

**Regional Integration in Northeast Asia:  
Present and Future**

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**The International Centre for the Study of East Asian Development, Kitakyushu**

# **Regional Economic Integration in Northeast Asia: Present and Future\***

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## **Abstract**

This paper reviews the status of economic integration in Northeast Asia and discusses future prospects for economic integration in the region. It also discusses the backgrounds of the rise of Northeast Asia economic integration, regional trade and investment relations, financial cooperation, environmental cooperation, science and technology cooperation and industrial cooperation. Future prospects for Northeast Asian economic integration will be given, followed by a discussion on issues related to a proposed China-Japan-Korea (CJK) FTA.

Due to the political and economic characteristics of the region, Northeast Asian economic integration is being achieved sporadically, focusing on areas where cooperation is in dire need for public interest rather than focusing on systematic integration. That is, economic integration in the region was first advanced in areas where mutual interests could be fully realized, rather than an institutional integration. There remain issues to be solved such as cooperation overlap and inefficiency problem because bilateral cooperation such as Japan-Korea, China-Korea and China-Japan, as well as and China-Japan-Korea trilateral cooperation are intertwined.

Northeast Asian economic integration is expected to press forward. It is highly possible that China is anticipated to become more actively involved in economic integration in Northeast Asia in near future. Korea, which is aiming to become a Northeast Asia economic hub, must set up conditions for the free movement of goods and resources in Northeast Asia as well as improve the internal business environment. As for improving external conditions, the China-Japan-Korea FTA could be an effective method of doing so. Considering China and Japan's rivalry relationship, Korea's role as mediator is crucial in the Northeast Asian economic integration.

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## **I. Introduction**

With the development of transportation and communication links, barriers caused by physical distance are gradually being lowered and the expansion of trade and investment is promoting the accelerated integration of the global economy. Trade and investment liberalization as well as the creation of regional trade blocs are forecast to accelerate such economic integration.

Economic integration implies the process of building institutional mechanisms for closer economic relations through preferential liberalization and cooperation in various fields such as trade and investment, finance, environment, industry and energy. In the case of Europe, preferential trade liberalization through the formation of trading blocs preceded financial cooperation. However, in Northeast Asia and East Asia, financial cooperation is more active than trade cooperation. This is closely related to the East Asian financial crisis. In addition, it might be related with the characteristics of the region, such as the different political systems, large gaps in economic development among countries and a leadership struggle between China and Japan. However, some concerns recently were raised over free trade agreements (FTAs) in Northeast Asia. From the viewpoint of economic integration in Northeast Asia, this can be momentum for the region to start region-wide, fully institutionalized economic integration.

This paper reviews the status of economic integration in Northeast Asia and discusses future prospects for economic integration in the region. Following this introduction, the paper discusses the backgrounds of the rise of Northeast Asia economic integration, regional trade and investment relations, financial cooperation, environmental cooperation, science and technology cooperation and industrial cooperation. Future prospects for Northeast Asian economic integration will be given, followed by a discussion on issues related to a proposed China-Japan-Korea (CJK) FTA.

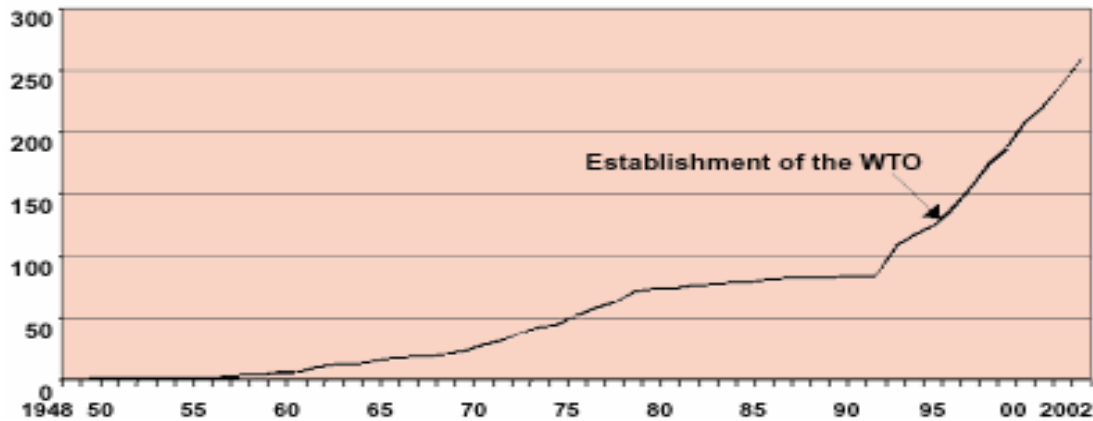
## **II. Background for the Rise of the Northeast Asia Economic Integration**

The Northeast Asian region is divided into conventional Northeast Asia and Northeast Asia in a broader sense. The conventional Northeast Asia region comprises of China, Japan and Korea. In a broader sense, Northeast Asia includes North Korea, Mongolia and Far East Russia, Taiwan and Hong Kong, in addition to CJK. Although Northeast Asia usually implies the region in a broader sense, the discussion in this paper will focus on conventional Northeast Asia because of the lack of reliable economic data for the region as a whole.

