

## Free Trade Agreements and Korea's Trade Policy

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*This paper examines Korea's reaction to the proliferation of regionalism in the world and provides an evaluation of Korea's free trade agreement (FTA) policy. Korea's approach of starting FTAs with smaller countries reduces the potential gains from FTAs; instead priority should be placed on forming FTAs with larger trading countries. The slow pace of establishing FTAs will ultimately be a disadvantage for Korea, positioning it as a late entrant to FTAs. This paper recommends that Korea promptly ratify its FTA negotiations with Chile and expedite negotiations on further FTAs with other countries. However, Korea and its trading partners must also recognize that FTAs are second best options and must not allow regionalism undermine the importance and the success of the Doha Development Agenda.*

**Keywords:** *Regionalism, Free Trade Agreement, Economic Integration, Trade Policy, Liberalization, Trade Negotiation, Multilateral Trade System*

### 1. INTRODUCTION

Korea has traditionally given higher priority to multilateral trade negotiations under the GATT/WTO global trading system. In fact, until the 1990s Korea had little reason to even consider regional agreements because its multilateral policies produced rapid trade expansion. Korea's largest trading partner, the United States, was not a proponent of regionalism until the 1980s and Korea's neighbors did not show much interest in regional trade agreements. Moreover, despite the regional character of APEC, including Korea, the U.S. and Asia-Pacific nations among its members, it has served as more of a forum than a trade agreement.

In the 1990s, the world experienced a sudden increase in regionalism – a trend that has continued into the 21<sup>st</sup> century. All but a few countries are members of regional trade agreements and, correspondingly, exceptions to basic multilateral rules of the WTO have evolved into the norm in global trade. To cope with the proliferation of regionalism, Korean policymakers have revised their indifferent approach to regional trading blocs and, in 1998, initiated discussions on the formation of FTAs. Subsequent to these changes in attitudes, Korea signed its first FTA--the Korea-Chile FTA--in February 2003. Moreover, the President of Korea, Roh Moo-Hyun, and the Prime Minister of Japan, Junichiro Koizumi, agreed to start government negotiations for a Korea-Japan FTA by the end of 2003. Negotiations for an FTA with Singapore are also being prepared for early 2004.<sup>1</sup> Other countries in Asia are progressively moving toward regionalism as well. ASEAN countries signed an agreement for the Asian Free Trade Area (AFTA) in 1992. At the meeting of ASEAN+3 in 2003, the ASEAN countries agreed to enhance the AFTA to an economic union like EU by 2010.

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<sup>1</sup> Joint Statement on the Results of the Summit Meeting between President Roh Moo-Hyun and Prime Minister Goh Chok Tong (October 23 2003).

Japan signed the Japan-Singapore Economic Partnership Agreement in 2002 and negotiated with Mexico to create an FTA. China and ASEAN signed a framework for establishing a Free Trade Area in 2002. India has also revealed interest in establishing a regional trade arrangement with ASEAN.

Five years have passed since the Korean government decided to form FTAs. At this juncture, assessment of the direction of Korea's policy and the performance of FTAs is necessary to set guidelines for future trade policies between Korea and its trading partners. Bhagwati (1992) argues that regional trade agreements increase costs due to meeting the requirements of rules of origin and observing complicated standards and procedures. Summers (1991) views that trade liberalization is trade liberalization, no matter what the route is. Cheong (2001) estimates that Korea-Japan FTA would increase GDP of Korea by 0.22-0.30 percentage points in the short run and 0.82-1.90 percentage points in the mid-to long term. Cheong and Lee (2000) estimate that the Korea-Chile FTA would also produce welfare gains for Korea. However, careful interpretation of the studies is needed. As Krueger (1999) points out, the outcome of studies on FTAs that are based on simulations using computable general equilibrium models depend on the way in which the system is modeled. For example, if the model assumes imperfect competition before an FTA and that competition increases after the FTA, the result of the simulation naturally reflects a gain in efficiency. Therefore, for an objective assessment, empirical examination is necessary when sufficient data are accumulated.

This paper reviews Korea's trade policy and FTA performance. It examines the government policies on FTAs and its implementation processes. It provides a descriptive analysis on the nature and scope of Korea's FTA and its relation with APEC and the multilateral trading system. Section 2 outlines Korea's trade history before the 1990s and the proliferation of regionalism, focusing on Korea's ties with the multilateral trading system and APEC. Section 3 describes the spread of regionalism in the world and its impact on Korea. Section 4 evaluates the progress of Korea's FTAs. Section 5 provides an evaluation of Korea's trade policy and its performance. The final section summarizes the paper's main findings and suggests policy prescriptions.

## 2. KOREA'S RELATIONS WITH THE WTO AND APEC

Trade expansion was an important factor behind the economic growth of Korea. During the period between 1970 and 2002, Korea's trade volume had increased by 17.2 percent annually, thereby driving the growth of the Korean economy (Table 1). Korea's trade grew much faster compared to world trade which showed a smaller annual growth of 10.5 percent during the past three decades.

