

**Joint Research Report and Policy Recommendations on  
a Free Trade Agreement between China, Japan and Korea:**

**Phase II:  
Road to Recovery of Regional Trade and Trade Facilitation in the CJKFTA**

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**Trilateral Joint Research**

**by**

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# Executive Summary

## Contents of the Joint Research

### *What are the issues?*

This report presents results of the Trilateral Joint Research by the Representing Research Institutions in China, Japan and Korea on a FTA between the three countries. The Action Plan for Promoting Trilateral Cooperation among China, Japan and Korea decided in the Trilateral Summit in December 2008, includes a clause titled Joint Studies on the Trilateral FTA, stating that Joint Studies started in 2003 will reach the conclusion phase in year 2008, and further in-depth studies will begin in 2009 by the three institutions. Under the plan, we have jointly started the phase two study on a CJK FTA this year.

In embarking upon the new phase, we have identified the assessment of the impacts of the recent Global Economic Crisis on trade in Northeast Asia as an important issue of research. As indicated above, the crisis has significant implications on the economies and trade in the region both in the short- and long-run. The trend of the regional trade patterns and the policy demands for intensifying intra-regional trade is a fundamental issue for considering a CJK FTA

The joint research teams have selected trade facilitation, as another research issue on a CJK FTA. From 2003 to 2008, the joint research on a CJK FTA in the first phase covered almost all the important issues on FTAs, other than trade facilitation (see Appendix). Trade facilitation in regional trade agreements is a comparatively new issue, and has increasingly drawn attention of the policy makers in trade and investment. Naturally, a prospective CJK FTA will have characteristics of a regional agreement, which will place a focus on both cooperation and liberalization aspects. The review and study on trade facilitation measures in a FTA will address the issues.

### *Global Economic Crisis and a CJK FTA*

China, Japan and Korea have suffered from the global financial crisis. Although most recently their economy and trade began to show some signs of recovery, their production and trade volumes still remain markedly below the pre-crisis levels. Moreover, since it is expected that the recovery will be slower in the economies of the United States and the EU, the difficulties that the three countries are facing in their trade are likely to last for a while.

As a long-run trend, the intra-regional trade between China, Japan and Korea has become truly important for the trade of China, Japan and Korea. In particular, in terms of import, the intra-regional share has become the predominant factor for all three countries, while the relative importance of the United States and the EU as importing sources has significantly weakened. Even in terms of export, the intra-regional market is by far the most important for Korea, and has become the most important for Japan surpassing the United States. However, China is an exception. For China, the United States and the EU have become the most important export destinations ahead of the intra-regional market.

The global economic crisis brought about the macroeconomic multiplier effects in the trade of the region. First, due to the crisis, exports from all the three countries to the United States and EU declined sharply. This led to the reduction in macroeconomic production in the three countries, bringing about a contraction of their import demand. A decline in the intra-regional trade emerged. The share of intra-regional trade in each country reflected differences in damage incurred and the timing of respective recoveries. In addition, international input-output relations, analyzed below, may have also affected the outcome.

Considering the effects of the global financial crisis in terms of the broad economic categories of Chinese, Japanese and Korean exports, one notes that China suffered only moderately from the decline in exports of consumption goods to Japan and Korea, whose share actually increased in the first two quarters of 2009. Major damage in China's intra-regional exports came from the reduction in the exports of semi-finished goods to Japan and Korea. Japan and Korea maintained the high shares of intermediate goods exports in the intra-regional trade. This means that the exports of intermediate goods from Japan and Korea to China declined in proportion to other commodities. We may observe the input-output effects, by which the reduction in the export of final goods from the region led to the shrinkage of the production, bringing about the reduction of intra-regional trade of intermediate goods.

#### *Trade Facilitation and a CJK FTA*

For these two decades, a new trend in the strategy to liberalize international trade has appeared among the policy-makers as an emerging consensus: to revisit the role of trade facilitation and to use such facilitation more actively as one of the major vehicles to promote trade. Trade facilitation in the new context covers much wider areas of trade policies than ever, not limited to customs procedures. One of the notable examples in East Asia is the APEC, which regards trade facilitation as one of two pillars for promoting trade in the region. The other example is the WTO Doha round, which assigned an important role to trade facilitation. Furthermore, recent RTAs tend to include a wider scope for trade facilitation.