The recent surge in interest related to economic integration in Northeast Asia can be attributed to the proliferation of regionalism, the East Asian financial crisis, the end of the Cold War, China's emergence and the expansion of Northeast Asian personal networks through various forms of meetings.

Since the launch of the WTO in 1995, it has been reported that more than 96 new regional trade agreements (RTAs) have been formed, indicating that countries are pursuing RTAs as a strategic trade policy rather than just as an insurance policy against the failure of the multilateral system. If an RTA is established in other regions, non-member countries suffer from trade diversion. Thus, even countries with little experience in RTAs are actively participating in smaller RTAs to prepare for regionalism and to gain experience for globalization through economic integration.

Figure 1: The Number of Regional Trade Agreements (1948-2002)



Source: WTO Web site [www.wto.org]

Generally, physical distance was cited as a major reason for increased transportation costs. Although international trade-related costs are falling with the development of transportation technology, physical distance is still an important factor in determining the scale of intra-regional trade. In addition, cultural factors play a vital role. Considering physical and cultural proximity in East Asia, it is highly possible that intra-regional trade will expand once an institutional framework such as an RTA is introduced.

As Northeast Asian countries have experienced disadvantages from the effects of regionalism in other parts of the world, countries in the region have begun to consider establishing their own regional trade bloc recently. Asian countries have finally begun to realize the importance of regional economic integration, noting that they would be at disadvantage compared to North America and Europe.

Under the Cold War ideology of the 1970s and 1980s, when Northeast Asian economies such as Japan and Korea began full-scale development, the U.S. refrained from

provoking trade frictions and absorbed exports from Northeast Asia despite its severe trade deficit. Consequently, Northeast Asian countries strove to enter the open U.S. markets, providing a large market with relatively fewer trade barriers. The U.S., for its part, did not want regional economic integration in Northeast Asia, and Northeast Asia did not feel a need for it since their economies were growing rapidly. “Thus, [those countries] did not feel any need to secure markets through discriminatory economic integration agreements” (Munakata 2001).

After the end of the Cold War, the U.S. did not need to give special considerations for developing Asian countries in terms of trade. Asian countries realized the limits of an export-oriented developmental policy that targeted the U.S. market. Being heavily dependent on a major export market such as the U.S. made East Asia vulnerable to the negative effects arising from a stagnating world economy. In order to prevent exposure to such risks, Asian countries should strive to restructure and create their own demand by curbing dependence on non-Asian regions for exports, creating domestic demand or making intra-regional demand the driving force for stable economic growth.

The 1997 financial crisis led the East Asian countries to realize the need to strengthen economic cooperation. A relationship between East Asian financial crisis and regionalism can be found in studies by Bergsten (2000), Eichengreen (2002), Yamazawa (2001) and Yip (2001). Yamazawa (2001) asserts that the turning point in East Asian regionalism was the Asian financial crisis. “Through the experience of that awful time, policy makers in this region acknowledged that they were not equipped to prevent and manage such a crisis. They were irked by their helplessness and undue dependence on the international financial institutions in Washington, and they began to toy with the idea of resolving their problems for themselves within Asia.” Yip (2001) states that “on the monetary side, the single greatest push for Asian regionalism was the financial crisis of 1997-1999. Many Asians felt that they were both let down by the West during the crisis. In their view, western banks and other financial institutions had created and exacerbated the crisis by pulling out their funds from the region.”

Ahn (2003) states that as a member of WTO, China takes on an important role not only regionally but also in the world economy. Recently, China has become the most favored destination for foreign direct investment in the world. Consequently, China's rapid growth with outward orientation is leading Northeast Asian economic dynamism, which can also spur the economic growth of the entire East Asia. Therefore, if Northeast Asian countries strengthen economic cooperation with China, the region as a whole is likely to enjoy sustainable growth.

### III. Trade and Investment Relations in Northeast Asia

Table 1 shows the economic importance of Northeast Asian countries in the world and the relative importance of each country in terms of trade in 2001. Northeast Asia including China, Japan and Korea, all three members of top 10 economies in the world, accounting for 21 percent of global total GDP and 17 percent of total global trade. Since China's economy is expected to maintain an astonishing economic growth rate of 7-10 percent for some time due to its strong domestic demand and export performance, the economic importance of the Northeast Asia will grow in the future.

Table 1: Intra-regional Trade of Northeast Asia in the World Economy (2001)

(Unit: %)

	GDP ratio	Trade ratio	Intra-trade ratio	Export ratio	Import ratio
Korea	1.4	2.3	-	2.4	2.2
China	3.7	3.7	-	4.2	3.1
Japan	13.5	6.0	-	3.2	5.4
Korea, China, Japan	18.6	12.0	21.8	13.3	10.8
Korea, China, Japan, Hong Kong	19.1	15.2	32.9	16.4	13.9
Northeast Asia (Broad Sense)	21.1	17.1	37.6	18.5	15.7

Source: Ahn (2003)

Northeast Asia saw its intra-regional trade share increase from 12.7 percent (1990) to 21.8 percent (2001). This is a positive sign for economic integration in the region in that Northeast Asian countries are getting more important to each other. When comparing the intra-regional trade of the main economic blocs of 1999 and 2001, NAFTA and MERCOSUR increased from 33.2 percent to 46.6 percent and from 11 percent to 18.1 percent, respectively. At the same time, EU's intra-regional trade has decreased slightly due to recent economic stagnation within the region. If East European countries join EU, intra-regional trade is likely to increase again.



