companies have agreed to cooperate in the area of mobile phones which was one of the regulated items under the previous system.[5]

C. *The Current State of the Trade in Services*

The trade in services is a sector rarely covered by analyses of the FTA, since its business activities cannot be readily translated into comprehensive statistical figures, and it is difficult to ascertain whether trade restrictions are being enforced or not. The Japan-Korea service trade should not be overlooked, however, because it generates relatively large amounts of money, and is subject to trade restrictions that are far more rigorous than those imposed on the commodity trade. Free trade area requirements set forth under GATT/WTO mention the abolition of trade barriers on

[4] Contrary to the Korean worry, import of these items did not increase significantly in the latter half of 1999 and the first half of 2000.

[5] No Korean study paid attention to the services trade despite the possible gain in Korea's balance of payments with Japan.

services. This is why we have tried to analyze the service trade despite the insufficient materials available.

What is the current status of the service trade in Japan and Korea? The patterns of the overall trade in services differ in the two countries. Japan has a very large commodity trade surplus, and an equally large service trade deficit (there are about half as many exports as imports). In comparison, Korea had, until 1997, small trade deficits in both commodities and services. In 1998 both went into surplus, although this was an unusual year in which both imports and exports shrank due to the financial crisis.

The service trade ratio measures the portion accounted for by services in the total trade of commodities and services. In Japan the service trade ratio for exports is 13–14 per cent, while that for imports is 28–30 per cent. This large difference reflects the relatively small volume of commodity imports and the large volume of service imports. It indicates that Japan is not as competitive in services as it is in the commodities. Meanwhile, Korea has a well-balanced service trade ratios: 15 per cent for exports and 16–17 per cent for imports. Looking at the total trade in services, Japan remains in deficit and Korea in surplus. Moreover, Japan exports 4–5 per cent of its services to Korea and imports about 3 per cent from Korea. This is in sharp contrast to Korea which exports 22 per cent of its services to Japan and imports 13–14 per cent from Japan. Both figures are about four times higher than those for Japan (Tables III and IV).

Looking at the trade data by major service categories, we see a marked trend in mutual exports and imports. In the case of Japan, services related to transport, travel, other profit-making businesses, and patent royalties are exported and imported, and this also applies to trade with Korea. Meanwhile, almost no construction services are exported to Korea, but a large percentage of telecommunications and financial services are. Likewise with Korea, services related to transport, travel, and other profit-making businesses are actively exported and imported. Trade between Japan and Korea in these sectors is also extremely active. Very high shares of travel services are exported to Japan, while a large share of patent royalties is imported from Japan. Apart from patent royalties and financial services, the geographical proximity of the two nations is a definite advantage when providing services related to transport, travel, other profit-making businesses, as well as telecommunications and other services. Therefore, the fact that Japan and Korea are neighbors appears to stimulate mutual exports and imports. Korea was by far the most popular overseas destination for Japanese travelers in 1998, at 1.95 million people, while Koreans comprised the largest number of foreign travelers to Japan until 1997 when 1.01 million people visited. However, the number of Korean travelers dropped to 720,000 in 1998, and were overtaken by Taiwanese at 840,000 people. It should be noted that trade in services related to transport, travel, other profit-making businesses, and construction is in surplus for Korea, while trade in patent royalties and

TABLE III

JAPAN'S EXPORTS AND IMPORTS OF SERVICES WITH THE WORLD AND KOREA

(U.S.$ million)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
Total								
World	61,573	73,657	83,884		115,471	141,449	149,307	
With Korea	3,674	4,338	3,912		4,400	5,373	5,943	
(%)	(5.97)	(5.89)	(4.66)		(3.81)	(3.80)	(3.98)	
Transportation								
World	21,229	23,496	26,400	A	33,790	36,564	37,602	A
With Korea	1,507	1,293	1,519	a	1,435	1,911	1,926	a
(%)	(7.10)	(5.50)	(5.75)		(4.25)	(5.23)	(5.12)	
Travel								
World	3,048	4,448	5,240	B	34,644	40,328	39,891	A
With Korea	604	645	656	a	1,898	1,869	2,364	a
(%)	(19.82)	(14.50)	(12.52)		(5.48)	(4.63)	(5.93)	
Communications								
World	474	1,499	1,650		799	2,033	2,077	
With Korea	19	124	109		29	123	108	
(%)	(4.01)	(8.27)	(6.61)		(3.63)	(6.05)	(5.20)	
Construction								
World	6,200	6,450	9,500	A	3,019	5,239	6,601	
With Korea	22	34	32		156	223	121	
(%)	(0.35)	(0.53)	(0.34)		(0.17)	(4.26)	(1.83)	
Insurance								
World	278	531	420		2,347	2,084	2,461	
With Korea	12	29	26		31	24	26	
(%)	(4.32)	(5.46)	(6.19)		(1.32)	(1.15)	(1.06)	
Finance								
World	294	3,086	2,237		440	3,241	3,237	
With Korea	25	490	145		0	12	9	
(%)	(8.50)	(15.88)	(6.48)		(0)	(0.37)	(0.28)	
Computers and information								
World	—	1,330	1,713		—	2,658	4,221	
With Korea	—	37	48		—	31	30	
(%)	—	(2.78)	(2.80)		—	(1.17)	(0.71)	
Royalties and license fees								
World	5,668	7,257	8,839	A	8,881	10,684	11,634	B
With Korea	571	672	518	a	5	11	8	
(%)	(10.07)	(9.26)	(5.86)		(0.06)	(0.10)	(0.07)	
Other business								
World	23,021	23,910	26,189	A	30,025	35,901	38,608	A
With Korea	910	996	792	a	832	1,127	1,315	a
(%)	(3.95)	(4.17)	(3.02)		(2.77)	(3.14)	(3.41)	

TABLE III (Continued)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
Personal, cultural and recreational services								
World	130	194	284		517	1,316	1,316	
With Korea	0	7	11		0	17	11	
(%)	(0)	(3.61)	(3.87)		(0)	(1.29)	(0.84)	
Government services								
World	1,231	1,456	1,413		1,009	1,400	1,660	
With Korea	3	62	57	b	14	23	26	
(%)	(0.24)	(4.26)	(4.03)		(1.39)	(1.64)	(1.57)	

Source: Bank of Japan, *Monthley Report of Balance of Payments*, April 1999.
Note: Characteristics: same as Table I.

financial services is in surplus for Japan.

Both Japan and Korea list barriers to services in the government schedule of specific commitments to the General Agreement on Trade in Services (GATS). The schedule features four modes: (1) cross-border transactions, (2) overseas consumption, (3) commercial bases, and (4) the free movement of labor, and two aspects: market access and native treatment, and it can list "No restrictions imposed," "Specific restrictions imposed," or "No undertakings given (no intention of imposing restrictions)." There is also "Not written" listing which is treated similarly to "No undertakings given." The four modes do not carry the same importance as measures to protect domestic service industries. Mode (3) is associated with direct investment and is included in "capital transactions," while mode (4) is included in "income transactions."

Similar patterns can be seen for Japan and Korea in the listing of the government schedule of specific commitments. First, under Mode (4), both countries impose rigorous restrictions on the free movement of labor in all sectors and business categories, except for activities conducted for a set period of time by managers of foreign corporations as well as specialists/professional workers who cannot be found domestically. This corresponds to entry and employment restrictions on overseas workers, but may not apply to the protection of domestic service industries. Moreover, although GATS Article 5 demands that all four modes of the service trade be liberalized, most treaty powers, including Japan and Korea, restrict in principle the free movement of labor. Thus, its complete liberalization through the formation of an FTA would no doubt be a task of major importance. For the other three modes, we find the following four patterns (Table V):

(A) No restrictions are imposed on cross-border transactions, overseas consumption, or commercial bases.

TABLE IV

KOREA'S EXPORTS AND IMPORTS OF SERVICES WITH THE WORLD AND JAPAN

(U.S.$ million)

Groups	Exports			Characteristics	Imports			Characteristics
	1995	1996	1997		1995	1996	1997	
Total								
World	22,827	23,412	26,301		25,806	29,592	29,502	
With Japan	4,400	5,373	5,943		3,674	4,338	3,912	
(%)	(19.28)	(22.95)	(22.60)		(14.24)	(14.66)	(13.26)	
Transportation								
World	9,272	8,765	11,005	A	9,645	10,230	10,310	A
With Japan	1,435	1,911	1,926	a	1,507	1,293	1,519	a
(%)	(15.48)	(21.80)	(17.50)		(15.62)	(12.64)	(14.73)	
Travel								
World	5,150	4,880	4,731	A	6,341	7,482	6,988	A
With Japan	1,898	1,869	2,364	a, c	604	645	656	a
(%)	(36.85)	(38.30)	(49.97)		(9.53)	(8.62)	(9.39)	
Communications								
World	561	643	652		642	706	865	
With Japan	29	123	108		19	124	109	
(%)	(5.17)	(19.13)	(16.57)		(2.96)	(17.57)	(12.60)	
Insurance								
World	n.a.	95	n.a.		255	203	162	
With Japan	31	24	26		12	29	26	
(%)		(25.24)			(4.71)	(14.26)	(16.03)	
Royalties and license fees								
World	299	185	252		2,385	2,431	2,414	B
With Japan	5	11	8		571	672	518	a
(%)	(1.67)	(5.95)	(3.17)		(23.94)	(27.65)	(21.46)	
Other business								
World	6,761	7,952	8,633	A	5,807	7,806	8,022	A
With Japan	832	1,127	1,315	a	910	996	792	a
(%)	(12.31)	(14.17)	(15.23)		(15.67)	(12.76)	(9.87)	
Government services								
World	694	764	862		412	435	465	
With Japan	14	23	26		3	62	57	
(%)	(2.02)	(3.01)	(3.02)		(0.73)	(14.26)	(12.27)	
Other services								
World	110	129	168		321	300	277	
With Japan	156	283	171		47	568	236	b
(%)	(3.92)	(2.27)	(1.11)		(0.71)	(5.14)	(1.72)	

Source: Bank of Korea, *Monthly Bulletin*, July 1999.