The emergence of the new trend had two backgrounds. One is that the traditional tools of trade liberalization, namely tariffication and tariff cuts, whose levels were already lowered, saw a reduction in their capacity to reduce trade costs. The other is that new border management institutions and technologies attracted more attention in the promotion of international trade.

It was natural development that the proliferated RTAs also put a focus on the trade facilitation agreements. Some more recent agreements specifically include standards, technical regulations, conformity assessment procedures, and sanitary and phytosanitary (SPS) measures. The more recent agreements generally tend to cover more. Such expanded coverage includes service trade, modern customs management procedures, the adoption of international standards, and more formal and institutional mechanisms of cooperation. In addition, some bilateral/regional agreements include infrastructure development and cooperation, which cannot be covered by the multilateral trade negotiations by their nature. The wider and comprehensive coverage of the recent regional agreements provides an important lesson to the CJKFTA, in particular in the clauses of non-conventional, non-customs-related types. Also, infrastructure development and cooperation is region-specific and important for the trade between the three countries.

Non-binding agreements like APEC have gone much further in promoting trade facilitation reform than binding agreements. Also, the trade facilitation in some FTAs takes the shape of cooperation. The broad perception behind such cooperation is that it generates positive externalities and economies of scale. The trade facilitation measures that create positive externalities take stronger characteristics of international /regional cooperation, as well as trade liberalization.

Researchers suggest that there are two economic effects of trade facilitation: static or efficiency gains, and the impacts coming from imperfect competition with positive externalities and economies of scale. Empirical studies suggest the unexpectedly large economic benefits from trade facilitation measures.

Trade facilitation will bring about economies of scale and the creation of positive externalities. Often, this can be most efficiently made *regionally* and through *cooperation*. While global provisions facilitating trade are ideal, the complexity of interests and existing localization may prevent them from being realistic. Cooperation within a regional framework would be more pragmatic. In some cases, the optimal coverage should be confined to smaller groups of countries, i.e. regions. Regional agreements in East Asia could have a much more active role in implementation, e.g. through mutual recognition, harmonization of standards and assistance, eventually the sharing of resources and joint efforts to improve the trade supply chain.

In many cases, the FTAs appear to be the most suitable mechanism to achieve the benefits of trade

facilitation in a region. Multilateral arrangement can also contribute to the delivery of the benefit of trade facilitation, and the solution may be optimal. But, as discussed above, the global agreement may take much longer to negotiate, and there may be much more complex conflicts/difference of interest among the members. In many cases, the majority of benefits from trade facilitation remain within the region with large trade partners. Mutual recognition sometimes has this nature. Technical standards can be also harmonized most efficiently in a region.

## **Policy Recommendations**

### *Progressing Region-wide Liberalization Initiatives*

It would be worthwhile here to touch briefly on the present status of East Asian-wide trade liberalization initiatives, which have an important implication in the economic, political and diplomatic context with the CJK FTA. In East Asia, ASEAN tended to precede China, Japan or Korea in forming FTAs. As repeatedly pointed out, the trade liberalization initiatives between the three countries lag behind ASEAN. Three “ASEAN plus one” FTAs have been already formed. Two research studies on region-wide FTA, namely an East Asia Free Trade Agreement (EAFTA) among ASEAN+3 countries and a Comprehensive Economic Partnership for East Asia (CEPEA) among ASEAN+6 countries, have been finished and their final reports have been submitted to the AEM+3 Consultation and AEM+6 Working Lunch on August 15, 2009. On both occasions, the Ministers agreed to recommendations in the EAFTA and CEPEA Study and decided to establish four working groups and commence governmental discussions on rules of origin, tariff nomenclature, customs-related issues, and economic cooperation.