**Table 1.** Korea's Economic Growth and Trade Expansion

	(US billion \$)		
	Korea's GDP	Korea's Trade Volume	World Trade Volume
1970	8.0	2.8	618.7
2001	427.3	290.9	12,596.3
Average Annual % Change	7.1 (%)	17.2 (%)	10.5 (%)

Source: Bank of Korea (2003a) and WTO (2002)

Trade expansion was achieved through the GATT global trading system and later through the WTO. Korea acceded to the GATT in 1967 and has fully utilized the multilateral trading system since then. Korea's outward-looking development strategy was well compatible with the liberalized world trading environment created by the GATT. Korea, in particular, benefited from the Generalized System of Preference (GSP) provided to developing countries under the GATT system. It also met its obligations and commitments to multilateral rules by participating in GATT's multilateral trade negotiations, including the Tokyo and Uruguay Rounds. After the WTO's inception in 1995, the Korean government, in cooperation with its trading partners, concluded agreements on trade in information technology products, financial services and basic telecommunications services. The Korean government participated in the Doha Development Agenda negotiations with the belief that launching a comprehensive round as early as possible was essential to the strengthening of the multilateral trade system. It is certain that Korea, with the 13th largest trade volume in the world, is a major beneficiary of the world trading system.

As a result, Korea did not show keen interest in regional economic integration. Another reason for this avoidance was because it was difficult to form strong economic integration in East Asia. The level of economic development was and still remains quite different among the countries in the region (Table 2). The per capita GNI of Japan was roughly five times that of Korea, and Korea's GNI was about five times that of China in 1980. Furthermore, the economic systems found in East Asia differed greatly – while Japan and Korea had market economies, China had a socialist economy. For Asian countries, the memory of Japanese occupation prior to 1945 was such a sensitive issue that it developed into a barrier to forming economic unions with Japan. Most significantly, however, the need or utility of regional economic integration was not as significant for Korea anyway, as its trade grew rapidly under the GATT, especially under the GSP.

**Table 2.** Comparison of Per Capita GNI in East Asian Countries

	(US\$)	
	1980	2002
Korea	1,598	10,013
Japan	9,257	31,868
China	307	970
Taiwan	2,344	12,900
Singapore	4,653	20,613

Source: Bank of Korea (2003b), *Monthly Statistical Bulletin*

During Korea's developmental stage, the U.S. and Japan were its only major trading partners: in 1970, almost half of Korean exports went to the U.S. (Table 3-1) and about 41 percent of its imports came from Japan (Table 3-2). A free trade agreement with the U.S. would have increased exports but was certainly not necessary because Korea already had an advantage in the U.S. market under its GSP status that lasted until 1989. A free trade agreement with Japan was not an option either because Korea had an import diversification policy aimed at discouraging imports from Japan.

**Table 3-1.** Korea's Export by Trading Partners

(% Share)

	1970		2002	
1	U.S.A.	47.3	U.S.A.	20.0
2	Japan	28.1	China	14.6
3	Hong Kong	3.3	Japan	9.3
4	Germany	3.2	Hong Kong	6.2
5	Canada	2.3	Taiwan	4.1
6	Netherlands	1.7	Germany	2.6
7	U.K.	1.6	U.K.	2.6
8	Singapore	0.9	Singapore	2.5
9	Taiwan	0.9	Malaysia	2.0
10	Thailand	0.6	Indonesia	1.9

Source: Korea International Trade Association, *Korea Trade Information Service***Table 3-2.** Korea's Import by Trading Partners

(% Share)

	1970		2002	
1	Japan	40.8	Japan	19.6
2	U.S.A.	29.5	U.S.A.	15.1
3	Germany	3.4	China	11.4
4	Malaysia	2.9	Saudi Arabia	5.0
5	France	2.6	Australia	3.9
6	Saudi Arabia	1.9	Germany	3.6
7	Taiwan	1.7	Taiwan	3.2
8	U.K.	1.7	Indonesia	3.1
9	Netherlands	1.2	U.A.E.	2.8
10	Canada	1.2	Malaysia	2.7

Source: Korea International Trade Association, *Korea Trade Information Service*

For these reasons, instead of pursuing a regional trade agreement or a strong form of economic integration, Korea has opted for participation in inchoate and informal regional economic cooperation bodies, such as APEC. APEC is commonly regarded as a regional 'forum' for trade and investment liberalization, business facilitation and economic and technical cooperation rather than a regional trade agreement due to the fact that it does not require binding obligations for trade or investment liberalization. It is non-exclusive and, hence, reductions in barriers achieved through APEC are available to non-member economies.<sup>2</sup> Korea is one of the 12 founding members of APEC, which launched its first ministerial meeting in Canberra, Australia in 1989. APEC leaders adopted the *Bogor Goals* in 1994 to achieve free and open trade and investment in the Asia-Pacific by 2010 for

<sup>2</sup> This feature is often referred to as "open regionalism" of APEC.

industrialized countries and by 2020 for developing countries. In addition, members have agreed to achieve the *Bogor Goals* via Individual Action Plans and Collective Action Plans.

Korea contributed to APEC by hosting the *APEC Investment Mart* and has worked with other member economies to encourage active investment flows within the region. Korea also hosted the *APEC Seoul Forum* to address issues regarding national and international economic disparity. *The Seoul Declaration*, adopted at the 1991 APEC Ministers' Meeting, set the general objectives and principles of the organization. The declaration is significant as it is the first official document that prescribes the association's principles, objectives, scope of activities, modes of operation and defines a set of principles and norms of the regional institution regarding open regionalism.