Notes: 1. Other services includes construction, finance, information, and personal, cultural, and recreational services.

2. Characteristics: same as Table II.

TABLE V

RESTRICTIONS ON SERVICE TRADES IN JAPAN AND KOREA

Groups	Services	
	Japan	Korea
(A)	Tourism, Pipeline transport, Distribution, Value-added telecommunications, Computer/Distributional/Recreational/Audio-visual/Rental-leasing services, R & D and Other business services	Tourism, Value-added telecommunications, Auxiliary transport, Computer/Audio-visual services
(B)	Construction, Internal waterways transport, Rail transport, Other auxiliary transport, Courier/Environmental/Real estate services	Distribution, Rental-leasing services, R & D and other business services
(C)	Air transport, Roads, Basic telecommunications, Insurance, Banking, Professional services, Health and social services	Construction, Marine transport, Insurance, Banking, Courier/Environmental services
(D)	Marine transport, Space transport, Education, Postal services	Internal waterways transport, Air transport, Rail transport, Roads, Space transport, Pipeline transport, Basic telecommunication, Education, Postal/Professional/Real estate/Recreational/Health and social services

Sources: GATS Specific Commitments of Japan (1997) and Korea (1994).
Notes: 1. Category: (A). Modes 1–3 nonrestricted; (B). Modes 1–2 restricted; (C). Mode 3 restricted; (D). Modes 1–3 restricted. Not recorded.
2. Mode 4 is restricted for all sectors.

(B) No restrictions are imposed on commercial bases, but cross-border transactions and overseas consumption are restricted.
(C) No restrictions are imposed on cross-border transactions or overseas consumption, but commercial bases are restricted.
(D) All three modes are restricted or no undertakings given (no intention of imposing restrictions).

It can be seen clearly that trade barriers increase in order from (A) to (D). Restrictions imposed on commercial bases as seen in (C) are merely the result of conventional foreign capital policies taken thus far which were reflected in the government schedule of specific commitments to GATS.

Korea has more (D) s than (A) s, with a heavier concentration toward the bottom, indicating that the country regulates the service trade quite rigorously. In terms of content, similar restrictions are seen in both countries. Tourism (travel), value-added electronic telecommunications, computers, and audio-visual equipment fall under (A), showing that these sectors are liberalized, while banks and insurance fall under (C), and education, postal services, and space transport fall under (D), indicating

that they are rigorously restricted. In all other sectors, Korea imposes even more rigorous restrictions than Japan. Sectors that fall under (B) in Korea are all categorized under (A) in Japan, while all those that fall under (C) in Korea, with the exception of banks and insurance, are categorized as (B) in Japan. Sectors that fall under (C) in Japan are all (D) in Korea, except for banks and insurance. The exceptions are marine transport and marine aid which have fewer restrictions in Korea than Japan (a mode higher in each case). Generally speaking, all countries take a cautious attitude on the status of commitment to GATS, and the impression is that rigorous restrictions—more than are necessary—tend to be imposed. In the WTO's new negotiation rounds, liberalization of services is being put forth as one of the major items on the agenda and these rigorous service trade restrictions will be steadily removed.

But how do the patterns of the Japan-Korea service trade that had been identified above relate to these barriers? Travel is liberalized in both countries, and the fact that more than twice as many Japanese people travel to Korea than vice versa is not because of either Japan's or Korea's restrictions on travel services, but because (1) Japan's average disposable income is higher than that in Korea, and thus a larger percentage of Japanese can afford to travel overseas; (2) because Japan's population is three times that of Korea's; and (3) because of economic conditions, namely, that Japan imposes substantially higher service prices than Korea. Other profit-making businesses are only minimally restricted. Both countries impose strict restrictions on telecommunications, banks, insurance, aerial transport, and marine transport. All these sectors are categorized under (C) and (D) and include commercial base restrictions. If liberalization is further stepped up, mutual export/import of the first three sectors in particular is expected to expand sharply. There are signs that Korea's rigorous restrictions on entertainment services will be lifted. As was the case with the commodity trade, under the Japan-Korea FTA framework, not only the abolition of restrictive measures but also the cross-border expansion of business perspectives and the rise in Korea's income levels will stimulate the mutual import/export of service trade.

D. *The Current Status of Japan-Korea Investment*

Until the end of 1998, Japan invested a total of U.S.$5.024 billion in Korea (execution basis), accounting for 23.4 per cent of total investment flowing into Korea. Meanwhile, the United States invested U.S.$5.320 billion, or 24.7 per cent, and Europe, U.S.$8.094 billion, or 37.6 per cent. As can be seen, Japan, along with the United States and Europe, is a leading investor in Korea. What sets Japan apart is its relatively large number of rather small investments. By sector, manufacturing and service industries each account for roughly 50 per cent of the total. Chemicals, electrical machinery, transportation machinery, and general machinery top the list of manufacturing sectors in which investment was made, while hotels account for

roughly half of all service-related investment, followed by finance.

While the growth of Japanese investment stagnated between 1996 and 1997, investment by the United States and Europe continued to grow. The reason for this was that, in addition to Korea proceeding with deregulation in preparation for joining the OECD and attracting the interest of U.S. and European corporations, there were a number of factors favorable to outside investors, including the depreciation of the won caused by the Asian currency crisis and the further financial deregulation that ensued. And geographically, while the United States and Europe regard Korea as one of their Asian manufacturing bases, Japan, being geographically close to Korea, had no choice but to regard its Korean manufacturing bases as complementing its own domestic manufacturing bases. This, incidentally, is one of the reasons why Japan has invested very little in Korea recently as compared with the United States and Europe (besides the recent business recession in Japan and the fact that most of Japan's investments in Korea had already been made during the initial stages of Japan's globalization activities).

Korean corporations, meanwhile, invested a total of U.S.$540 million in Japan between 1980 and September 1999. They had invested U.S.$100 million annually even prior to the Asian financial crisis. Roughly half of this investment was made in the trading sector, and only 20 per cent in the manufacturing sector.

Under the Kim Young Sam administration, the Korean government lifted foreign capital regulations in stages. To overcome the foreign currency liquidity crisis, from the end of 1997 the government expedited the easing of various regulations that were regarded as impediments to indirect and direct investments. Business category-specific direct investment regulations are currently imposed, but in an extremely limited manner. As of April 1999, seven sectors had not yet been liberalized (including fisheries and broadcasting), while sixteen sectors had been partially liberalized (including the newspaper publishing and telecommunications businesses). The process of applying for direct investment was greatly simplified during Kim Young Sam's regime. Normal investing can now be done at the counters of foreign exchange banks (including Korean branch offices of foreign banks). Regulations imposed at government office counters—once pointed out as an investment barrier—have been lifted. Restrictions on land ownership by foreign corporations have also been progressively eased.

Although not a barrier that directly affects investment, regulations on Japanese culture constitute an important problem. These regulations virtually prohibit the screening and broadcasting of Japanese motion pictures, performance of songs, and import of videos, CDs, LDs, and other visual and sound media that feature such musical performances. Regulations imposed on Japanese culture not only directly hamper product trade such as movies, music CDs, and other items, and the service trade such as recycling; they also have adverse effects on investment and other Japan-Korea transactions as a whole, as well as tarnishing the image that Japanese

businessmen have of Korea. During his visit to Japan in 1998, President Kim Dae Jung announced his plan to abolish these regulations in stages. Since then, two sets of measures to partially eliminate them have been implemented. While these efforts should be praised, the government is being called on to lift all regulations promptly to further promote Japanese investments in Korea.

E. *Price Differentials between Japan and Korea*

When trade restriction measures are enforced, a difference arises between domestic and international prices. If a major difference existed between restrictive measures in Japan and Korea, or if restrictions are mutually imposed on each other's products, a price difference is created between the two countries, even for similar products. Therefore, by comparing prices, we can quantitatively determine the effects on trade of tariff as well as nontariff restrictions. For this purpose we conducted a survey in which we compared commodity prices in Japan and Korea. The survey was carried out in Seoul and Tokyo between August and October 1999 targeting thirty-five items. We studied retail prices, primarily of public utilities, services and commercial products, and after making adjustments for the yen/won exchange rates and volume differences, we calculated the percentage difference between Korean and Japanese prices (Table VI)

Many items showed a difference in price of 1 or higher, with most items costing more in Japan than in Korea (twenty-eight out of thirty-five items). Items that cost less in Japan were tap water, photocopy paper, business cards, bath towels, videotapes, cellular phones, and gasoline. Utility rates such as public transportation, telephones, gas, and postage cost two to four times as much in Japan as in Korea, while service rates such as haircuts and shoeshines cost two to three times as much. Meanwhile, daily necessities such as rice, milk, beer, tissue paper, men's shirts, electric rice cookers, televisions, and air conditioning, and automobiles and cement cost up to two times as much in Japan as in Korea. Electric bulbs, pencils, clothing, microwave ovens, and refrigerators cost two to four times as much. Japanese workers are paid roughly 2.3 times more than their Korean counterparts, and if that is made the criterion, daily necessities should cost around 130 per cent more in Japan. Utility rates and service charges are strongly affected by this difference in labor costs and deliberately keeping them at a low level is part of government policy. Items that have two to four-fold price differentials appear to reflect differences in quality. They seem to contain a substantial element of "equilibrating price differences" which remains even after market mechanisms have run their course.

Regarding intermediate goods and industrial services, since 1995 the Ministry of International Trade and Industry (MITI)[6] of Japan has been conducting an annual survey on the disparity between domestic and overseas prices concerning the input

[6] It has changed to the Ministry of Economy, International Trade and Industry (METI) since January 2001.