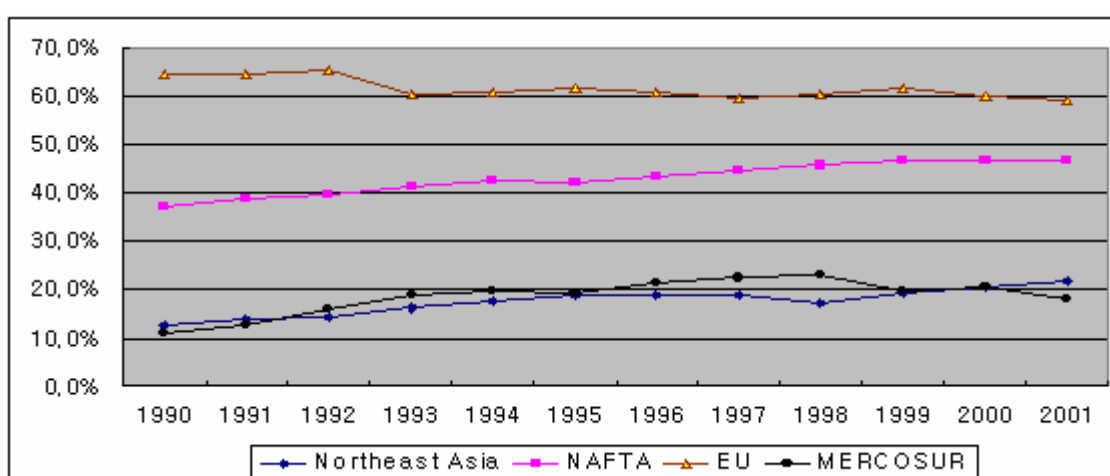
Table 2: Intra-Regional Trade in the Main Economic Blocs

(Distribution Ratio: %)

	EU			NAFTA			Northeast Asia			MERCOSUR		
	1980	1990	2001	1980	1990	2001	1980	1990	2001	1980	1990	2001
Intra-regional Trade	57.3	64.5	59.4	33.2	37.2	46.6	-	12.7	21.8	9.7	11.0	18.1

Source: IMF, *Direction of Trade Statistics Yearbook*, historical and 2003.

Figure 2: Trade Volume of Main Regional Economic Blocs

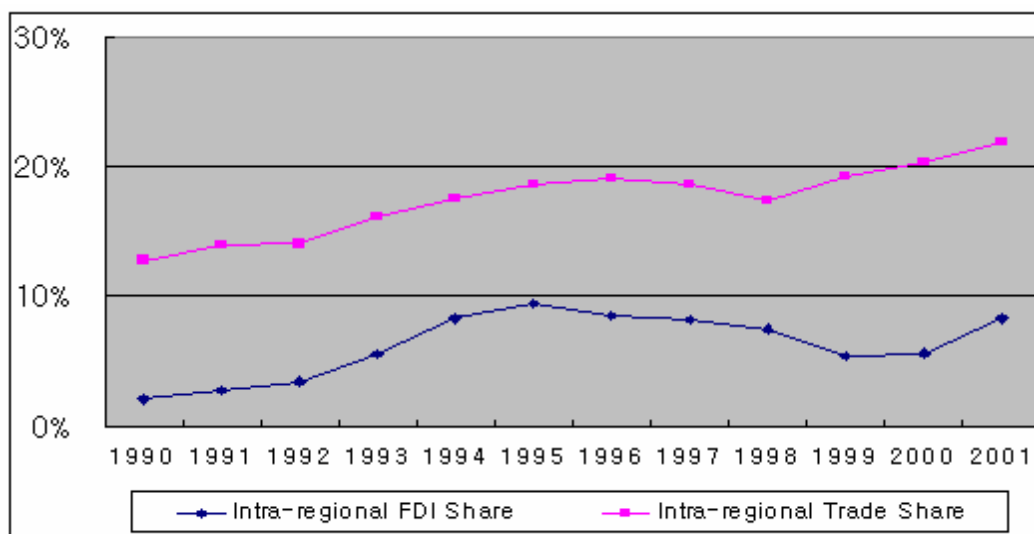


Source: IMF, *Direction of Trade Statistics Yearbook*, 2003.

Figure 3 shows that direct investment among China, Japan and Korea increased dramatically after 1990. At the beginning of 1990, the volume increased rapidly, achieving a record high in 1995. Intra-regional investment was 2.4 percent in 1990 but had increased to 9.8 percent by 1995. In 1999, it dropped to 5.1 percent, increasing to 8.9 percent in 2001.