### 3. RECENT TRENDS IN REGIONAL ECONOMIC INTEGRATION AND THE KOREAN PERSPECTIVE

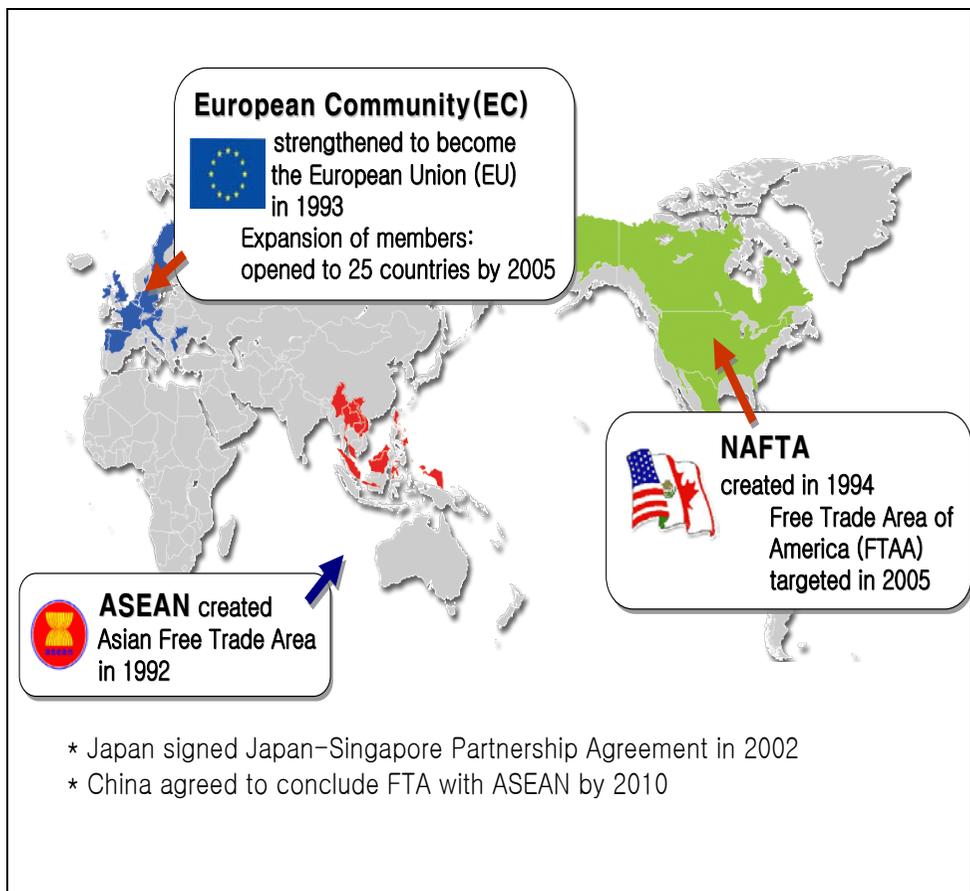
The WTO global trading system, from which Korea benefited, has recently met new challenges. There has been a surge in regional trade agreements (RTAs) since the early 1990s. The number of RTAs in the world was 127 in 1994 but more than doubled by 2003. The WTO estimates that it will increase to 300 by 2005 (WTO 2003). The rising regionalism has taken several forms including: the emergence of new RTAs, new links between existing RTAs and strengthening of existing RTAs. Many industrial and developing countries in the world have adopted regionalism and are members of one or more regional integration agreements.

The EU enjoys the longest history of post-WWII regional economic integration. It began with three economic communities in the 1950s, moving onto become a customs union in the 1960s and a common market in the 1970s. In 1993, the European Community raised the level of economic integration from that of the common market to an economic union (Figure 1). The EU utilizes regionalism extensively by maintaining a diverse and complex relationship with other forms of regional integration. The tendency of rising regionalism in the world is partly due to the influence of regional agreements most of which the EU has been involved in. Recently, the EU decided to expand its membership from the present 15 to 25 by 2005.

An important policy shift from the viewpoint of Korea occurred when the United States, a country that long opposed regional trade agreements, departed from its conventional multilateral disposition and extended unilateral trade preferences to the Caribbean countries under *Caribbean Basin Initiative* in the early 1980s. A free trade agreement with Israel followed in 1985. Then, in 1986, the U.S. and Canada began talks that led to the Canada-U.S. Free Trade Agreement. Negotiations for extending the Agreement to Mexico began a few years later and the North American Free Trade Agreement (NAFTA) was concluded in 1992, becoming effective in 1994. The U.S. recently revealed plans to form a Free Trade Area of the Americas (FTAA) encompassing both North and South American countries by 2005. The adoption of regionalism by the U.S. has had a direct effect on global trade patterns. NAFTA expanded the share of intra-regional trade to total trade in North America increasing from 38.5 percent in 1990 to 47.5 percent in 2001. The NAFTA also had an indirect impact on trading partners outside the region through trade diversion. Comparing the performance of Korea with Mexico in the U.S. market, notable differences are found in Figure 2. Mexico's market share in the U.S. jumped to 11.6 percent in 2002 from 6.1 percent in 1990, while the market share of Korean products in the U.S. market fell to 3.1 percent from 3.7 percent

during the same period. The evidence produced by Kreinin and Plummer(2000) supports the view that NAFTA had a trade diversion effect on Korea's trade with North America. The combined effect of trade creation and trade diversion can be found in the change in total trade volume of Mexico. Mexico had a share of 1.19 percent in world trade in 1990, and its share increased to 2.73 percent in 2001. The share of Korea's trade in the world also increased, but only modestly: 1.93 percent in 1990 to 2.34 percent in 2001. The resulting change in the trade volume rankings was dramatic (Table 4). In 1990, Korea had the 12th largest trading volume in the world while Mexico had the 22nd. By 2001, Mexico's trade volume surpassed Korea's: Mexico was 12<sup>th</sup> and Korea 13<sup>th</sup>.<sup>3</sup>