TABLE VI

PRICE DIFFERENTIALS BETWEEN JAPAN AND KOREA

	Korea (Won)	Japan (Yen)	Price Differential (Japan/Korea)
Public utility charges			
1. Taxi (base fare)	3,000 (3 km)	660 (2 km)	3.46
2. Subway (one section)	500	160	3.36
3. Bus (one section)	500	200	4.20
4. Telephone (basic charge)	2,500	3,140	13.90
Telophone (charge for a call)	50	10	2.10
5. Electricity charge (industrial use 1 kw/h)	43.3	10.35	2.51
6. Gas charge (1 cubic meter)	225	43	2.01
7. Water charge (1 cubic meter)	690	25	0.38
8. Postal charge (post card)	140	50	3.75
9. Postal charge (letter)	170	80	4.94
Consumption goods and services			
10. Rice	27,800 /10 kg	970 /2 kg	1.83
11. Milk	1,400 /litre	180 /litre	1.41
12. Beer	1,300 /355 cc	218 /350 cc	1.84
13. Shoeshine	2,000	500	2.75
14. Barber	10,000	3,500	3.85
15. Electric bulb	500	190	3.99
16. Pencils (a dozen)	2,500	720	3.02
17. Copy-paper (A4 2,500 sheets)	240,000	1,120	0.49
18. Name cards (100 sheets)	14,000	1,000	0.75
19. Tissue paper	1,600 (280 sheets)	318 (400 sheets)	1.46
20. Panty stockings	1,300	500	4.04
21. Casual socks	2,500	500	2.10
22. Caps	7,000	3,000	4.50
23. White shorts (cotton 100%)	48,000	7,800	1.71
24. Bath towels	40,000	3,000	0.79
25. Video tapes (2h)	4,800 (SK)	265 (Matsushita)	0.58
26. Rice cookers	100,000 (Samsung)	12,500 (Sanyo)	1.31
27. TVs (25 inches)	780,000 (Samsung)	74,800 (Matsushita)	1.01
28. Microwave ovens	200,000 (Samsung)	65,000 (Matsushita)	3.41
29. Refrigirators	870,000 (Samsung 2 door 470 cc)	208,000 (Hitachi 4 door 440 cc)	2.51
30. Air conditioners	1,200,000 (Samsung)	225,000 (Matsushita)	1.97
31. Portable telephones	350,000 (LG)	10,000 (Mitsubishi)	0.30
32. Gasoline (a litre)	1,150	92	0.84
33. Automobiles	1,500,000 (Hyundai Souata 2000)	2,000,000 (Toyota Premio 2000)	1.40
34. Steel products	80,000 (H type)	31,000 (H type)	4.07
35. Cement	2,552 (40 kg)	8,650 (1t)	1.42
36. Average starting salary for college graduates	1,250,200	262,000	2.30

Source: Survey by JETRO Seoul center in Seoul on August 30 (1–27 & 33–34) and October 20 (28–32). Counter prices: 9–26, 30–34 (at Nihombashi Takashimaya: 15–25, and at Ginza Mitsukoshi: 30–32).

Note: Won/Yen rates: 100 won = 9.54 yen on September 1. And 100 won = 9.05 yen on October 25.

structure. The survey investigates items down to their subcategories and includes comparisons not only with Korea, but also with the United States, Germany, China, and other countries. This makes it possible to position the Japan-Korea price differential in an international context (Table VII). According to the survey, most products cost more in Japan than in Korea: industrial services cost between 3.5 and 5 times more; minerals and wood products cost around 4 times more; ceramics, paper/pulp, chemicals, general machinery, electricity, and piped gas cost around twice as much; and transport machinery, steel, nonferrous metals, and metal products cost between 1 and 1.6 times more. The only exception is electrical machinery which cost only 0.66 times as much in Japan as in Korea. In terms of price differences with the United States, industrial services and energy cost between 1.1 and 2.3 times as much in Japan as in the United States, although almost all the industrial products mentioned above cost less in Japan than in the United States. It should be noted, however, that calculations of price differentials include exchange rate conversions. Thus, in terms of the Japan-Korea price differential, prices in Japan have become even higher as a result of the depreciation of the won after 1998, while in terms of the Japan-U.S. price differential, prices in Japan have tended to be lower as a result of the depreciation of the yen between 1995 and 1998. However, with the higher yen and the return of the won market from the latter half of 1998, the yen-won rate has remained at the 1998 level, but the yen-dollar rate has returned to 1996 levels, which means that goods and services in Japan no longer seem low-priced like before in comparison with those of the United States. These fluctuations in exchange rates have not yet completely fed through to commodity prices, and can by no means erase the two- to four-fold price differentials found between Japan and Korea.

Many price differences existing between Japan and Korea can also be explained by the difference in income levels, differences in customs and lifestyles, and low prices enforced as governmental policies. These differences suggest the following.

(1) The actual price difference far surpasses the price difference that directly arises from the tariff rates of between 8 per cent and over 20 per cent. This may be a reflection of Japan's high-cost structure. Another reason may be that Japan's long-standing business practices have up to now prevented the introduction of full-scale competition with foreign corporations taking an active part. This, however, applies to Korea as well, and new, more realistic approaches that will be made possible through an FTA are likely to effectively correct the both countries' business practices.

(2) However, two- to four-fold price differentials promote market competition. If a Japan-Korea FTA were to be established, it would not only abolish all tariffs but would also encourage market competition that would transcend national borders. As a result, lower-priced products would cross borders. This is because there is a strong demand for low-priced items, even in Japan where

TABLE VII

JAPANESE PRICE DIFFERENTIALS COMPARED WITH KOREA AND THE UNITED STATES

	with Korea				with the United States			
	1995	1996	1997	1998	1995	1996	1997	1998
All	2.70	2.37	2.45	3.39	1.52	1.48	1.18	1.11
Manufactures	1.29	1.52	1.65	2.09	1.44	1.31	1.12	1.00
Materials	1.20	1.56	1.82	2.31	1.00	0.97	0.93	0.84
Textiles	0.92	1.19	1.25	1.86	1.03	0.87	0.76	2.02
Wood	1.12	2.72	3.33	4.23	1.04	1.30	1.10	0.85
Pulp and paper	0.86	1.50	2.00	2.39	0.78	1.06	1.07	0.90
Chemicals	1.09	1.22	1.75	2.09	0.75	0.75	0.99	1.01
Ceramics	1.35	1.78	1.83	2.43	1.12	1.05	0.86	0.79
Iron and steel	1.00	0.78	0.99	1.28	1.01	1.04	1.11	0.87
Nonferous metals	0.87	0.81	0.86	1.14	0.94	0.94	0.94	0.75
Metal products	0.58	0.75	0.82	1.01	1.02	0.63	0.56	0.55
Minerals	3.14	3.35	3.89	4.82	1.49	2.17	1.73	1.75
Scraps	—	—	—	—	1.16	1.77	1.31	0.89
Processed and assembled	1.11	1.41	1.44	1.87	1.02	1.09	0.80	0.57
General machinery	0.95	2.14	1.95	2.63	0.96	0.93	0.81	0.77
Electric machinery	0.95	0.60	0.85	0.66	0.98	1.09	0.65	0.31
Transport machinery	1.22	1.16	1.27	1.66	1.20	1.33	1.19	0.92
Precision instruments	—	—	—	—	0.70	0.82	0.67	0.74
Other manufactures	—	—	—	—	0.90	0.91	0.84	0.83
Energy	1.58	1.50	1.45	1.78	2.74	2.16	1.86	1.85
Petroleum and coal products	0.98	1.06	0.88	1.17	3.54	2.74	2.32	2.29
Electricity and municipal gas	2.15	1.92	1.98	2.36	1.73	1.42	1.28	1.28
(Electricity for big customers)	2.15	1.92	1.98	2.36	1.70	1.46	1.18	1.14
(Municipal gas)	—	—	—	—	1.82	1.26	1.61	1.79
Indutrial services	4.29	3.34	3.35	4.85	1.61	1.71	1.25	1.26
Finance and insurance	1.36	1.45	1.66	1.84	1.40	1.09	1.06	0.86
Real estate	5.59	3.97	3.72	6.64	2.05	1.67	1.35	1.26
Transport	2.01	2.10	2.57	3.00	1.64	1.40	1.40	1.32
Information services	—	—	—	—	0.91	3.23	1.08	1.11
Telecommunications	3.68	3.15	4.23	4.66	1.86	1.26	1.32	1.61
Other services	5.21	4.14	3.58	4.25	1.32	1.07	1.02	1.32

Source: Japan, Ministry of International Trade and Industry, "Survey on Foreign and Domestic Price Differentials for Intermediate Input," June 1999.

Note:

Exchange Rate for 1995–98

	1995	1996	1997	1998
Korea (Yen/Won)	0.130	0.137	0.129	0.094
U.S. (Yen/Dollar)	96.45	107.61	122.36	125.49

incomes are on average 2.3 times higher than those of their Korean counterparts.

It cannot be denied that these price differentials would work to Korea's competitive advantage. While a Japan-Korea FTA might not eliminate price differences entirely, it would work to reduce them. It is certain, however, that the agreement would correct Japan's persistent high cost structure as well as restrictions it places on competition through its business practices.

IV. PREDICTED EFFECTS OF A JAPAN-KOREA FTA

A. *Static Analysis of Tariff Elimination*

What effects would a Japan-Korea FTA bring about? First would be the expansion of trade through the abolition of tariff and nontariff measures. We would see a reduction in domestic prices of imported items in those sectors where Japan and Korea have a clear competitive edge, as well as an increase in import volumes. This is the "trade creation effect" brought about by regional integration. The scale of this effect can be calculated by the static method of multiplying the import growth rate (obtained by multiplying the amount of tariff reduction by the elasticity of substitution) by the current import value. Meanwhile, a Japan-Korea FTA might also generate a trade-diversion effect whereby a reduction would be seen in imports from third countries on which tariffs and other barriers would continue to be imposed. The scale of this effect can also be calculated using a static premise. Between Japan and Korea, the latter's exports of textiles, sundry goods, and marine products to Japan (on which Japan would still impose relatively high tariffs) would increase, while Japan's exports to Korea of machinery (whose production Korea had restricted under its system of import diversification) would increase.