The notable implication of Figure 3 was that the levels of Northeast Asia's intra-regional direct investment remain low. It is worthwhile to note that the movement of trade and investment seems to be mutually reinforcing. Therefore, strengthening economic cooperation will not only increase direct investment, but will also attract foreign investment.

Figure 3: FDI and Trade Volume among Korea, China, and Japan



Source: Ahn (2003).

Despite a sharp decrease in the global foreign direct investment (FDI) in 2001 compared to that of 2000 (Table 3), CJK's share of global FDI has increased (Figure 4), proving the economic significance of the Northeast Asian region.

Table 3: Trends in FDI Volume in CJK, EU and NAFTA

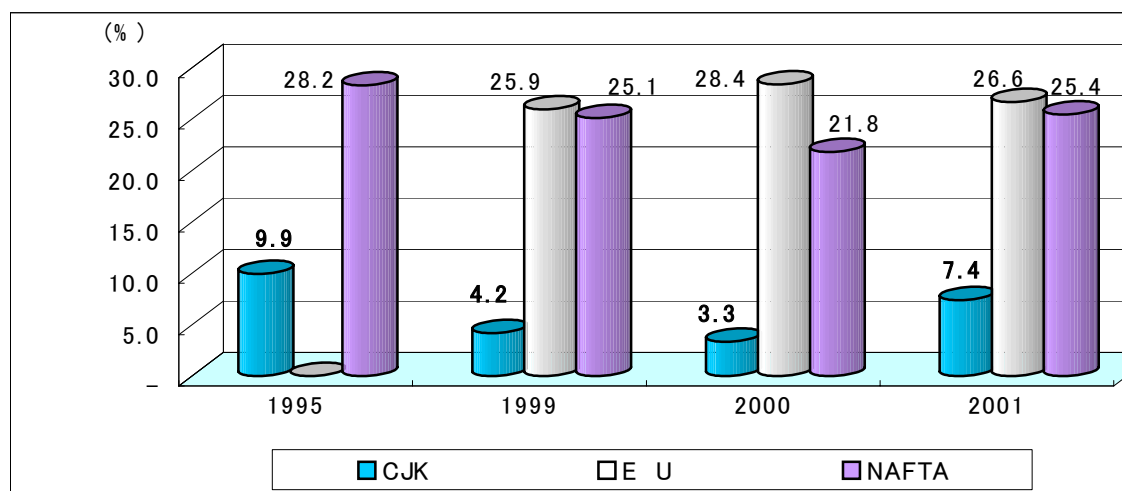
(Unit: \$billion)

	1995		1999		2000		2001	
	ODI	FDI	ODI	FDI	ODI	FDI	ODI	FDI
CJK	<b>28.1</b>	<b>37.7</b>	<b>28.2</b>	<b>60.4</b>	<b>37.5</b>	<b>55.9</b>	<b>48.0</b>	<b>53.6</b>
EU	n/a	N/a	338.1	211.1	398.5	400.0	228.6	138.1
NAFTA	110.3	76.7	204.5	326.4	225.6	388.0	167.1	183.0

Note: ODI indicates Overseas Direct Investment.

Source: IMF, *Balance of Payment Statistics*, April 2003.

Figure 4: The Share of Global FDI Held by CJK, EU and NAFTA



Source: IMF, *Balance of Payment Statistics*, April 2003.

#### IV. Current Economic Cooperation in Northeast Asia

##### 1. Financial Cooperation

Eichengreen (2002), an internationally well-known financial economist, states, “the Chiang Mai Initiative is indicative for a historic shift in Asia’s approach to regional integration. That crisis fostered the belief that Asian countries need to band together in order to create a framework for economic, financial, and political stability in which the contagious spread of crises is minimized and they are insulated from destabilizing impulses emanating from outside.”

The framework for financial cooperation in Northeast Asia has been consolidated by the Chiang Mai Initiative, which emphasizes regional currency swaps to provide self-help and support mechanisms (Ahn 2001).

One of the Chiang Mai Initiative components is a network of bilateral swap arrangements (BSAs) and repurchase arrangements encompassing the 13 ASEAN+3 countries. BSAs were designed and implemented to provide liquidity support to member countries that experience short-run balance of payment deficits.

In order to prevent the spread of negative impacts from the financial crisis to other countries, East Asia countries have realized the necessity of strengthening regional cooperation between neighboring countries. The goal of the Chiang Mai Initiative is to offer quick liquidity to member countries in the case of a financial crisis by preparing and

intensifying liquidity assistance measures in the East Asia region. By July 2003, 13 BSAs were concluded at a total of \$33.5 billion, as seen in Table 4. By preventing an extreme crisis or systemic failure in a country and subsequent regional contagion as occurred in the recent Asian financial crisis, this facility is expected to contribute to financial stability in the region (Park and Wang, 2003).