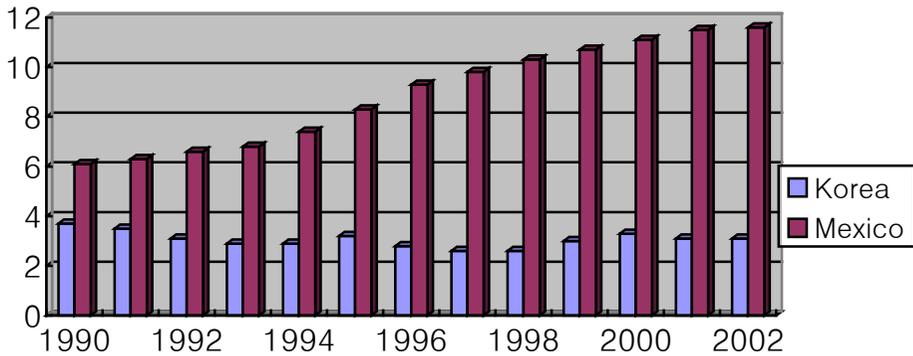
**Figure 1.** World Trends of Regional Economic Integration



<sup>3</sup> In 2002, Korea's trade volume slightly exceeded that of Mexico.

**Figure 2.** Korea and Mexico's share in U.S. market

(Unit: % share)



Source: U.S. Census Bureau, Foreign Trade Division (2003)  
*U.S. Trade in Goods, U.S. Trade Balance with Korea,*  
*U.S. Trade Balance with Mexico*

**Table 4.** Comparison of Korea and Mexico in World Trade

Ranking	1990	2001
1	U.S.	U.S.
2	Germany	Germany
3	Japan	Japan
4	France	France
.	.	.
.	.	.
12	Korea	Mexico
13	.	Korea
.	.	.
.	.	.
22	Mexico	.

Source: Korea International Trade Association, *Korea Trade Information Service*

During the same period in Asia, ASEAN countries signed an agreement for an Asian Free Trade Area (AFTA) in 1992. Initially there were six member countries: Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. Vietnam joined in 1995, Myanmar and Laos in 1997, and Cambodia in 1999. At the meeting of ASEAN+3 in 2003, the ASEAN countries agreed to expand the AFTA to an economic union like EU by 2010.

Japan joined the FTA bandwagon by signing the Japan-Singapore Economic Partnership Agreement in 2002 and entered into negotiations with Mexico. Japan is also seeking FTAs

with ASEAN, as a group and with individual countries, and it has created expert and joint study groups to examine FTAs with Chile and China. Moreover, China and ASEAN signed a framework for establishing a Free Trade Area in 2002. India is beginning to reveal interest in establishing a regional trade arrangement with ASEAN.

As noted in Section 2, until the 1980s, Korea did not have a strong need for FTAs with its major trading partners. However, now both the U.S. and Japan, long-standing trading partners of Korea, are actively pursuing FTAs. In addition, the geographical distribution of trade has changed considerably for Korea (Table 3-1 and 3-2). While the U.S. and Japan remained Korea's largest trading partners in 2002, the shares of China and the rest of Asia increased quite significantly. China and Hong Kong together had a share of 20.8 percent, becoming Korea's largest export market, outstripping the U.S. share of 20.0 percent in 2002 (Table 3-1). It is, thus, vital that Korea keeps a close eye on the growing markets of China and Asia, paying attention to the recent progress in FTA negotiations between China, ASEAN and Japan.

The slow and stalled pace of multilateral trade negotiations is also of concern to Korea. The WTO Ministerial meeting held in Cancun, Mexico, in September 2003 failed to adopt a declaration and negotiations for the WTO Doha Development Agenda are not likely to meet the target date of January 2005. Past experience, especially during the Uruguay Round, revealed that the slow progress in multilateral negotiations was accompanied by an increase in regional agreements. The direction of causality is not clear, but the coincidence of slowing multilateral liberalization and accelerating regionalism should serve as a warning signal to Korea, as it is heavily dependent on trade.

#### 4. KOREA'S FTA POLICY AND ITS IMPLEMENTATION

Korea has been one of the few exceptions to an increasing trend of RTA adoption among WTO member countries. While Korea strongly supports the world trading system orchestrated by the WTO, it must cope with proliferating regionalism. Korea must formulate policies that ensure it is not left behind as an economic island in Asia or the world. In response, policymakers in Korea have revised Korea's traditional approach to regional trading blocs and continue to explore the possibility of establishing FTAs with its trading partners. The government's decision for FTA policy was initially made by the Ministerial Committee on International Economic Policy in November 1998. An FTA with Chile was chosen as the first agreement, and subsequent FTAs with similar small and medium-sized countries were to follow after holding discussions with related government agencies and conducting studies on the potential merits and disadvantages. Additional FTAs with large economies such as the U.S., Japan and China were to be decided upon after in-depth analysis.

The first formal attempt at a Korean FTA started with the negotiations with Chile in December 1999. Six rounds of official negotiations were held up to October 2002 and, in February 2003, the heads of both countries signed an agreement concluding the negotiations. Incidentally, the Korea-Chile FTA was also the first cross-Pacific trade agreement ever signed.<sup>4</sup> Cheong and Lee (2000) estimate that the FTA, when in force, will increase Korea's exports to Chile by \$0.6 billion dollars and increase imports from Chile by \$0.2 billion

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<sup>4</sup> Korea Institute for International Economic Policy, Information Center for Korea's FTA policy [<http://www.kiep.go.kr/fta/fta.nsf>].

dollars. The agreement is intended to serve as a milestone that will expand trade and business with Latin American countries. Behind the choice of Chile as the first negotiating partner lies the intention to minimize political repercussions. However, the agreement is still waiting for ratification from Korea's National Assembly; among the sensitive issues delaying the ratification is agriculture, which was a main focus of the negotiations.