To illustrate this point more concretely, we undertook a quantitative estimation using a CGE model. The CGE model was designed to assess policy effects. Because it is a "computable general equilibrium," it inevitably includes a number of restrictions, and it is important when analyzing the findings that we have a correct understanding of these restrictions. The CGE model we used is an international model that specifies seven countries and regions which includes Japan, Korea, and the United States. It features a rough industrial classification of eleven sectors, including textiles and clothing, metal products, and electronic machinery. It is a static model and compares two states of equilibrium before and after policy implementation. Goods and factor prices change flexibly so that supply and demand of both products and production factors are in balance. Since the model does not incorporate financial and foreign exchange markets, exchange rates and interest rates are provided exogenously. Production technology and consumer preferences are fixed at a certain level, and simulation of policy changes is calculated by changing either

the parameters or the exogenous variables. To obtain the data on various countries' trade, production, and tariff rates, we used Purdue University's GTAP4 database which is often used in CGE analyses of this type. We attempted a simulation to measure the dynamic effects of tariff abolition and FTA formation.

First, if an FTA is formed between Japan and Korea, the following changes are predicted occur as far as tariff barriers are concerned: Japan's tariffs on exports from Korea will be abolished, as will Korea's tariffs on imports from Japan. With the abolition of customs duties, both the prices of Korean products sold in Japan and Japanese products sold in Korea will fall by the amount of such duties. In conjunction with this, the volume of production and consumption will be adjusted within each sector in both Japan and Korea, and prices will change to reach a new equilibrium. As a result, the amount of surplus or deficit in bilateral trade will change, although in our CGE model, this difference in trade balance is fully financed by the transfer of capital (Simulation 1, or S1: tariff abolition and complete transfer).[7] (See Tables VIII and IX.)

- In the base year, Japan's exports to Korea were greater than Korea's exports to Japan, and Korea's tariff rates were higher than those of Japan. Thus, if tariffs are lifted, the rate of increase of Japan's exports to Korea (16.3 per cent) will surpass that of Korea's exports to Japan (8.3 per cent). Consequently, Japan's trade surplus will expand by 34.5 per cent.
- For both Japan and Korea, exports to the United States will increase and imports from the United States will decrease. While Japan's exports to the United States would increase by 0.14 per cent and imports from the United States would decrease by 0.27 per cent, Korea's exports to the United States would increase by 1.6 per cent and imports from the United States would decrease by 2.9 per cent. This decrease in imports is due to the trade conversion effect, i.e., the price of U.S. products being higher in the Japanese and Korean markets. Increased exports to the United States would be the result of these indirect effects and thus the margin of increase would be restricted.
- For both Japan and Korea, imports and exports to and from the rest of the world would increase by a small margin, with Korea posting larger increases. This can be attributed to expansion of trade between Japan and Korea. For Japan, the increase in exports would be greater than that in imports, and Japan's total trade surplus would expand by 8.2 per cent. Similarly for Korea, the increase in exports would be greater than that in imports, and its total trade deficit would shrink by 4.1 per cent. The increase in world trade would be a meager 0.11 per cent.

[7] In the GTAP database, it is assumed that tariff rates include tariff equivalents of nontariff measures. In checking the Japan-Korea data, however, we found that they contained almost exclusively tariff rates, and did not include the Import Sources Diversification Program or quantitative restrictions on agricultural/marine products.

TABLE VIII

EFFECTS ON TRADE BALANCE IN FOUR SIMULATIONS

(U.S.$ million)

	Exports	Change (%)	Imports	Change (%)	Trade Balance	Change (%)
(1) Japan's trade with Korea						
Base case (1995)	36,729.1		25,456.2		11,272.9	
Simulation 1	42,718.3	16.31	27,560.9	8.27	15,157.4	34.46
Simulation 2	42,940.1	16.91	27,481.9	7.96	15,458.2	37.13
Simulation 3	48,566.9	32.23	30,649.3	20.40	17,917.7	58.94
Simulation 4	42,058.6	14.51	28,325.5	11.27	13,733.1	21.82
(2) Japan's trade with the United States						
Base case (1995)	131,371.4		85,662.0		45,709.4	
Simulation 1	131,556.2	0.14	85,428.3	–0.27	46,127.9	0.92
Simulation 2	131,096.9	–0.21	85,798.2	0.16	45,298.7	–0.90
Simulation 3	178,066.3	35.54	76,810.2	–10.33	101,256.1	121.52
Simulation 4	177,901.7	35.42	77,052.8	–10.05	100,849.0	120.63
(3) Korea's trade with the United States						
Base case (1995)	27,168.2		33,561.2		–6,393.0	
Simulation 1	27,603.3	1.60	32,596.4	–2.87	–4,993.0	–21.90
Simulation 2	27,369.7	0.74	32,881.8	–2.02	–5,512.1	–13.78
Simulation 3	36,558.1	34.56	28,035.8	–16.46	8,522.3	Surplus
Simulation 4	35,812.6	31.82	28,949.2	–13.74	6,863.4	Surplus
(4) Japan's trade with the world						
Base case (1995)	484,058.6		416,877.8		67,180.9	
Simulation 1	490,711.8	1.37	418,051.6	0.28	72,660.1	8.16
Simulation 2	489,399.5	1.10	419,471.9	0.62	69,927.6	4.09
Simulation 3	648,294.1	33.93	392,902.5	–5.75	255,391.6	280.16
Simulation 4	640,742.9	32.37	391,558.0	–6.07	249,184.9	270.92
(5) Korea's trade with the world						
Base case (1995)	139,488.7		146,107.0		–6,618.3	
Simulation 1	143,378.3	2.79	149,726.4	2.48	–6,348.1	–4.08
Simulation 2	142,354.0	2.05	150,683.8	3.13	–8,329.7	25.86
Simulation 3	181,349.5	30.01	146,134.0	0.02	35,215.5	Surplus
Simulation 4	176,062.2	26.22	141,880.3	–2.89	34,181.9	Surplus
(6) Total world trade						
Base case (1995)	5,662,890.1		5,662,890.1			
Simulation 1	5,669,143.7	0.11	5,669,143.7	0.11		
Simulation 2	5,670,522.8	0.13	5,670,522.8	0.13		
Simulation 3	5,703,205.5	0.71	5,703,205.5	0.71		
Simulation 4	5,695,621.7	0.58	5,695,621.7	0.58		

Notes: 1. Simulation 1: tariff abolition and complete transfer. Simulation 2: tariff abolition and incomplete transfer. Simulation 3: tariff abolition and productivity increase. Simulation 4: productivity increase alone.
2. Percentage change from base case.

TABLE IX

EFFECTS ON MAJOR VARIABLES

(1) Change in wage rates (deflated by changes in average production cost)

	Base Case (1995)	Simulation 1		Simulation 2		Simulation 3		Simulation 4	
		Wage Rate	Change (%)	Wage Rate	Change (%)	Wage Rate	Change (%)	Wage Rate	Change (%)
Japan									
Skilled workers	1	1.000	0.00	1.000	0.00	1.104	10.44	1.104	10.44
Unskilled workers	1	1.000	0.00	1.000	0.00	1.103	10.33	1.103	10.33
Korea									
Skilled workers	1	1.004	0.41	1.004	0.35	1.095	9.48	1.090	8.99
Unskilled workers	1	1.002	0.21	1.004	0.35	1.080	7.95	1.077	7.69

(2) Changes in national income (deflated by changes in average production cost)

	Base Case (1995)	Simulation 1		Simulation 2		Simulation 3		Simulation 4	
		National Income	Change (%)	National Income	Change (%)	National Income	Change (%)	National Income	Change (%)
Japan	4,689,511	4,689,479	0.00	4,689,510	0.00	5,179,355	10.45	5,179,266	10.44
Korea	395,366	396,810	0.37	396,864	0.38	431,370	9.11	429,653	8.67

(3) Changes in national welfare (in terms of equivalent variation)

(U.S.$ million)

	Base Case (1995)	Simulation 1		Simulation 2		Simulation 3		Simulation 4	
		Equivalent Variation	Change (%)	Equivalent Variation	Change (%)	Equivalent Variation	Change (%)	Equivalent Variation	Change (%)
Japan	3,072,986	970	0.03	1,150	0.04	286,728	9.33	285,558	9.29
Korea	245,319	846	0.34	930	0.38	18,432	7.51	17,393	7.09

- In terms of Japan's sector-specific outputs, we would see increases of 0.5 per cent for general machinery, 0.2 per cent for other manufactured goods, and 0.1 per cent for metals, but slight decreases in electric machinery and services. Prices (excluding tariffs) would remain almost unchanged. Meanwhile, output in Korea would increase in all sectors: 2.9 per cent in textiles, 1.2 per cent in general machinery, and 0.9 per cent in electrical machinery. Prices would drop across the board by 0.4 to 0.9 per cent.
- These structural changes in production would affect employment as well. However, in this CGE model, wages change to ensure that full employment is maintained. Therefore, increases or decreases in wage levels would indicate whether labor is in excess demand or supply. Although there would be no changes in wage rates in Japan, in Korea skilled labor would be in excess demand, while unskilled labor would be in excess of supply. Consequently, there would be a move to hire more skilled labor.
- Real national income, an indicator of the welfare effects of tariff abolition, would remain unchanged in Japan. In Korea, however, it would increase by 0.3 per cent.

In an alternative CGE model, total world savings are distributed across various countries and regions in the proportion decided per the base year, and capital is transferred accordingly. If the trade balance generated as a result of tariff elimination exceeds this allotted capital transfer, terms of trade will change so that the trade balance will fall within the range of capital transfer (Simulation 2, or S2: abolition of tariffs and incomplete transfers). The CGE model's analysis of KIEP's tariff reduction appears to be based on this assumption.