Table 4: Progress on the Chiang Mai Initiative

(as of March 31, 2003)

<b>BSA</b>	<b>Currencies</b>	<b>Conclusion Dates</b>	<b>Size</b>
Japan-Korea	\$/Won	4 July 2001	\$7 billion <sup>a</sup>
Japan-Thailand	\$/Baht	30 July 2001	\$3 billion
Japan-Philippines	\$/Peso	27 August 2001	\$3 billion
Japan-Malaysia	\$/Ringgit	5 October 2001	\$3.5 billion <sup>a</sup>
Japan-PRC	Yen/Renminbi	28 March 2002	\$3 billion
Japan-Indonesia	\$/Rupiah	17 February 2003	\$3 billion
Korea-PRC	Won/Renminbi	24 June 2002	\$2 billion
Korea-Thailand	\$/local currency	25 June 2002	\$1 billion
Korea-Malaysia	\$/local currency	26 July 2002	\$1 billion
Korea-Philippines	\$/local currency	9 August 2002	\$1 billion
PRC-Thailand	\$/Baht	6 December 2001	\$2 billion
PRC-Malaysia	\$/Ringgit	9 October 2002	\$2 billion
PRC-Philippines	\$/Peso	Negotiation completed	\$2 billion
Japan-Singapore	Under negotiation		

Notes: PRC = People's Republic of China, Korea = Republic of Korea

<sup>a</sup> The US dollar amounts include commitments under the New Miyazawa Initiative: \$5 billion for Korea and \$2.5 billion for Malaysia.

Source: Park and Wang (2003).

Park and Wang (2003) state that China and Japan are expected to provide leadership in forging regional consensus for expanding and consolidating BSAs as a regional institution. However, they have not been able to agree on a number of operational issues, including the surveillance mechanism.

## 2. Environmental Cooperation

Northeast Asian countries such as China, Japan and Korea have almost the same environmental conditions, geographically speaking. Problems such as acid rain and long-range transboundary air pollutants brought about by China's recent rapid economic growth and increases in the use of fossil fuels are the main environmental issues in the region. The China-Korea Environmental Cooperation Agreement was ratified in order to resolve

environmental problems such as China's acid rain and a joint program based on the agreement is in progress. Projects such as a joint inspection project between Korea and China on long-range transboundary air pollutants and the East Asian acid deposits measuring network are in progress as well.

Furthermore, the three core countries in Northeast Asia – China, Japan and Korea – are moving ahead with trilateral environmental ministerial meetings in order to raise the awareness of environmental cooperation in the rest of the Northeast Asian region. Methods on how to strengthen China's environmental programs such as environmental technology and capital cooperation with China are being facilitated.

## **Main Projects**

### *Joint Committee for Environmental Cooperation between the People's Republic of China and the Republic of Korea*

The Joint Committee is focusing on 12 on-going cooperation projects, including investigation and research on the effects of acid rain on plants, transboundary models and measures of acid rain pollutants, and research on the marine environment in the Yellow Sea.

### *China-Japan-Korea Tripartite Environment Ministers Meeting (TEMM)*

Though the Northeast Asian region is achieving economic development most dynamically, it is jointly recognized that environmental contamination is increasing in the atmosphere, water quality and the ecosystem. Thus, the necessity for cooperation between the core countries in the region was recognized.

In addition, because long-range transboundary air pollutants (acid rain) and pollution in the Yellow Sea and East Sea are beginning to rise as environmental issues, cooperation between nations to deal with them is inevitable. The necessity of facilitating the progress of environmental cooperation through environmental meetings has been proposed among the three Northeast Asian core countries, Korea, Japan and China. Environmental issues such as yellow dust are being addressed through the Environmental Ministerial Meetings that are held annually since 1999.

Five priority areas of mutual cooperation among the three countries were set at the second TEMM (2000, Beijing): raising consciousness of the environmental community; fresh water (lake) pollution prevention; land-based marine pollution prevention; cooperation in the environmental industry; and environmental conservation in Northwest

China. The following projects have been identified and being developed or implemented to date.

#### **Other environmental cooperation:**

- *TEMM Web site*
- *Joint Environmental Training Project*
- *Tripartite Environmental Education Network (TEEN)*
- *Ecological Conservation in North-west China*
- *Action Plan for the Protection, Management and Development of the Marine and - Coastal Environment of the Northwest Pacific Region (NOWPAP)*
- *Northeast Asian Conference on Environmental Cooperation (NEAC)*
- *North-East Asian Subregional Programme of Environmental Cooperation (NEASPEC)*
- *Acid Deposition Monitoring Network in East Asia (EANET)*
- *Environment Congress for Asia and the Pacific (ECO ASIA)*
- *Asia-Pacific Migratory Waterbird Conservation Strategy*

### **3. Science and Technology Cooperation**

Contrary to the limitations of political ideologies, the Northeast Asian cooperation in the field of science and technology allows economic and industrial cooperation possible along with the terminal composition of regional networking. The merits of science and technology cooperation, which has a relatively low level of mutual understanding, is that it is an opportunity for cooperation to expand and be reinitiated in other fields.

The Northeast Asian cooperation in science and technology is focusing on bilateral cooperation rather than Northeast Asia as a whole. As for North and South Korea, joint research projects are underway, with issues such as food aid at the top of the agenda.