China, Japan and Korea, take dominant shares in East Asia, in terms of economic magnitude, population, and trade and investment. Huge amounts of direct investment have flowed from Japan and Korea toward ASEAN, as well as toward China. With the accumulation of external production assets, huge production networks have been established in East Asia. The networks in East Asia, however, will not work efficiently under the limited framework of “ASEAN plus ones”. Even at present, dominant share of trade and investment flows in the region are among China, Japan and Korea. The optimal formation of production network will be only possible when an FTA is achieved among China, Japan and Korea. With this background, it is concerned that the trade liberalization initiative among the three countries lags behind any other region-wide initiatives in East Asia

It also deserves referring to the CJK Trilateral Investment Treaty, which is under negotiation. The free trade and investment are complementary to each other. In the region, once CJK FTA and CJK Investment Treaty are both established in place, the two agreements are expected to significantly make

a solid foundation of economic growth and prosperity in the region.

### *Policy Recommendations*

#### *Recommendation 1: To Share the Common Policy Direction toward Further Liberalizing Regional Trade*

The intra-regional trade has become the crucial element for China, Japan and Korea. As seen in the analytical part of this report above, the trade structure of the three countries at present has fragility to depend excessively on the final demand of the United States and Europe. Although most recently their economy and trade began to show signs of recovery, their production and trade volumes still remain markedly below the pre-crisis levels. Moreover, since it is expected that the recovery will be slower in the economies of the US and the EU, the difficulties that the three countries are facing in their trade are likely to last for a while. To compensate for the slowing demand in the US and the EU, a larger regional market will be needed. This is also desirable in the longer-term with shrinking global imbalances.

Ensuring a liberalized environment is one of the essential factors to expedite the economic recovery and sustain the economic growth in the region. A CJK FTA creating a larger market will certainly boost further the already-important intra-regional trade and investment, and raise efficiencies of their economies. The research teams recommend that the three countries should share the common policy direction toward further liberalizing regional trade policies. A CJK FTA will be an essential component to pursue the policy direction.

#### *Recommendation 2: To Take Advantage of Trade Facilitation in a CJK FTA.*

Trade facilitation has drawn increasing attention as an effective tool to reduce trade costs. The recent FTAs in the world tend to include trade facilitation measures with wider coverage. Trade facilitation has characteristics of international cooperation, as well as trade concession. Some of the trade facilitation measures, such as harmonizing various trade-related procedures and standards, have a nature of economies of scale and positive externality. A CJK FTA will provide a good opportunity to materialize such benefits. Empirical studies found that some trade facilitation measures would create large economic benefits to all the parties.

The research teams recommend that a CJK FTA should take advantage of trade facilitation. A recommendable approach is “step-by-step”. The initial agreement of the CJK FTA would better include some effective trade facilitation measures, limited to cross-border issues. But others may be

negotiated and implemented afterward as the matters of regional cooperation. To ensure that the approach functions properly, it is recommended that the initial agreement of the CJK FTA also stipulate institutional set-ups, such as periodical meetings, to review and negotiate the trade facilitation measures in the future.

*Recommendation 3: To Upgrade Joint Research on the CJK FTA by Commencing Discussion among Three Government Officials*

The joint research teams reaffirm the importance of a regional FTA among China, Japan and Korea. In the future, the CJKFTA would ensure the liberalized trade environment in the region. The liberalized environment will greatly contribute to ensuring the economic recovery in East Asia, as well as developing a strong source of macroeconomic final demand in the region. With this understanding, the joint research teams recommend the leaders and governments of the three countries to support the formation of the CJK FTA.

In particular, it is recommended that discussion on the CJK FTA should be commenced among three government officials, by reforming the present mechanism to official discussion in government level from the next year. This will enable to start the discussion on a CJK FTA among the government officials, in addition to business and academia participants.

*Recommendation 4: To Maintain and Further Utilize the Existing Mechanism of Academic Trilateral Joint Research.*

The CJK Trilateral Joint Research started in 2001. The current mechanism enabled the joint research teams to conduct independent economic research on important trade and investment issues in the region. The present mechanism will be able to continue to serve the CJK leaders meeting to identify and review important issues in the region in the future. In addition to the above recommendation of upgrading the joint research on CJK FTA to government level, we recommend that the leaders and governments of the three countries maintain and further utilize the existing mechanism of academic trilateral joint research, aside from the separated and upgraded government level trilateral joint research on a CJK FTA.