- If a trade deficit exceeds the limit of allotted capital inflow, the terms of trade will change for the worse, and production and imports/exports will be automatically adjusted to keep the trade balance within an acceptable range. Similarly, if a trade surplus exceeds the limit of the capital outflow allotment, the terms of trade will be improved, and imports/exports will be automatically adjusted to keep the trade balance within an acceptable range. These measures take place primarily by reducing export prices and raising import prices across the sectors.
- Therefore, in S2 Japan's exports to Korea will increase by 16.9 per cent, imports will increase by 8.0 per cent, and the trade balance will be in surplus by 37.1 per cent. All of these figures are slightly greater than those estimated in S1. However, in S2 Korea's exports to the rest of the world will increase by 2.1 per cent, smaller than that estimated in S1, and imports will increase by a hefty 3.1 per cent. As a result, the trade deficit will expand. In other words, in S2 Korea's trade deficit will expand, while in S1 it will shrink. And while the real national income will increase marginally in Japan, it will increase by 0.38 per cent in Korea.

What would actually occur may fall somewhere between these two assumptions, and the more active capital transfer becomes, the closer the outcome will be to S1. Whichever assumption is used, according to the CGE model, abolition of tariffs would have some effect on Japanese-Korean trade, but only minimum effects on the two countries' overall production, trade, and prices.

B. *The Dynamic Effects of Harmonizing the Markets*

But would these be the only effects of a Japan-Korea FTA? As we have seen previously, between Japan and Korea there is actually more intra-industry specialization of trade in which the two countries mutually import and export low-end and high-end products as well as parts and finished products. In these sectors, tariff and nontariff measures are either low or nonexistent, and as calculated by static analysis, would not be supplemented.

The foregoing calculations were based on static premises and they only estimates a part of the effects of a Japan-Korea FTA. It should be noted that the Japan-Korea FTA here refers not to an FTA in the narrow sense of a contract to abolish only tariffs and nontariff barriers between Japan and Korea. Rather what we have in mind is a systematic framework that includes far-ranging bilateral cooperation, covering investment agreements, standards certifications, intellectual ownership rights, and other items as was envisioned in "Japan-Korea Economic Agenda 21," and which would ultimately integrate the markets of Japan and Korea. Under this framework a market worth roughly five trillion dollars with a combined population of 170 million people—roughly two-thirds the size of the U.S. market—would emerge.

Japan and Korea, which would comprise this integrated market, have similarities and differences. Both have a large medium-level income group, high education standards, and a highly developed urban infrastructure. Meanwhile, the two countries currently have a wage difference of about 130 per cent, and Japan's economy is roughly nine times bigger that Korea's. Unlike Japan, where the graying of the population has progressed substantially and a decrease in consumption is inevitable and drawing closer, Korea still has some twenty years' time until the onset of a full-scale aging society, which means that consumption levels can, in the short term, continue to rise. Korea would benefit greatly from absorbing Japan's advanced technologies, while Japan would find Korea's continual growth, vitality, and competitive stimulation highly attractive.

What would happen to bilateral economic relations if the Japan-Korea markets continued to integrate further? First, Korean and Japanese corporations might step up their sales activities in their partners' markets, increasing competitive pressure as a result. As we have seen in the analysis of Japan-Korea trade patterns in the previous section, the two countries are located adjacent to each other, and a good percentage of their transactions in food, clothing, transport, and air travel services are between themselves. The two countries are not hampered by distance. But until

now, due to factors other than tariff/nontariff barriers, the governments of the two countries have discouraged joint ventures and other collaborative corporate activities. This is evident in the large price difference seen in certain commodities. Thus, the integration of Korean and Japanese markets would exert stronger competitive pressure on Korean corporations than they are experiencing at present. Some Korean sources have voiced apprehension that all of Korea's sectors would be dominated by Japanese companies. That, however, is an overly bearish projection. Some Korean corporations in some sectors may in fact quit, but more importantly, Korean companies will survive in a large number of sectors, become globally competitive, and continue to provide products to an integrated Japan-Korea market. Thus the two- to four-fold price difference investigated in Section III would clearly work to Korea's advantage.

Second, not only would competition intensify between Korean and Japanese corporations, but strategic collaboration between them would also be created in many sectors. Corporations in both countries are stepping up efforts to withdraw from unprofitable operations and to strengthen specialized businesses through mergers and acquisitions. Quite a few of these strategic partners are companies that, until now, had been competitors. Several collaborative efforts between Korean and Japanese corporations have already been formed, and more are expected to come about in response to the intensified competition mentioned above. In sectors where the technological division of labor between Korean and Japanese corporations has already progressed, there will be more division of labor pertaining to R & D activities in areas of specific strengths as well as the sharing of technologies. Furthermore, Japanese corporations have already made inroads into China and Southeast Asia in numerous sectors and reallocated production to those areas, and some Korean corporations have recently begun following suit. This is another area in which Korean and Japanese corporations can collaborate to promote an international division of labor and production re-allotment with China and Southeast Asia.

Third, the Japan-Korea integrated market will prove attractive not only to Japanese and Korean corporations, but also to a large number of U.S. and European corporations which are interested in making inroads into the Asian market. To reinvigorate the domestic economy, both Japan and Korea currently are implementing policy measures to attract foreign corporations, and even accept large-scale mergers and acquisitions. It should be assumed that the intensifying competition and corporate collaboration described above will progress as a result of the increasing presence of U.S. and European corporations and the expectation that Japan-Korea market integration will expand further. In this respect, Japanese-Korean market integration would greatly benefit Korea. Foreign corporations are attracted to larger markets, and a country that integrates with an even larger country can entice foreign corporations which its own market alone cannot otherwise attract. We all know how Mexico takes advantage of NAFTA to attract foreign corporations hoping to

sell their products in the U.S. market, and how Tunisia, through its association with the EU, attracts non-EU corporations hoping to utilize Tunisia's access to the EU market. Similarly, Korea will enjoy tremendous advantages by integrating with the Japanese market which is nine times larger than its own market.

Fourth, personnel exchanges, from tourists to businesspersons, would be dramatically stepped up. With the holding of the 2002 FIFA World Cup, the infrastructure for exchanges is expected to be built and rapidly strengthened through such things as increases in airline flights and simplification of visa procedures. Korea is busily expanding its international airport, and there is a strong possibility that Seoul, rather than Narita or Kansai, will come to serve as the main hub for northeast Asia. To cope with the rapid progression of aging in Japan, the government is even considering accepting more foreign workers. It is thus highly possible that Japan may ease the acceptance of skilled workers and R&D professionals from Korea. Increased exchanges of people between the two countries would put a halt to decreasing consumption brought about by the aging of Japan's population. At the same time the similarities between the consumer markets of both countries would be enhanced through cultural interchange and the spread of information.

Sectors where both Japan and Korea have a competitive edge in international markets and conduct active mutual trade would be expected more frequently to generate intensified competition, corporate cooperation and attract more foreign corporations than would sectors where either Japan or Korea has established a comparative advantage, such as those mentioned above. In other words, intra-industry specialization will be stepped up further. As a result of these dynamic changes, the corporate, production, and trade structures in both countries will undergo dramatic changes as well, and their trade creation effects will be far greater than those generated by static analyses. All readers will no doubt agree that formation of the Japan-Korea FTA will bring about not only tariff/nontariff barrier elimination effects which static analyses can supplement, but also dynamic effects derived from such factors as intensified competition and corporate collaboration. It should be noted, however, that these dynamic effects cannot be easily projected quantitatively. The scale of these dynamic effects is not in direct proportion to the height of tariff/nontariff barriers; the relationship between the two is not that simple. Price reductions resulting from tariff elimination may indeed promote competition and promote corporate collaboration. More often, however, they are triggered by such factors as the potential of the market and the possibility of technological development. We therefore have no choice but to rely on information on industries where the intra-industry division of labor is actually being stepped up between Japan and Korea, such as machinery, chemicals, and metals.[8]

[8] Fukuchi et al (1997) undertook an econometric analysis of the long-term impacts of personnel movement, the flow of information and commodities, and foreign direct investment between two regions, and simulated their impacts on economic development over ten years. This study contrasts

It is unfortunate that although the dynamic effects of an FTA are considered more important by many economists, CGE analysis continues to focus only on calculating the effects of tariff removal. We cannot obtain accurate numerical figures, such as tariff rates, from dynamic effects, however, if we consider that the effects of tariff removal are currently being used to set average tariff rates (that are calculated using broad, sector-specific classifications) and that they do not include nontariff barriers, these effects are no better than rough numerical calculations. Let us attempt, therefore, a similar numerical calculation for dynamic effects by introducing a bold assumption: we will assume that productivity will improve in the machinery, metal, and chemical sectors at rates far surpassing those of other sectors as was seen in the industry-specific outlook of dynamic effects in Section IV, C. Since tariff rates are low in these sectors, the effects of tariff removal will be minimal. It may be more appropriate, therefore, to surmise that productivity will improve as the FTA promotes competition and corporate collaboration and attracts more foreign capital. We will assume that productivity will increase by 30 per cent in the sectors of intra-industry specialization and by 10 per cent in textiles and other manufacturing sectors and services, but not improve in primary industries (Simulation 4: increase in productivity). We will also assume that this will apply to both Japan and Korea. If it takes ten years for an FTA to be formed, the annual rate of increase will be 1 to 3 per cent on average, which is not an overly high estimate (Simulation 3: abolition of tariffs and increase in productivity). Dynamic effects calculated in this manner are different from the static effects of tariff removal, and are far larger. In terms of the effects of an FTA that would combine the two, the dynamic effects would prevail (Tables VIII and IX).