#### **Examples of Bilateral Cooperation**

##### *China-Korea Science and Technology Cooperation*

- China-Korea Science and Technology Agreement (September 1992)
- China-Korea Committee for Science and Technology Cooperation (Deputy Minister, seven official meetings to date)
- Exchange of Technology Survey Group (20 participants, four times annually), Joint Research (116 projects to date) and the Operation of Joint Research Center (four projects such as the development of new material).

### *Japan-Korea Science and Technology Cooperation*

- Japan-Korea Science and Technology Agreement (December 1985)
- Japan-Korea Committee for Science and Technology Cooperation (Director General, 12 official meetings to date)
- Japan-Korea Science and Technology Forum (fourth time), Joint Research (Total 394 projects) and Exchange of Researchers (446 Post-Doc, Internship)

### *The Establishment of Science and Technology Cooperation Center between Korea-Mongolia (October 2002) and other Cooperation Projects*

## **Examples of Trilateral Cooperation among China, Japan, and Korea**

### *The Meeting for Director General of Science and Technology (2002)*

- Agree on the China-Japan-Korea Science and Technology Forum (Subject: Cooperation in Life Science)
- Discuss Advanced Technology (IT, BT, NT, Energy, New Material), Three Countries' Commonly Concerned Fields (Weather, Environment), Science and Technology Policy.

### *STI-Port (Science Technology Information-Port) Projects in Progress*

- The Establishment of a Science and Technology Hub in Northeast Asia
- The Network for Science and Technology Information

### *China-Japan-Korea Weather Meteorologists' Meeting (one/two meetings since 1998)*

- Exchange of Information on Weather Forecasting

## **Examples of Science and Technology Cooperation between South Korea and North Korea**

### *Five Joint Research Projects including super corn, agricultural chemicals*

### *Project for Building a Framework for Science and Technology Cooperation between South Korea and North Korea*

- Two Study Groups for North Korea Science and Technology Study Group
- Science and Technology Network for North Korea

#### **4. Industrial and Economic Cooperation**

The production resources are complementary in Northeast Asia. In the Northeast Asian region, it seems that economic integration in the private sector is being enforced through investment and trade. Korean and Japanese investment has increased considerably, targeting the domestic Chinese market and China's cheap labor market. Investment in China has expanded in diverse fields from labor-intensive industries such as fiber and clothing to capital-intensive industries such as electric and electronics, automobiles and information technology. At the same time, economic cooperation channels between the private and government sectors are moving forward. It is mostly a trilateral (China, Japan and Korea) or bilateral cooperation forum.

##### **Examples of Bilateral Industry and Economic Cooperation**

###### Japan-Korea Industrial Cooperation

- *Japan-Korea (Kyushu) Economic Exchange Forum: 10<sup>th</sup> Forum (July 2003, Cheju)*
- *Japan-Korea (Hokuriku) Economic Exchange Forum: 4<sup>th</sup> Forum (May 2003, Daegu)*
- *Asia Industry and Technology Fair: Co-organized by China-Japan-Korea since 1998*

###### China-Korea Industry and Investment Cooperation

- *China-Korea Industry Cooperation Committee: 6<sup>th</sup> Meeting (June 2003, Seoul)*
- *China-Korea Investment Cooperation Committee (2<sup>nd</sup>, July 2002, China)*
- *China-Korea Private Sector Investment Committee (January 2001)*
- *Development Survey Group for China's West Inland (September 2000, China)*

It is based on the recognition of the importance of moving forward with trilateral economic cooperation that the trilateral industrial cooperation channel is progressing. That is, trilateral economic cooperation in Northeast Asian is being achieved due to technology transfer, regional development and establishing horizontal industrial cooperation relations in order to build a strategic cooperative foundation aimed at a 21<sup>st</sup> century Northeast Asian era.

##### **Examples China-Japan-Korea Industrial Forum**

###### Yellow Sea Economic and Technology Exchange Meeting

- *1<sup>st</sup> Meeting: March 2001, Japan (Fukuoka)*



- 2<sup>nd</sup> Meeting: October 2002, Korea (Junju)
- 3<sup>rd</sup> Meeting: September 2003. China (Weihai)

#### China-Japan-Korea Industry Cooperation

- *China-Japan-Korea Hi-tech Business Forum/Consulting (December 2003, Beijing)*
- *China-Japan-Korea Business Forum: 2nd Meeting (November 2003, Beijing)*

#### **Examples of Other Cooperation Fields in Progress and under Discussion**

- Agriculture and Fisheries Information and Communication Technology
- Harmonization of Trade Rules such as Customs Clearance, Standards, SPS, IPR
- Logistics, Marine Transportation, Railroad
- Energy

### **V. Discussion on the China-Japan-Korea FTA**

Discussions on FTAs in Northeast Asia recently began, along with the expansion of economic cooperation into diverse fields. Japan and Korea have discussed a bilateral FTA since 1998, and next year they are expected to start formal negotiations. Furthermore, Chinese Premier Zhu Rongji's proposal for a trilateral FTA study at the China-Japan-Korea Summit held in Phnom Penh, Cambodia in November 2002, has been taken up at various institutions in the three countries. This paper will analyze the background, barriers and economic effects of the China-Korea-Japan FTA.