The Chilean government has been showing strong interest and support for the Korea-Chile FTA, since the negotiations started in December 1999. After the agreement was signed in February 2003, the lower house of Chile's Congress ratified it by a large majority. Deliberation in the Senate was expected to place on September 2003, but it was postponed due to the downward spiral of the political situation in Korea. Difficulty in receiving final approval by the Korean National Assembly has caused the Chilean government to reconsider its immediate and one-sided ratification of the FTA. They have since pressured the Korean government to show its good faith on the ratification of the Korea-Chile FTA through a formal request (*Yonhap News* 2003).

Regarding the Korea-Japan FTA, a joint study group, involving members of the government, academia and business, was formulated in July 2002. The group held eight meetings and produced a report on October 2003. The group assessed that the Korea-Japan FTA "would bring force a wide range of benefits by creating a win-win situation for both countries" (Joint Study Group of Korea-Japan FTA 2003: 67). The bilateral FTA, according to the report, would also be an effective instrument in alleviating remnant historical tensions between the peoples of the two countries. Based on the recommendations of the report, President Roh Moo-Hyun of Korea and Prime Minister Junichiro Koizumi of Japan agreed to start government negotiations by the end of 2003.

While the report concludes the gains from a Korea-Japan FTA outweigh the costs, the obstacles are considerable. A Korea-Japan FTA, the research finds, unambiguously raises the GDP in both countries. Cheong (2001) estimates that Korea-Japan FTA would increase Korea's GDP by 0.22-0.30 percentage points in the short run and 0.82-1.90 percentage points in the mid- to long term. In the case of Japan, Kawasaki (2003) estimates that a bilateral FTA would increase Japan's GDP by 0.04 percentage points in the short term and 0.12 percentage points in the long term.<sup>5</sup>

The first obstacle hindering the realization of a Korea-Japan FTA is the problems arising at the sector-levels. The manufacturing industries of Korea, in general, are less competitive than those of Japan. The average tariff rate was 7.9 percent in Korea and 2.5 percent in Japan in 2001, and reducing the gap through a Korea-Japan FTA would have a negative impact on Korea's manufacturing industries. Agriculture is another sensitive sector in both countries. In Korea, the FTA with Chile is presently pending in the National Assembly essentially because of opposition from agriculturalists, and in Japan, agriculture is seen as the greatest impediment to an early conclusion of the FTA with Mexico. For the Korea-Japan FTA, the sensitivity surrounding agriculture is much higher in Japan: the Korea Rural Economic Institute estimates that the Korea-Japan FTA would increase Korea's agricultural exports of 10 major exporting products<sup>6</sup> by up to \$58 million in the Japanese market. Another source of concern is the adverse impacts of the FTA on the trade balance between Korea and Japan; Korea's trade deficit with Japan would increase by \$3.8 billion to \$6.0 billion in the short

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<sup>5</sup> Both the studies of Cheong (2001) and Kawasaki (2003) use simulation models which need caution for interpretation as noted by Krueger (1999).

<sup>6</sup> Kimchi, tomatoes, eggplants, fruits of the genus capsicum (including pimento), roses, lilies, chestnuts, chrysanthemums, cucumbers and pork.

term and \$0.4 billion to \$2.4 billion in the long term (Joint Study Group of Korea-Japan FTA 2003: 25). In the section on non-tariff barriers, the group admits that even they were unable to reconcile their differences: "The Korean side highlighted the trade restrictive nature of NTMs (non-tariff measures) in Japan and called for concerted efforts to eradicate such NTMs. In response the Japanese side pointed out that Japanese companies operating in Korea have been also suffering from Korean NTMs and [suggested] to review concrete issues one by one" (Joint Study Group of Korea-Japan FTA 2003: 36). Besides economic difficulties, cultural and historical issues remain obstacles to overcome in the FTA negotiations. Seliger (2003) notes that a controversy over Japanese history textbooks and the Yaskuni shrine have had negative impacts on the Korea-Japan FTA discussions.

Given the geographic proximity and mutual economic interdependence of the two countries, an FTA between Korea and Japan could be an important step forward. However, to conclude a comprehensive FTA, as suggested by the joint group, there is need for stronger commitments from both countries. Korea and Japan had experience of concluding a bilateral economic agreement in 2002. At the plenary session of the ninth bilateral negotiations in Tokyo, Korea and Japan concluded a draft for a Korean-Japanese investment treaty. The bilateral investment treaty, also referred to as an investment protection agreement, is aimed at enhancing both countries' industrial competitiveness while compensating for their different industrial structures through investment protection measures and liberalization. Despite its narrower scope than FTA, this treaty took four years of negotiations and ratification procedures before it became effective in January 2003.