- If productivity increases primarily in the machinery and metal sectors in Japan and Korea, output will increase by 20–30 per cent and prices will drop by 15–16 per cent in Japan. On the other hand, although similar changes would occur in Korea, output would increase by 23–46 per cent, a substantially greater level than in Japan, and prices would drop by 12–15 per cent.
- Japan's exports to and imports from Korea will both increase. With dynamic effects alone, the increase in exports brought by improved productivity is more or less the same as that brought about by tariff removal. And since imports increase by a hefty 11 per cent, the trade surplus will increase by only 22 per cent. But if we add these with S1, which is the outcome of the effects of tariff removal, exports will increase by 32 per cent, imports will increase by 20 per cent, and trade surplus will expand by 59 per cent.
- Japan's exports to the United States would increase substantially (36 per cent) due to a reduction in Japanese product prices, but imports would decrease (10 per cent), and the trade surplus with respect to the United States would expand

greatly with those which stick to static analyses allegedly because of the lack of quantitative data.

(122 per cent). Korea's exports to and imports from the United States would show similar patterns, although on a larger scale (35 per cent and 16 per cent, respectively). The trade deficit with the United States would switch to a trade surplus of U.S.$8.522 billion.

- Japan's world exports would increase by 34 per cent, and imports would decrease by 6 per cent, expanding its trade surplus. Korea's world exports would increase by 30 per cent, and imports would increase by 0.02 per cent, turning its deficit into a trade surplus.
- As a result, U.S. world exports would decrease and imports would increase, expanding its trade deficit. However, since these are indirect effects, the change would be smaller than that seen in Japan and Korea. World trade would increase by 0.71 per cent.
- However, real national income would increase by 10.45 per cent in Japan, and 9.11 per cent in Korea, both impressive figures.
- Looking at the employment effects through changes in wage rates, as we did in our static analysis, when productivity improves, it generates dramatic price changes, and thus the effects are conspicuous. Real wages for both skilled and unskilled labor would increase by about 10 per cent. In other words, demand for both types of labor would exceed supply, leading to an increase in employment. In both Japan and Korea, the rate of wage hikes would be higher for skilled than unskilled workers, and there would be a greater increase in the supply of skilled than unskilled labor.

Because this model centers on price adjustment, changes in prices tend to be larger. In other words, it produces large conversion effects vis-à-vis the United States and other third countries. Actually, however, the large-scale expansion of the U.S. trade deficit would raise the value of the yen and won against the U.S. dollar. The deterioration of the U.S. terms of trade with Japan and Korea would be compensated for to a similar degree which would suppress any price changes.

The dynamic effects generated by a Japan-Korea FTA would bring about substantial changes in trade with countries other than Japan and Korea. It would be incorrect, however, to criticize these changes by regarding them in the same light as the trade conversion effects brought about by the discriminatory lifting of tariff and nontariff barriers. This CGE model assumes that, for a period of ten years, only Japan and Korea will change, and that other countries would remain unchanged. This is a simulation attempted simply for the purpose of identifying the FTA's dynamic effects, and nothing like this would actually occur in reality. Nevertheless, this simulation does reveal a certain truth: if two countries cooperate in revitalizing their economies, the countries around them that do not react in any way will suffer "trade conversion–like" effects. But since these are not the effects of discriminatory policies, they cannot be criticized as discriminatory.

C. *The Effects of a Japan-Korea FTA: Industry-Specific Outlook*

We will now attempt to forecast the effects of a Japan-Korea FTA on major industries, based on the analyses made in Section III. Here, we will focus on the following ten sectors: textiles/clothing, chemical products, metals, general machinery, electrical machinery, transportation machinery, other manufactured goods, transport services, travel services, and other services (other profit-making businesses, construction, patent rights, etc.). These are all major export and service categories in Japan and Korea, and most are busily traded between the two countries. Although raw materials and fossil fuels constitute major import items for both Japan and Korea, they are primarily imported from third countries, and would thus not be directly affected by a Japan-Korea FTA.

The effects were forecast in the following manner. First, an investigation was made of the trade patterns according to industry, tariff/nontariff measures, and commodity price differences. Trade patterns clearly reflect the respective competitive strengths of Japanese and Korean corporations. Korea dominates textiles and clothing, and has substantial surplus exports. Both countries actively import and export chemical products, metals, general and electrical machinery, and other manufactured goods, although Japan posts surplus exports. Very little transportation machinery is traded between the two countries. While both countries actively import and export transportation, travel, other profit-making businesses, and construction services, with Korea posting surplus exports, Japan posts surplus exports in patent rights usage fees. Regarding tariffs, Japan still imposes relatively high ones on textiles/clothing and some "other manufactured goods," but imposes either zero or extremely low tariffs on machinery and metals. At the Uruguay Round, Korea promised to abolish tariffs on steel. However, it still imposes an 8 per cent tariff rate on many machinery and chemical products. Concerning commodity price differences, Japan generally charges higher prices than Korea, reflecting the former's 70 per cent higher wage level. Some Japanese sectors charge three to four times more than their Korean counterparts.

Now, we will apply the two effects of FTA formulation mentioned in Section IV, namely, abolition of tariff/nontariff measures and dynamic effects. A range of industrial information was used as a source for investigating dynamic effects. Table X summarizes the results.[9]

[9] Several major cases of collaboration between Japanese and Korean firms were reported in such areas as steel, automobiles, and telecommunications. The world's number two steel company, Nippon Steel, has collaborated in production and marketing with the world's number one steel company, Pohan Steel. Japan's number three steel maker, Kawasaki Steel, agreed on collaboration in capital and technology with Korea's Hyundai Pipe. In automobiles, Japan's Nissan decided to provide technology for manufacturing chasses to Korea's Renault-Samsung Automobile, both under the control of Renault of France. In the area of mobile-phones, SK Telecom of Korea is collaborating with NTT Docomo, and the LG group is doing the same with Nippon Telecomm.

TABLE X

EFFECTS OF A JAPAN-KOREA FTA BY INDUSTRY

Major Industrial Categories	Effects on Production, Trade, and Investment in Japan and Korea
Textiles / clothing	Abolition of high tariffs imposed on certain products would help increase exports to Japan. Japanese companies would counter by producing more high-end, fashionable items. This might increase their exports to Korea.
Chemical products	The two countries are closely matched in terms of technical ability and competitive strength. Abolition of tariffs that still remain on certain products would increase mutual imports/exports. Both countries have surplus facilities, so cooperation in facility disposal and division of labor regarding the production of competitive items is possible. Division of labor exists between the two countries in synthetic textile materials. There is a possibility that European and U.S. corporations may penetrate the market.
Metals	No direct influence of an FTA is expected as both countries abolished tariffs on steel at the Uruguay Round. There will be more cooperation in disposing surplus facilities and increased division of labor regarding production (due to Japan's higher costs) through strategic collaboration between Korean and Japanese corporations. As a result, mutual imports/exports should increase.
Electrical machinery	With Korean companies catching up with their Japanese counterparts, exports of household electric appliances to Japan have increased. However, this is partly due to tariffs and to the system of categorizing countries from which it imported goods which have protected these companies. An FTA may intensify competition, but collaboration with Japanese corporations have created the potential for technology transfers and divisions of labor/production.
General machinery	Japan has the competitive advantage. When Korea abolished its 8 per cent tariff, Japan's export surplus increased. Korea may collaborate with Japanese corporations for the transfer of technology; divisions of labor/production are possible by taking advantage of Korea's lower costs.
Transportation machinery	Both Japan and Korea actively export passenger cars to third countries, but import and export very few between themselves. With liberalization in Korea (lifting of the 8 per cent tariff on passenger cars and 13 per cent one on components), exports from Japan should increase, although exports of low-priced items from Korea to Japan should increase as well. Japanese companies may advance into the parts sector and replace imports. Exports of technology may also increase.
Other manufactured goods	With the abolition of high tariffs, imports from Korea should increase, although there may be restrictions in terms of quality. Taking advantage of cost competitiveness in furniture and other products, Korea may make inroads into the Japanese market. Japan should increase exports of famous-brand miscellaneous goods to Korea.
Transport services	Mutual imports and exports are likely to show an increase, although because of its price advantage, Korea will continue to register a surplus in exports.
Travel services	Mutual exchanges should increase following expedited visa procedures and joint use of air and marine services. Due to its low commodity prices, however, Korea should continue to register a substantial surplus in exports.
Other services	Mutual imports and exports are likely to show an increase in other profit-making businesses and various other services. Korea should continue to dominate in construction services, and Japan, in patent right usage fees and financial services.

V. THE NEED FOR CLOSER INDUSTRIAL COOPERATION

Trade and investment have continued to expand between Japan and Korea based on market mechanisms, and to supplement these activities, the government and the private sector have encouraged industrial cooperation. It is hoped that these efforts will be further strengthened to form a Japan-Korea FTA.

A. *Conventional Technical Cooperation between Japan and Korea*

The transfer of technology is already taking place between Japan and Korea as a result of Japanese corporate direct investments in Korea and technical partnerships with Korean corporations. They have contributed tremendously to raise the level of Korea's technology. Many Koreans contend that, unlike Europe and American corporations, Japanese companies are reluctant to transfer technology to Korea. The fact is, however, Japanese corporations have made considerable contributions in many industrial sectors in which Korea has competitive power. In response to growing calls to strengthen bilateral cooperation, the government and the private sector have established a variety of organizations to implement a range of cooperative projects.

Three agencies have been working to bring Korean trainees to Japan and dispatch Japanese specialists to Korea: the Association of Overseas Technical Scholarship (AOTS), the Japan Overseas Development Corporation (JODC), and the Japan-Korea Industrial Technology Co-operation Foundation (JKF). By 1998, AOTS had accepted 6,400 Korean trainees, JODC had dispatched 158 specialists, while JKF had received 643 trainees and dispatched 141 specialists. All three agencies together had accepted approximately 7,000 trainees and dispatched approximately 300 experts. Korea has been a major beneficiary of this project, with Japanese technological cooperation clearly contributing to raising the level of Korean technology. Besides these technical cooperation activities carried out jointly by the government and the private sector, there are government-level technical cooperation and trade investment promotion programs carried out via the Japan International Cooperation Agency (JICA) and the Japan External Trade Organization (JETRO).