#### **1. Background of a CJK FTA**

##### **Response towards the global trend of regionalism**

Regionalism offers special benefits to companies in member countries but discriminates against those in non-member countries. Discriminatory treatment not only results from tariffs, but also from trade systems such as anti-dumping, standards and conformity and customs clearance. Therefore, the trade volume increases between FTA member countries but relatively decreases between non-member countries. Trade between the members of a regional trade agreement accounts for 47 percent of total world trade, a proportion that is expected to hit 55 percent by 2005.

The East Asia region was excluded from the trend of regionalism that began in the 1990s, but cooperation in East Asia was initiated and driven by ASEAN through

ASEAN+3 after the financial crisis. Economic cooperation issues are discussed more actively in East Asia than in Northeast Asia. Nevertheless, considering the scale of its market as well as its economic development and openness, regional cooperation driven by ASEAN is limited in its ability to effectively cope with the global trend of regionalism. In this respect, establishing an East Asian FTA by enlarging CJK FTA to Southeast Asia could form the foundation for East Asia becoming one of the three major axes of the world economy.

### **Avoiding excessive regionalism**

East Asian countries have recently shown a strong interest in regionalism, but this regionalism might hinder regional stability and cause economic inefficiency. Bilateral FTAs between China, Japan and Korea as well as bilateral FTAs between China-Japan and individual countries from ASEAN might bring about a serious “spaghetti bowl” effect when different rules of origin are adopted.

The hub-and-spoke problem may also arise within East Asia when ASEAN member countries pursue a FTA hub through AFTA or when China/Japan competitively pursue FTAs with ASEAN. The negative effects caused by the excessive rise of bilateral FTAs can be minimized if a CJK FTA comes about before the others and is then developed out into other regions in East Asia.

### **Enhancing regional security**

Economic integration has not only economic implications, but also political significance when looking into the background of the EU formation. Close economical relations established through a CJK FTA can contribute to enhancing regional stability due to the very nature of FTAs, even if a CJK FTA is solely focused on economic issues. Military cooperation in Northeast Asia is far from being active, however its positive role in strengthening economic cooperation can also contribute to the development of better future relations for China, Japan and Korea.

The political and military significance of the situation in which a CJK FTA is being discussed cannot be underestimated, especially when considering its role in enhancing cooperation with adjacent countries to solve the recent instability of the Northeast Asian region. Moreover, good relations with Japan and China are essential, even for the sake of political stability in Korea peninsula, which is likely to develop in the near future. Establishing a foundation for cooperation through a FTA will be favorable for inter-Korean economic cooperation.

## **Regionalism as a new momentum for economic growth**

East Asia's economy has continued its dynamic growth thanks to Japan's post-war growth and Korea's post-1970s expansion, which was followed by the growth of ASEAN member countries such as Thailand and Malaysia in the 1980s. The economic growth of East Asian countries, however, has greatly slowed due to the long-term stagnation of Japan's economy since the start of the 1990s and the financial crisis of East Asia in 1997.

China is continuing to see rapid economic growth, but East Asia's economic impetus has slowed and it will be difficult to find external incentives for sustainable economic growth outside the region due to global economic depression. However China, Japan and Korea are heavily dependent upon external economies, and it will be hard for them to find momentum for economic recovery domestically considering their unfavorable economic situations. Domestic setbacks include sustained Japanese deflation, the possibility of Korean real estate bubbles, problems related to non-performing loans and unemployment.

Due to global economic stagnation and the domestic conditions for East Asian countries, a source of economic growth may be intensifying regional cooperation. Strengthened economic cooperation through a CJK FTA may bring economic growth to the region through FDI inflows due to trade service improvement and liberalization in services as well as through the expansion of intra-regional trade under the FTA's trade liberalization and facilitation.

## **Expecting economic effects of a CJK FTA**

The possibility of economic cooperation between China, Japan and Korea is very high considering their geographical proximity and their economic importance in the world economy. Economic cooperation between these countries would give considerable benefits to each country because the resources of China, Japan and Korea are complimentary to one another. A CJK FTA will promote cooperation between the companies in each member country, while at the same time accelerating the division of labor.

The economic situation faced by China, Japan and Korea requires industrial restructuring, and an FTA will facilitate this restructuring process, leading to improved efficiency. China needs to reengineer its supply-oriented economic structure into a demand-oriented structure and is now carrying out a reform drive in state-owned enterprises and the financial sector. Korea and Japan are facing excessive investment problems in various industries, including the automobile, petrochemical and electronics industries.

Abolishing tariffs preferentially will enable companies to access markets in other member countries, creating positive effects through market enlargement. Benefits from external economies through direct investment are also expected in the form of the spread of skills and organizational management, the development of industrial relations and improved investment conditions.

## **2. Prerequisites for a CJK FTA**

### **Building credibility and dissolving competitive relations between China, Japan, and Korea**

The CJK relation is ameliorating thanks to the expansion of economic and human exchange, but there is still a deep chasm of distrust towards Japan based on the past. Mutual understanding and friendly relations between Japan and Korea were consolidated by co-hosting the Japan-Korea World Cup. In addition, the proportion of the population that experienced the period of occupation under Japan is falling and historical issues are less likely to arise in discussions on a Japan-Korea FTA.