A joint study group for a Korea-Singapore FTA was formed in November 2002. The group met three times during 2003 and produced a report in October 2003. Although the two countries are not major trading partners, they have at least modest bilateral trade relations: Singapore ranked 10<sup>th</sup> among Korea's trade partners and Korea ranked ninth among Singapore trade partners. This report recommends that Korea and Singapore form an FTA that goes beyond tariff elimination, covering services, investment, government procurement and intellectual property (Joint Study Group of Korea-Singapore FTA 2003: 51). President Roh of Korea and Prime Minister Goh Chok Tong of Singapore agreed to begin formal negotiations in early 2004. The two leaders also set the goal of completing a comprehensive FTA within a year from the start of negotiations, a timeframe that is much shorter than that of the Korea-Chile or Korea-Japan FTAs. The Korea-Singapore FTA would have the impact of improving bilateral trade and investment between the two countries. A more important implication is its impact on the RTA movements in the Asian region. Cheong(2002) shows that an East Asian FTA covering the whole region is economically desirable and calls for efforts toward a region-wide FTA. It is uncertain, though, that Korea-Singapore FTA would be a step to such a region-wide FTA supporting 'domino' effect.<sup>7</sup> It is worth noting that Singapore has already signed FTAs with New Zealand, Australia, the European Free Trade Association, Japan and the United States. A Korea-Singapore FTA would increase competition within and outside ASEAN countries, possibly causing complications of FTAs as described by the 'spaghetti bowl' effect.<sup>8</sup>

A bilateral Korea-China FTA or trilateral Korea-China-Japan FTA should be specially noted. China, including Hong Kong, has already become the leading export market for Korea.

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<sup>7</sup> Baldwin(1993) explains that regional blocks induce pro-membership political activity of exporters and consequently enlargement of blocks.

<sup>8</sup> Bhagwati, Greenaway and Panagaria (1998) note that the complicated and overlapping FTAs among countries have harmful effects due to multiple criteria for same products.

The increasing importance of China is also recognized by Japan, which is the largest economy in Asia. Given the geographical proximity and increasing intra-regional trade in the North East Asian region<sup>9</sup> and the complementary industrial structures, there is great potential for trilateral economic integration between Korea-China-Japan. However, not much progress has been made: at a meeting held during ASEAN+3 summit in October 2003, the leaders of these three Northeast Asian countries discussed the issue of FTAs but the joint statement was only general addressing the study of a tripartite FTA without giving a specific commitments. It seems that China, Japan and Korea are more eager to form FTAs with ASEAN as a whole or individual ASEAN members than between themselves. Sheng (2003) describes the situation as the Northeast Asian axis versus ASEAN axis. Some Chinese prefer to have an FTA with Japan and Korea first, but many are skeptical of such approach. China does not have enough confidence to form free trade agreements with Japan and Korea and prefers ASEAN countries as first targets. At the same time, reluctance by Korea and Japan to open the agricultural market to Chinese products also reduces chances for an early launch of a Korea-China-Japan FTA. As the three economies differ considerably in their trade norms and institutions, they need to harmonize their trade-related rules and procedures before the formation of an FTA. Furthermore, overcoming historical animosity and gaining a public consensus will be a crucial task, in addition to economic considerations.

Concerning the U.S., Korean and American scholars co-authored a book: *Free Trade between Korea and the United States?* (Choi and Schott 2001). The question posed in the title of the book characterizes the sensitivity of the issue. Using a computable general equilibrium model, the study finds that both Korea and the U.S. would benefit from a bilateral FTA. In the conclusion, however, the authors return to the mainstream avoidance for such a move. They conclude that unilateral reforms may be a better option than a preferential trading arrangement since the gains to Korea would come from increased efficiency in its industries induced by trade reform. Moreover, the political reaction to opening the agricultural market has also been cited as a big difficulty for a Korea-U.S. bilateral FTA. Negotiations for a bilateral investment treaty between Korea and the U.S. started after the foreign exchange crisis, reflecting Korea's interest in attracting U.S. investment. There is a high potential for the further expansion of bilateral investment in view of the fact that Korea is eager to increase foreign investment while U.S. investment in Korea still accounts for a small percentage of its total investment abroad. However, the agreement has not been concluded because of the differences in position regarding the screen quota system in Korea. To give added momentum to the bilateral business, corporate CEOs from the two countries are urging the leaders of their respective countries to conclude talks on the Korea-U.S. bilateral investment treaty.

FTAs with other countries and regions are also under consideration. Studies for a Korea-Thailand FTA, Korea-Mexico FTA, Korea-ASEAN FTA, East Asian FTA, Korea-EFTA and Korea-New Zealand FTA are currently under examination, among others. Although it has not been formally announced, the Korean government seems to have set a time schedule for FTAs. In the short term, FTAs with Chile, Singapore and Japan have priority. In the medium term, FTAs with Mexico, ASEAN and the U.S., and in the long term, expansion to FTAs for Northeast Asia and ASEAN+3 and the EU are likely to be on the list.<sup>10</sup>

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<sup>9</sup> Trade among Korea, China and Japan has increased 2.1 times from 1994 to 2001, faster than the corresponding figure of the world trade, 1.7 times.

<sup>10</sup> For more details of Korea's FTA progress, see Information Center for Korea's FTA Policy, KIEP [<http://www.kiep.go.kr/fta/fta.nsf>].

## 5. ASSESSMENT OF TRADE POLICY DIRECTION AND PERFORMANCE OF KOREA

The potential benefits of FTAs include increase in market size, inducement of foreign direct investment, increasing productivity and enhancing security by strengthening political ties with member countries. Cheong (2002) expects that Korean FTAs will expand the market and intensify competition, attracting foreign investment and improving the competitiveness of Korean industries. Through FTAs, "Korea seeks to establish strategic alliances with its trading partners and to lay the foundation for national prosperity in the 21<sup>st</sup> century" (Cheong 2002: 47). Such high hopes are overly optimistic, although it may not be all that naive.

