

Role of South Korea-Japan FTA in Deepening Asian Economic Cooperation

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1. Asian Economic Cooperation & S. Korea-Japan FTA

Economic cooperative initiatives among Asian countries have substantially increased since the late 1990s, particularly after the Asian financial crisis in 1997-1998. The ASEAN + 3 meeting of 1997 was the first in history to gather the heads of state or government from China, Japan and South Korea as well as the 10 ASEAN countries. In May 2000, an ASEAN + 3 meeting produced the Chiang Mai Initiative, which was the first kind of a regional financial cooperative scheme in Asia.

A more prominent development has been achieved in terms of trade arrangements. China concluded a framework agreement on free trade with ASEAN in November 2002. The FTA covering goods entered into force in July 2005 and that for services in July 2007, although not all ASEAN countries joined the agreements. Japan also concluded FTAs with some of the ASEAN countries such as the Philippines, Malaysia and Singapore. South Korea also concluded a framework agreement with ASEAN in December 2005. The FTA for commodities between South Korea and ASEAN (except Thailand) entered into force in June 2007.

In some sense, China, Japan and South Korea have all competed in the race for FTAs in the region. But, in the middle of 2008, Japan and South Korea reopened talks between themselves to examine whether they will be able to resume the FTA negotiations that have been suspended since November 2004. Right after the Beijing Olympics, Chinese Prime Minister Hu Jintao and South Korean President Lee Myung Bak agreed to establish an FTA as early as possible. Economic cooperative initiatives or even FTAs involving India, Australia and New Zealand are also very active.

For all these efforts, the South Korea-Japan FTA would have a significant meaning since it would substantially change the dynamics of FTA competition in Asia. The South Korea-Japan FTA is an agreement between the two most advanced economies in Asia. Unlike FTAs involving less developed countries, Japan and South Korea share many similar economic structures and stand out as the only two member countries in Asia of the Organization for Economic Cooperation and Development (OECD). This similarity in economic situations would inevitably lead both countries to make their FTA comprehensive in scope, not simply a tariff-reducing arrangement.

Therefore, the content and structure of the South Korea-Japan FTA will become an important precedent of economic cooperative arrangement for many other countries. FTAs in which developing countries are main players have typically been low-level economic cooperation arrangements that primarily focus on tariff reduction, leaving aside many other issues such as, *inter alia*, investment, competition, government procurement, services trade and intellectual property. In that

sense, FTAs involving ASEAN, China and India tend to follow this trend. If Japan and South Korea reach an FTA that addresses a wide variety of nontariff issues, it may have an important precedent impact for subsequent FTAs seeking to counter the South Korea-Japan FTA.

Secondly, potential complementarity between industries of Japan and South Korea may cause considerable trade diversion for other regional countries. In addition, more foreign direct investment between them, if carried out, would bring about various industry concerns for other countries in which foreign direct investment might be replaced or relocated. These adverse economic effects for other regional economies may cause a chain reaction to pursue reactive FTAs to minimize trade and investment diversion.

2. Issues for a S. Korea-Japan FTA

The first formal round of negotiations over the proposed South Korea-Japan FTA took place in December 2003. For South Korea, the FTA with Japan was the most meticulously prepared trade agenda. The business communities of both countries urged their governments to consider concluding an FTA. This proposal was accepted by the governments that spent 15 months for joint study by both countries' delegations composed of scholars, business representatives and government officials. Pursuant to recommendations of the joint study group, the South Korea-Japan FTA negotiations were officially launched December 22, 2003.

Despite such preparatory efforts, the formal initiation of FTA negotiations raised a number of seemingly insurmountable issues ranging from nontariff barriers to overseas processing activities using North Korean territory. The South Korean government became very defensive mainly because South Korea had scored tremendous trade deficits with Japan. In fact, South Korea's cumulative trade deficit with Japan of the past decade exceeded \$200 billion. In 2008, the bilateral trade deficit is estimated to reach \$30 billion. Regardless of economic validity of the concerns over the deficit, the South Korean government was heavily pressured to address this issue.

That situation made the whole negotiations very difficult. FTA negotiations are basically to facilitate more trade, not necessarily to balance trade accounts. But, when market access negotiations began, the South Korean government was very keen to balance trade interests or benefits. Therefore, the requests of the South Korean government aiming to alleviate the chronic trade deficit problem turned out to be very difficult for the Japanese government to accept or accommodate. Simply put, merely eliminating tariffs will not address that concern.