These exchange projects and technical cooperation activities were carried out by Japan in response to calls to promote technology transfer and resolve the imbalance in bilateral trade. This unbalanced trade itself derives from Korea's pattern of trade which relies on Japanese imports for components, intermediate goods, and machinery/equipment. We must wait until small- and medium-scale parts companies develop in Korea. Technical cooperation from Japan will in the long run definitely help in this development. As a result of Korea's membership of the OECD, assistance given to Korea beginning January 2000 will not be counted as part of ODA, which means that Japanese government-led cooperative activities will inevitably

taper off with the elapse of time. We therefore need to establish a mechanism that will enable the private sector to initiate technology transfers on its own initiative. The "Japan-Korea Economic Agenda 21" provides a systematic framework for realizing the dynamic effects of a Japan-Korea FTA mentioned in Section 4.2 by promoting investment and technical transfers. Efforts to make this system work should form the basis for Korean-Japanese relations in the twenty-first century.

B. *Japan-Korea Fishery Problems*

So far the primary focus of this report has been on the manufacturing sector. However, Japan and Korea have many problems and issues in common in the agricultural, forestry, and fisheries sectors as well. To solve these problems, both countries must make further efforts and cooperate with one another to reach agreements on a range of issues.

First is the issue of the Japan-Korea Fisheries Agreement. In the surrounding fishing grounds to which both countries have access, fishermen from both countries catch sardine, mackerel, saury pike, crabs, and other marine species. Negotiations between the governments of Japan and Korea, particularly those involving the management and conservation of these common resources, have been difficult. The current New Fisheries Agreement provides only a temporary solution to the issue, such as by stipulating a vast temporary fishing zone that includes Yamatotai, and managing fishing by mandating that vessels hoist their national flags. While both countries use common resources in each of their exclusive fishing zones, they deal the issue of resource management quite differently. At the same time, as was seen in Section III, in the marine product trade between the two countries, Korea exports thirty times more to Japan as does Japan to Korea. From the perspectives of resource management and maintenance of regional communities, Japan enforces import restrictions and imposes relatively high tariffs on these products. Korea also imposes adjustment tariffs on certain marine products. It is essential, therefore, that the two countries jointly manage these resources and further cooperate in their use.

C. *Cooperation in the Agricultural Sector*

Another difficulty is agriculture. Japan and Korea have many issues in common. For example, both countries have thus far protected their domestic agriculture with price support measures, combined with national border protection policies on rice, wheat, dairy products, beef, pork, sugar, and other specified items. Both countries have self-sufficiency rates in grain of about 30 per cent. They are basically self-sufficient in rice, although they accepted minimum access at the Uruguay Round. While maintaining their own supply of rice, they both have a grain supply-demand structure which rely overwhelmingly on imports of feed grain. And while Korea meets its own demand for most vegetables, fruit, meat, and dairy products, Japan

has come to rely heavily on imports for supply of these products. Neither country has significant agricultural resources and their farmers usually operate on a very small scale. In Korea 57 per cent of farmers are exclusively engaged in farming; in Japan the figure is only 17 per cent. The volume of agricultural produce traded between Japan and Korea is extremely small. This is because the two countries have used the import quota system to isolate from the international market the so-called sensitive items that are common to them both.

It is important that these sensitive items be handled in ways that comply with GATT/WTO provisions and that are agreeable to relevant parties in both countries, bearing in mind their common goal of developing and maintaining the agriculture, forestry, and fisheries industries in industrialized countries. It is essential when concluding a Japan-Korea FTA that both countries adjust their border protection policies to enable their agriculture, forestry, and fisheries businesses to coexist and co-prosper. To do this both countries must cooperate for the time being in the study of crucial agricultural policies that are common to them both, such as food security, maintenance and conservation of national land and natural resources, and promotion of agricultural areas.

VI. THE PATH TO FORMULATING A JAPAN-KOREA FTA

A. *Framework of the "Japan-Korea Economic Agenda 21"*

The "Japan-Korea Economic Agenda 21" presents a wide-ranging inter-governmental cooperative framework. It calls for the conclusion of tax treaties, investment agreements, and standards certifications, as well as cooperation in such sectors as standards and intellectual property rights. The governments of Japan and Korea have already begun work on the first two items.

The Japan-Korea Tax Treaty will determine the taxes imposed on domestic activities carried out by the other party's corporations and individuals. It was signed in October 1998, and both countries are anticipating its early enforcement. Preliminary negotiations on the investment agreement began in February 1999 with the hope of promoting mutual investment between Japanese and Korean corporations. The agreement incorporates measures that enhance the following items contribution to protecting investment and establishing investment environments: national as well as MFN treatment, the obligation to ensure transparency, prohibition of demands related to performance, protection of invested assets and freedom to remit profits, and dispute settlement processes. Standards certifications, meanwhile, seek ways for both countries to mutually accept the results of compatibility assessment procedures carried out in the other country, while mutually recognizing their systems. The purpose is to facilitate the use of assets and services and to promote trade between both countries. Standards pertain to cooperation in making domestic stan-

dards comply with international standards, and in developing and standardizing international standards. In the field of intellectual property rights, the two countries will cooperate in building common bases for protecting intellectual property rights, including harmonizing the application of investigation criteria, cooperating in measures to prevent counterfeiting of goods, and drawing up WTO, World Intellectual Property Organization (WIPO), and other international rules. These facilitation measures will help activate the commodity and service trades, capital flows, and personnel exchanges between Japan and Korea which are indispensable for realizing the dynamic effects of a Japan-Korea FTA.

B. *An FTA Is the Ultimate Goal*

Today's FTAs include efforts to liberalize the commodity and service trades along with wide-ranging cooperative activities. However, to conclude agreements incorporating these liberalizing and cooperative activities, parties require a systematic FTA framework centered on liberalization. To start the process of setting up such a framework, the parties first need to continue individual talks on liberalizing agreements and economic cooperation projects, and begin enforcing those that have been agreed upon. They should establish their FTA as a systematic framework based on these cooperative activities. In this sense, an FTA is the ultimate goal. It is not realistic, however, to attempt FTA negotiations at the end of the process. Proposing the establishment of an FTA is a vision that encourages efforts by clearly setting the ultimate goal. Without an ultimate goal, individual negotiations would not proceed smoothly, resulting in loss of momentum for bringing bilateral relations closer. Parties should conduct FTA negotiations concurrently with individual negotiations, reach an agreement within two to three years, and make known the framework for their FTA. In due course the two parties may opt to make preparations, including liberalization, in stages. The "Japan-Korea Economic Agenda 21" defines an FTA in the narrowest sense, i.e., elimination of tariff and nontariff barriers. However, harmonizing the markets of Japan and Korea by combining liberalization with facilitation and economic cooperation is a new, pragmatic approach to forming an FTA.

C. *Promotion of Currency and Financial Cooperation*

Thus far this report has not touched on currency or financial issues. To bring bilateral relations closer, it is essential that Japan and Korea cooperate in this area. Unless the yen and won markets are stabilized, trade and investment will not continue to expand between the two nations.

We all know that the Asian currency crisis of 1997 was clearly traceable to the currency policies of East and Southeast Asian countries that had pegged their domestic currency values only to the U.S. dollar. Having learned from this, Japan and Korea are studying a method of pegging their currencies not only to the U.S. dollar,

but to a basket of currencies that would include the euro and the yen. Under this system, the won market would be able to better adjust to changes in the value of the U.S. dollar and the yen and ultimately stabilize the yen/won rate. Japan has been actively working to prevent another Asian currency crisis. Along with liquidity assistance measures including those implemented so far, the country is working to establish a stable currency regime and to further internationalize the yen.

In conjunction with this, efforts must be made to integrate Japan and Korea's financial and capital markets following the integration of their commodity and service markets. Without this, competition through mutual bilateral cooperation cannot be sufficiently promoted, and collaboration between Korean and Japanese corporations would be discouraged. Governments of both countries are making vigorous efforts to make their domestic financial systems comply with international standards, and were active participants in the recent commodity and service liberalization negotiations. During the course of mutually aligning their domestic financial and capital systems, the two countries may also nurture the seeds of bilateral cooperation.

Korea is concerned about its persistent trade deficits with Japan, and continues to demand that Japan makes efforts to improve the situation. The trade imbalance, however, stems from the fact that the two countries have different industrial structures. This will be resolved as Korea's industries become increasingly sophisticated and catch up with those of Japan, and as Japan's savings rate drops and current account deficit expands as a result of its aging society and declining birth rate. A program such as Import Sources Diversification will be needed in order to forcibly correct this situation in the short run. Until this happens, it may be wiser for Korea to make maximum use of Japan's advanced technologies and capital exports. A more rational direction would be to use the capital outflow from Japan to make up for Korea's deficits. If this can be done, the transfer problem, that of making only Korea bear the burden of adjusting the deficits, would not occur. To ensure this capital flow occurs efficiently on the private-sector level, the two countries must integrate their financial and capital markets.

VII. PUBLIC RESPONSES AT HOME AND ABROAD

The Institute of Developing Economies, Japan External Trade Organization (IDE-JETRO) and the Korean Institute of Economic Policy (KIEP) jointly organized two symposia in 2000, one in Seoul in May and one in Tokyo in September. At the Seoul symposium Korean panelists expressed:

(1) worry that the Korean trade deficit with Japan would deteriorate further,
(2) fear that Korean firms would be overwhelmed under free competition,
(3) mistrust in Japanese markets and systems, and
(4) preference for Korea-Japan-China cooperation to a Korea-Japan bilateral FTA.