First of all, the Korean government policy of starting with small trading partners limits the effect of FTAs. The Asian Development Bank (ADB 2002) notes that "a larger combined economy is more attractive for investment and creates more potential for trade." In relation to the Korea-Chile FTA, the current trade volume between Korea and Chile is \$1.2 billion, a small fraction of Korea's total trade volume of \$313.6 billion in 2002. This contrasts the experience of the EU and NAFTA where their combined economies form the major economic powers of the world with intra-regional trade shares constituting over half of total trade. The efficiency gains from potential FTAs are also reduced by the partial and biased nature of Korea's FTA policies. The ADB (2002) explains that a closer approximation of free trade creates more competition and the exclusion of non-competitive sectors reduces the opportunity for efficiency gains. This is the reason why the WTO requires comprehensive coverage as a condition to regional trade agreements. The Korea-Chile FTA allows a large scope of exceptions: for the Korean market, many agricultural products are excluded or liberalization is postponed until an agreement arises from the Doha Development Agenda. For the Chilean market, manufacturing products such as white goods and the financial sector are excluded.<sup>11</sup>

Furthermore, the progress of FTAs in Korea is too slow to achieve substantial gains from regional arrangements. After five years since the Korean government decided to proceed with FTAs, not a single FTA has come into force. The FTA with Chile was originally intended for early conclusion, serving to initiate Korea into the experience of FTAs. This experience was to then generate other FTAs, but the negotiation for the first FTA took more than three years and is still not ratified. Freund (2000) shows that firms of the early entrant members of FTAs have first-mover advantages, leading to increased welfare in the member nations. He notes that the welfare gains of the initial members of regional agreements are higher than the gains from the multilateral approach, and that late entrants attain a lower welfare level than that from multilateral liberalization. If Korea keeps an extremely slow pace and assumes the position of a follower to FTAs, welfare gains will be fairly limited. Therefore, Korea needs to move toward larger FTAs at a faster rate; in this respect, the urgency of forming FTAs with the U.S., China and Japan is apparent. The three countries are not only the major economies in the world, but also important trading partners of Korea. The share of exports to the U.S. accounts for 20 percent of Korea's total export share and the combined share of China and Hong Kong accounts for another 20.8 percent (Table 3-1). An FTA with the U.S. requires political will from both Korea and the U.S., since it involves sensitive issues like agriculture and emotional reactions. An FTA with China is a difficult

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<sup>11</sup> The Joint-Statement by President Roh and Prime Minister Goh on October 2003 explicitly mention 'comprehensiveness' as a goal of Korea-Singapore FTA. For other FTAs of Korea, the coverage of sector will be a controversial issue and a key factor for the success of FTAs.

task because it also involves agriculture. Both Korea and China's strategies are to form an FTA with ASEAN first and expand it to other Northeast Asian countries later. Depending on the result of the competition, one country will become the late entrant that bears disadvantage described by Freund (2000). In order to avoid such risk, both countries should attempt to move directly toward a bilateral Korea-China FTA or a Northeast Asian FTA given the strong interdependence of their economies and their complimentary structures. The agreement with Japan to begin formal negotiations is a positive sign for Korea, in the sense that it involves a big market size and trade volume. However, a formal deadline or target date has not yet been set.

The reason why Korea took a step-by-step approach to FTAs was to minimize the reaction of opposition groups and to gain political support.<sup>12</sup> Indeed, it is very difficult to get political support for trade liberalization in Korea.<sup>13</sup> Over half of the members of the National Assembly support the farmers' movement against the Korea-Chile FTA. A German scholar in Korea describes three distinguished features of Korean self-perception with regard to relations with other countries (Seliger 2003). The first role is that of a victim: Korea is a small country between large and historically inimical nations, and foreign influences are viewed as potential threats. The second is the role of the Hermit Kingdom: that is, that Korea is a country with a unique, pure and authentic culture and should 'withstand' foreign influence. Third is the role of a 'tiger state.' The last perception is outward looking, but only in one direction – Korea's export to the outside world. These perceptions shared by many Koreans laid grounds for opposition to trade liberalization from the public, including consumers, affected sectors and interest groups. Since, Korean government tends to accommodate the perceptions of the people, it has chosen a defensive stance to trade liberalization despite Korea's strong interest in the expansion of trade. The step-by-step approach to FTAs is a reflection of this defensive stance.<sup>14</sup> The proper approach is, instead of accommodating incorrect perceptions, to change the perception and to proceed with efficiency-oriented ventures that are economically justified. Although changing perceptions is extremely difficult, the government should try to prove the gains of liberalization with proper policy choice.

Often, long-term sustainable benefits and growth from FTAs require countries to take positions that entail short-term costs and demand a strong political leadership. In Mexico, it was President Salinas who proposed an FTA to the U.S. He believed that Mexico must open and integrate itself more extensively into the world economy in order to progress and meet the employment needs of a burgeoning young population. In the U.S., NAFTA was opposed by a number of powerful groups. Nevertheless, both Presidents George H.W. Bush and Bill Clinton demonstrated leadership to overcome the obstacles and to convince the population of the benefits of open markets. In order to maximize the gains from FTAs, Korea should proceed with a broader vision for FTAs, including agreements with major trading partners such as China, Japan and the U.S. with comprehensive coverage.<sup>15</sup>

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<sup>12</sup> And to build learning experience before negotiating FTAs with major trading partners.

<sup>13</sup> One may argue that other countries also have opposition groups, but resistance from Korean groups is much stronger – the evidence of which was shown at Cancun, September 2003.