Also, the timing of the FTA negotiations in South Korea was not favorable either. For South Korea, the FTA negotiations followed right after conclusion of an FTA with Chile, which was the first free trade agreement in its history. The South Korea-Chile FTA already provoked

TABLE
South Korea's FTA situations

Completed	Chile	4/2004	Entry into force
	Singapore	3/2006	Entry into force
	EFTA	9/2006	Entry into force
	ASEAN	6/2007	FTA on goods enters into force
		11/2007	FTA on service signed
	United States	6/2007	Signed
In progress	Canada	3/2008	13th round negotiations
	ASEAN	1/2008	21st round negotiations
	India	12/2007	9th round negotiations
	Mexico	12/2007	1st round negotiations
	Japan		Suspended
	European Union	5/2008	7th round negotiations
In preparation	GCC		
	China	2/2008	4th jointly study group meeting
	MERCOSUR		
In consideration	Australia, New Zealand, Peru, Korea-China-Japan		

Source : Compiled by author

the country substantially due to agricultural market liberalization included in the FTA, although the absolute magnitude of agricultural importation from Chile was not large. But, unlike Chile, Japan is one of the largest – probably the most difficult – trade partners that has a huge industry base to compete with most of the manufacturing sector in South Korea. Such fear and concern for market liberalization, combined with an anti-globalization sentiment, crystallized into South Korean opposition of the FTA with Japan.

Furthermore, the political atmosphere of both countries was hostile. Then President Roh Moo Hyun devoted himself to closer ties with North Korea and took very seriously the offshore processing arrangement using the Kaesung Industrial Complex in the North. The South Korean government strongly insisted on including products manufactured in Kaesung within the scope of the South Korea-Japan FTA. At that time, however, the Japanese government had a serious diplomatic conflict with North Korea with respect to Japanese people kidnapped by North Korean agents. The inclusion of products made in the North Korean territory within the South Korea-Japan FTA was clearly an unthinkable option.

Those problems, among others, appeared already serious enough to scare away negotiators from both governments. In fact, after the sixth round of negotiations held November 1, 2004, the South Korean government suspended the negotiations, blaming the poor effort of the Japanese government to open its agricultural market. Behind the agricultural issue, however, there were many more serious conflicts and difficult issues to be resolved.

3. Prospects & Problems in Changed Circumstances

After the heads of government changed in both countries, Japan and South Korea tried to re-stabilize the diplomatic relationship that had been unprecedentedly harmed. Conceivably, strengthening economic coalition has been raised as a solution to remedy the diplomatic and political animosity between the two countries. The best

option appeared to be to resume the suspended FTA negotiations. On June 25, 2008, both governments met after a dormant period of more than three and a half years to examine whether they would be able to officially resume the FTA negotiations. The friendly mood of both governments toward a closer relationship under the new leaderships seemed to be able to achieve more economically beneficial accomplishment. This was of course until Japanese middle school textbooks taking up a disputed island again disrupted the whole prospect of the FTA and relieved government officers of both countries of painstaking work to calculate national interests and negotiation strategies.

Currently, the chance is very slim. The South Korean government is in a very difficult situation to restart the FTA negotiations with Japan. The Japanese government seems to be in a more difficult situation to reopen the FTA negotiations. Therefore, the dormant period for the South Korea-Japan FTA may become much longer than it is hoped. However, if the negotiations themselves can be resumed, the whole negotiating process might be completed without much controversy for the following reasons.

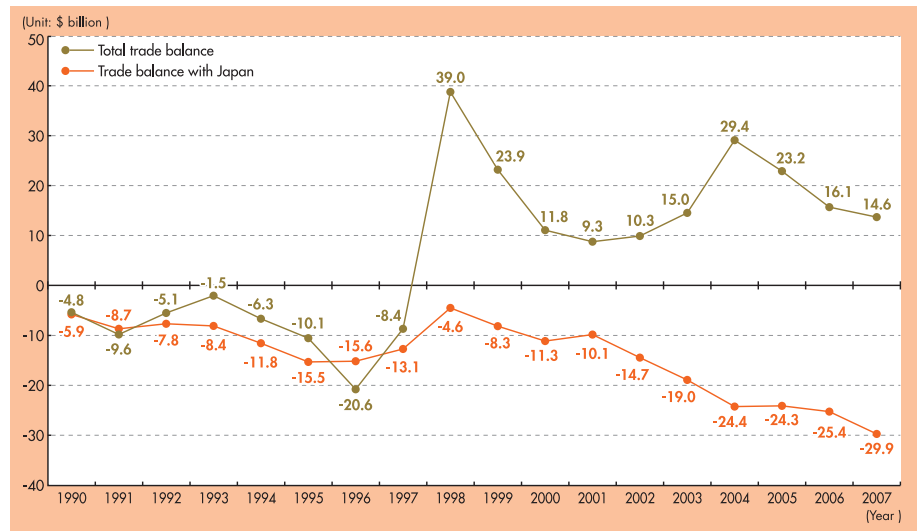
Firstly, the South Korean domestic manufacturing sector that was the key opposing force would become more flexible in embracing market liberalization with Japan. South Korea already concluded an FTA with the United States and is about to finish an FTA with the European Union. Given the rapid pace of trade liberalization with other countries, the arguments against the FTA with Japan, even in the automobile sector, have been substantially undermined.