Regarding the first point, the Japanese panelists responded that Korea's persistent deficit with Japan reflects principally its stage of industrialization and would be resolved as Korea catches up with Japan over time, given Korea's growth rate which is twice as high as Japan's and Japan's rapidly aging population. In the service trade Korea has an increasing surplus with Japan and the remaining net deficit of Korea's current account balance will continue to be financed by capital flow and cause no harmful impact on Korean economic growth.

The Korean panelists did not respond directly but maintained a cautious attitude. They pointed out that, while the negative effect of tariff elimination would emerge quickly, the positive effect of dynamic impacts would emerge only later, and they wanted to see preparatory measures taken in advance such as establishing a Korea-Japan Investment Bank and an Industrial and Technical Cooperation Committee in order to lead to a Korea and Japan intra-industry specialization as was indicated in the Joint Communiqué ("Towards Closer Japan-Korea Economic Relations" 2000). Regarding the time dimension of the negative and positive effects of an FTA, it is more likely that, contrary to the Korean suggestion, the positive effect will come sooner than the negative effect of tariff elimination which will only be effected at the end of ten years. Businessmen will not wait until the FTA is completed but will react quickly to the announcement of an FTA. (See Yoo [2000].)

Concerning the Korean fear of being overwhelmed under free competition, given the size difference between Korea and Japan, more Japanese firms will survive the market competition, but it is too pessimistic to predict that Korean firms will survive only in primary and labor-intensive industries and be defeated by Japanese firms in the machinery, metal, and chemical industries. The prediction does not fit the current reality in which intra-industry specialization is in progress in the latter industries as well as the service industries between the two countries. It is more likely that both Korean and Japanese firms will survive the intensified competition and become globally competitive in those industries having intra-industry specialization.

The Korean concerns reflect the mistrust of Japan that still lingers among the Korean public, as well as the strong resistance to market opening among Korean businessmen. Japan is also not free of similar resistance from vested interest group, especially in the fishery, farming, and apparel businesses. A strong impediment to forming an FTA does not come from abroad but from vested interest groups at home. However, this suggests a strong case for an FTA. The resistance from vested interest groups at home tends to impede the move toward liberalization at the WTO and APEC. If we persuade them to accept an FTA, it will pave the way for a successful liberalization at APEC and the WTO. An FTA serves as a laboratory for liberalization which we stressed in our joint communiqué.

Concerning Korean preference for Korea-Japan-China cooperation, we would welcome extending a Japan-Korea FTA to tripartite cooperation with China, but

China seems to be fully occupied with joining the WTO at the moment and not ready to plan for an FTA.

At the Tokyo symposium, there was a change in a positive direction. All panelists agreed on the necessity of an FTA for Japan and Korea to meet the challenge of globalization and the following comments were added to the discussion at the Seoul symposium.

—A Japan-Korea FTA would contribute to the security of Northeast Asia.

—An FTA should pursue a broader economic partnership rather than just tariff reduction.

—Both sides should conduct a survey to designate areas for concrete cooperation such as information technology.

—Both sides need to change their conventional views about each other and foster mutual trust between the countries. The governments should take visible pre-FTA measures to encourage its formation. An increase in the number of flights between Narita and Seoul and shorter procedures for visa applications were suggested as concrete examples.[10]

Immediately before the Tokyo symposium, President Kim Dae Jung visited Japan again and reached agreement with Prime Minister Mori on the following.

—Further efforts for closer relations between Japan and Korea,

—Japanese food assistance to North Korea,

—An early conclusion to negotiations on the investment treaty,

—Promotion of cooperation in the IT sector.

They also agreed to set up a Japan-Korea Business Forum in order to promote private sector talks toward a Japan-Korea FTA.

In conclusion, closer Japan-Korea relations are needed for both to survive globalization. It should center on intra-industry specialization, and an FTA is the best framework for guiding market competition toward such specialization. The trade imbalance will be resolved over time, but Japan should try to mitigate Korean concerns about the trade deficit, competition with Japan, and their mistrust in Japan's markets and systems. The business forum to be set up shortly will provide an effective framework for discussing these measures and pave the way toward governmental negotiations.

VIII. A JAPAN-KOREA FTA IN THE ASIA PACIFIC CONTEXT

The proposal of the study group setup in December 1998 to examine the establishment of a Japan-Korea FTA drew keen interest, not only among Asia-Pacific countries such as the United States, Australia, and those in Southeast Asia, but also in

[10] The increase in the number of flights between Tokyo and Seoul by utilizing Haneda Airport for international flights is now being negotiated and will be settled in time for the World Soccer Games in 2002.

the EU. In the present globalizing environment, countries which are themselves involved in regional integration become more aware of other nations' moves. They naturally become concerned about how their own trade and investment might be affected by closer relations between major trading countries such as Japan and Korea, and worry that they may be subject to trade conversion effects or discrimination. We must respond not only to the interests and concerns of Japan and Korea, but also to those of third countries.

Japan and Korea are both leading members of the Asia-Pacific Economic Cooperation (APEC) forum. In the Bogor Declaration of 1994, APEC declared that it would liberalize trade and investment in the Asia-Pacific region by the years 2010 to 2020. It is currently implementing programs centered on two major themes. These are the liberalization/facilitation of trade investment and economic technical cooperation. A Japan-Korea FTA is expected to realize liberalization and facilitation earlier than planned in both countries, thereby helping APEC meet its goals. If realized, an FTA would become a powerful driving force in fulfilling APEC's vision. Moreover it would transcend the limits of APEC and contribute to realizing liberalization on a global scale.

At two APEC fora (APEC Study Center International Consortium that met in Brunei in May 2000 and the APEC Economic Outlook meeting in Manila in July) and on other international occasions, this author spoke to non-Japanese and non-Korean audience (politicians and government officials as well as academics and researchers) about a Japan-Korea FTA. They responded with the following concerns:

(a) a Japan-Korea FTA may cause diversion effects on the trade and investment of third countries,
(b) the promotion of a Japan-Korea FTA may delay WTO liberalization, and
(c) both a Japan-Korea FTA and tripartite cooperation including China may induce an inward-looking East Asian regionalism.

Regarding (a), trade-creation effects that derive solely from abolishing tariff/nontariff measures, as seen in Section VI, are only minimal. Also, trade-diversion effects, which reduce trade with third countries, emerge in association with trade-creation effects, but are also minor in nature. By comparison, the dynamic effects brought about through increased competition and corporate collaboration lead to trade-creation effects that far surpass the static effects. A Japan-Korea FTA would directly contribute to revitalizing the two economies and thus reinvigorating all economies in the Asia-Pacific region. The liberalization efforts of the two countries will be boosted along with strengthening their initiative to liberalize within the Asia-Pacific trade liberalization structure and the multilateral trading regime. In order to sooth the concerns (b) and (c), the two governments should make it clear that a Japan-Korea FTA would be consistent with GATT Article 24. They should also take parallel initiatives in APEC and WTO liberalization, and state clearly that

they will adhere to "open regionalism" no matter what form of regional cooperation they engage in.

It should be noted that both Korea and Japan are now discussing FTA with other partners—Korea with Chile, Israel, and New Zealand, and Japan with Singapore, Mexico, Chile, and Canada. It is likely that FTAs of other combinations, especially Korea-Chile and Japan-Singapore, will precede any Japan-Korea FTA. The same rationale for an FTA is shared by each of these FTA talks, but the cost of domestic adjustment will be much less in these combinations than that in a Japan-Korea FTA.

Although bilateral FTAs have proliferated since the late 1980s, both Japan and Korea are latecomers and neither has any FTA experience. Official negotiations on FTAs are in progress between Korea and Chile and between Japan and Singapore, which will serve as an experimental attempt in bilateral FTAs for Japan and Korea. An FTA requires the adjustment of domestic production and a wide set of individual arrangements at home. The Japan-Singapore FTA will be a "new age FTA" which will include not only the elimination of tariff and nontariff barriers in traditional conformance with GATT Article 24, but will also seek to promote investment and reach a mutual recognition agreement on rules and standards. It should also be equipped with effective rules of origin and safeguard measures. Since Singapore is not a big exporter of fishery and farm products, Japan will need to make much less adjustment in these sectors for an FTA with Singapore. This makes Singapore a most qualified partner for Japan to experiment with a new age FTA. An FTA with Korea will bring far heavier adjustment cost at home. Nevertheless, if Japan and Korea cannot overcome these impediments and agree on a FTA between the two, neither country will survive the challenge of globalization in the twenty-first century.

REFERENCES

Fukuchi, Takao; Yamane Keizo; Tang Guoxing; and Ren Zhao Zhang. 1997. "Shanhai · Chōkō ryūiki—Kobe · Hanshin kōeki sokushin purojekuto no keizai kōka" [Long-term effects of promotion project of economic tie between Shanghai-Changjiang-river area and Kobe-Kansai area]. *Chiikigaku kenkyū* (Tsukuba City) 27, no. 1: 1–13.

Institute of Developing Economies (IDE), Japan External Trade Organization. 2000. "Toward Closer Japan-Korea Economic Relations in the 21st Century," Full report (in Japanese) and Summary Report. Tokyo, May.

Korean Institute for Economics (KIE). 2000. "Korea-Japan FTA and Future of Korean Business." Seoul, September.

Korean Institute for International Economic Policy (KIEP). 2000. "Toward a Korea-Japan FTA: Assessment and Prospects." Seoul, May.

Okuda, Satoru. 2000. "How Can Korea Take Advantage of Changing Japanese Market?: An Application of Gravity Model and RCA Analysis." Presented at the APEC Study Center Japan Consortium Conference at Makuhari, December 16–17.

"Towards Closer Japan-Korea Economic Relations: Proposal for Formulating a 21st Century Partnership (Joint Communiqué)." 2000. Tokyo and Seoul: Institute of Developing Economies, Japan External Trade Organization and Korea Institute for International Economic Policy, May 23.

Yoo, Jang-Hee. 2000. "Economic Cooperation in the Northeast Asia and the Korea-Japan Bilateral Relations." Seoul, October.