<sup>14</sup> Japan adopted a similar approach by starting FTA excluding agriculture with Singapore.

<sup>15</sup> As explained in section 4, there are many difficulties associated with FTAs with these countries. The right roadmap, nevertheless, is to concentrate resources and efforts to overcome the obstacle and not to choose a detour through Chile, Singapore or ASEAN.

FTAs have transformed the global trading system, which Korea greatly benefited from during its rapid development status. It is yet unclear whether FTAs are a stepping-stone or a stumbling block to the development of the international trade system<sup>16</sup>. Korea's cautious approach to FTAs targeting small countries first will result in very small effects, positive or negative. The demonstration of trade creation or the costs incurred by complications by Korean FTAs will be unpronounced. However, problems associated with time and government resources must be noted. The FTA negotiations with Singapore and Japan will reduce the allocation of resources to handle trade issues in multilateral trade negotiations at the WTO. Officials from Korea's trading partners have also limited time for multilateral trade negotiations due to involvement in FTAs. Gordon (2003) describes that the U.S. government shifted its focus from the WTO to FTAs even before the failure of the WTO Ministerial Meeting in Cancun in October 2003. Such a high-risk trade policy of the U.S. government, according to Gordon, is bound to cause serious problems to the U.S. and the world trading system.

The WTO secretariat (2002) noted that "it is generally recognized that RTAs are a second best option to MFN [Most Favored Nation] trade liberalization" (World Trade Organization Secretariat 2002: 12). Korea should not allow regionalism to undermine the importance of the global trading system, viewing FTAs as limited, second best options. In this regard, the success of the Doha Development Agenda is very important. Although the Cancun Ministerial Meeting in September 2003 did not succeed in adopting the joint statement, it provided the basis for further discussion. Korea and its trading partners should try to revitalize the WTO negotiations; particular attention is needed for the modality of the agricultural sector and intensive negotiations for service trade are also called for. Expanding open trade and investment on a multilateral level should continue to be an essential element of trade policy of Korea and its trading partners.

## 6. CONCLUSION AND POLICY IMPLICATION

Korea was a major beneficiary of the multilateral trading system. Korea's trade grew much faster than the world trade within the framework of GATT and WTO. Regional trade agreement was not of higher priority due to the difficulty in the region and little interest of Korea's trading partners. Korea advocated 'open regionalism' in APEC, which is non-exclusive. The recent trend of increasing regionalism in the world has affected Korea's trade performance and its trading partners' approach. Korea's share in the U.S. market has dropped, while the share of Mexico, a member of NAFTA established in 1994, doubled. The U.S., which has long been the largest trading partner of Korea, shifted its policy focus to regionalism. Japan, a close neighbor and important trading partner, also began movement for regional arrangement. China, a new emerging market, began efforts for regional trade.

To cope with trends of regionalism, the Korean government decided to pursue FTAs in 1998. Some progress has been made during the five years after the decision. The Korea-

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<sup>16</sup> The topic has been the subject of theoretical and empirical studies. Krueger (1999) summarizes the arguments of both sides. Arguments for stepping stones: 1) demonstration of trade creation by FTAs would increase further liberalization, 2) developed countries can first form FTAs and pull other countries, and 3) FTAs can initiate sophisticated level of trade liberalization. Arguments for stumbling blocks: 1) complicated rules of origin increase cost, 2) members of FTA tend to raise barriers to outside, and 3) beneficiaries of trade diversion accrued from FTAs increase rent seeking activity.

Chile FTA was signed in February 2003. The joint study group for a Korea-Singapore FTA was formed and produced a report on October 2003. Formal negotiations are planned to start in early 2004 and a target is set to conclude the negotiations within a year. The joint study group for Korea-Japan was formed and produced a report on October 2003. Based on the recommendation of the report, the two governments agreed to start negotiations by the end of 2003. Studies on Korea-China and Korea-China-Japan FTAs are also conducted, but discussions between the officials of the respective countries have not yet produced concrete plans or commitments. FTAs with the U.S., ASEAN, Mexico, New Zealand and EFTA are currently under examination.

This paper notes that considering the policy direction and progress made in Korea, gains from FTAs would be small. The government policy decided in 1998 was to start FTAs with small countries and to expand to larger economies later on. A smaller combined economy is less effective in creating trade and attracting investment (ADB 2002). The pace of Korea's adoption is so slow that Korea can bear the disadvantage as late entrant to FTAs, described by Freund (2000). Strong opposition to the FTAs and trade liberalization are rooted in Korean's self-perception as a victim of foreign threat (Seliger 2003). The Korean government tends to accommodate to this emotion with a defensive approach taking small incremental steps to trade liberalization.

The policy implications of this study are as follows: First, Korea should expedite the FTA process. After five years of initiating its FTA policy, Korea still does not have a formal FTA in force. Prompt ratification of the Korea-Chile FTA will be a minimum requirement in this regard. Second, priority should be given to FTAs with big countries. There may be many challenges and difficulties, but benefits will also be large. Between the two FTAs in line for formal negotiations, the Korea-Singapore FTA is targeted for earlier conclusion rather than a Korea-Japan FTA. Considering the structure and complexity, changing the order of the concluding times may be difficult. However, focus in terms of allocation of efforts and resources should be placed on the FTA with Japan. Third, Korea should not allow regionalism to undermine the importance of the global trading system, while proceeding with FTAs. FTAs are second best options to multilateral trade liberalization (WTO secretariat 2002). Korea and its trading partners should try to revitalize the WTO negotiations and make efforts for the success of the Doha Development Agenda.

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