Secondly, the South Korean government introduced a trade adjustment assistance (TAA) system in 2007, guaranteeing certain short-term readjustment needs for adversely affected industries. Although the system entered into force during the South Korea-US FTA negotiations, the need to introduce it as part of the South Korea-Japan FTA was actually discussed. In any case, the TAA system should alleviate the concern of many parts of the manufacturing sector in South Korea with respect to the FTA with Japan.

Thirdly, mutual gains from trade liberalization in the agricultural

CHART

South Korea's trade balance with Japan/rest of the world



Source : Korea International Trade AssociationKorea International Trade Association

sector seem to be vastly increased. The South Korean government has adopted many advanced agricultural production and distribution systems, including better quarantine procedures and producer-recording systems. Therefore, greater market access to South Korean agricultural products would be better for the Japanese market, which occasionally suffers from cheap but less safe products of other developing countries. Moreover, much increased interest of South Korean consumers in food safety, particularly after the recent domestic mad cow disease scandal, would substantially increase export possibility for Japanese farmers who produce safe, higher-quality products. So, a seemingly win-lose situation for agricultural trade between Japan and South Korea can easily translate into a win-win situation for both countries' farmers and consumers.

Fourthly, the South Korean government has accumulated quite a lot of experience in FTA negotiations while dealing with countries such as India, Mexico, Canada, the United States and the European Union. Moreover, it should also prepare FTAs with other major countries such as China and member countries of the GCC and MERCOSUR groups. So, negotiations with Japan on many nontariff issues, including investment, competition, intellectual property, services trade, technical barriers to trade and government procurement, would be much more rational, at least compared to the negotiations before they were suspended.

Fifthly, the Kaesung Industrial Complex issue may be resolved by modeling it after the arrangement under the South Korea-US FTA. In this FTA, it was agreed to establish a "Committee on Outward Processing Zones on the Korean Peninsula." That committee would designate under certain conditions "outward processing zones" that are not confined to the Kaesung Industrial Complex. In case some products are produced in the designated outward processing zones, they are treated equally like products produced in other areas of (South) Korea. It is indeed different from South Korea's previous FTA arrangements such as those with EFTA, ASEAN and Singapore that categorically include products from the Kaesung Industrial Complex within the FTA scope.

The arrangement in the South Korea-US FTA may be an effective starting point to address probably the most politically controversial issue in the South Korea-Japan FTA. Instead of completely ignoring the economic reality between the two Koreas or instigating too much domestic political resistance by wholly embracing trade with North Korea in the South Korea-Japan FTA, the establishment of the committee whose function remains contingent on the future development of economic, political and diplomatic relationships may be a better solution.

Lastly, Japan and South Korea are currently the two leading WTO members in the process of rules negotiations in the Doha Round sponsored by the WTO. In particular, the two countries have actively cooperated in raising various proposals to amend the current trade remedy systems in the WTO, most notably the antidumping system. In fact, South Korea adopted several new trade remedy rules, often suggested in the Doha negotiations, in their recent FTAs. If Japan and South Korea adopt new trade remedy systems, that will be a critically important precedent in terms of rule making in the WTO system.

4. Conclusion

The importance of and the need for closer economic cooperation among Asian countries have continued to grow notably since the middle of the 1990s. The South Korea-Japan FTA will certainly facilitate this initiative by inducing other countries in the region to act or react to trade and investment diversion. Whether the South Korea-Japan FTA will be able to step up the level of regional economic integration by setting up the example that broadens and deepens economic partnership now depends on how the two governments can navigate through the turbulent current of political oceans. **JS**

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