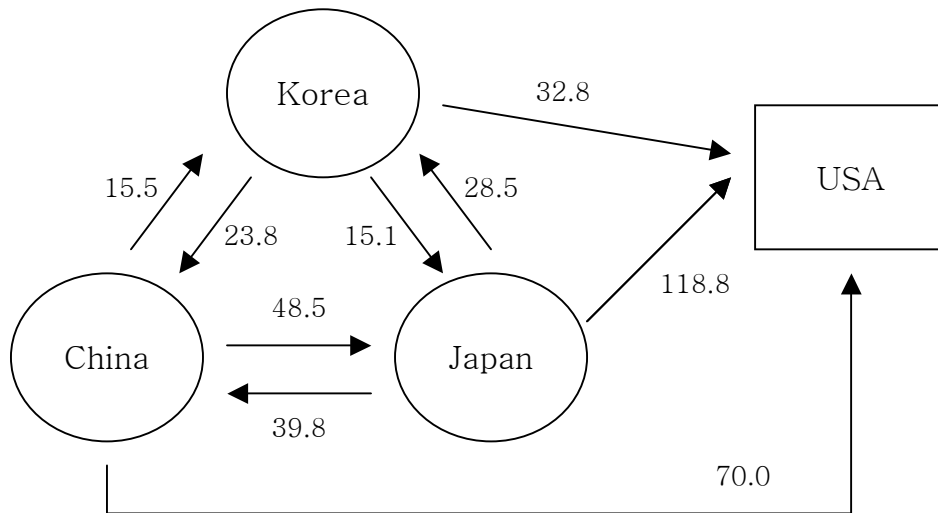
However, national border disputes and issues related to the Yasukuni War Shrine in Japan have caused mutual distrust to continue between China and Japan, and the two countries are said to be experiencing difficulties in building relations of trust (Economist, 2002). Solidifying mutual trust, principally a political concern, between China, Japan and Korea is one of the essential prerequisites to implementing a CJK FTA.

### **International politics and national security**

The United States is not only the number one trading partner for both Korea and Japan, but is also an important partner in military and national security. A FTA inclusive of China may not match the military and national security interests of the U.S. and therefore might draw significant attention from that area.

Non-economic factors are not likely to become an issue with a CJK FTA as FTA discussions are mainly confined to matters focused on strengthening economic cooperation rather than political and social integration, as is the case for European Union. Nevertheless, it is necessary to research and analyze the possibilities of conflict between CJK FTA and U.S. interests and find measures to dissolve them.

Figure 5: Trade Relations between China, Japan and Korea  
(unit: \$ billion)



### Restructuring the weak industries

The main goal of a FTA lies in enhancing economic efficiency through restructuring, but weak industries can act as an obstacle to implementing an FTA. Agriculture is being targeted for restructuring in all CJK countries, and Korea and Japan in particular will face political and economical burdens in opening their agriculture to China under a CJK FTA. In case of Korea, a number of small and medium-sized companies can be targeted for restructuring, whereas in China, inefficient state-owned-enterprises could shrink drastically due to restructuring.

China has deep interest in the agricultural market of Korea and Japan and it is likely that China might require that the agricultural sector be included in a CJK FTA. Therefore, the three countries take countermeasures to meet restructuring and free trade in industries including agriculture before actively promoting a CJK FTA.

### Accelerating China's internal reform

China improved a considerable part of its trade system when it became a member of the WTO. However, it is still considered to have low transparency in customs clearance and intellectual property rights. Implementing an FTA with ASEAN could be helpful for maintaining the economic reform momentum that was sparked by China's entry into the

WTO. China should steadily carry out internal economic reform, mindful that some scholars are pointing to its underdeveloped trade system in a negative evaluation of potential FTAs with China.

### **3. Estimation of the economic effects of a CJK FTA**

#### **Analysis model, simulation hypothesis and scenarios**

The simulation model used in this exercise is a computational general equilibrium (CGE) model with Baldwin-type Capital Accumulation. Rather than building a database for running a simulation model, the author used the Global Trade Analysis Project (GTAP) version 5, which was released in 2001. This database is world-widely used by CGE economists and trade analysts. Detailed information on the GTAP database can be found at the GTAP homepage (<http://www.gtap.agecon.purdue.edu/>).

Although the model tries to reflect economic linkages among major economic agents in a general equilibrium framework, assumptions simplifying real economic relations are inevitable. Four assumptions are made for the purposes of building a CGE model and simulations as follows:

- 1) Perfect competition is assumed in all economic sectors.
- 2) Hong Kong is considered a part of the Chinese economy.
- 3) The tariff rate of China is adjusted to current tariff rates.
- 4) A China-ASEAN FTA, Japan-ASEAN FTA and Japan-Korea FTA are assumed depending on the purpose of analysis.

Four scenarios are introduced for experimental simulations:

- Scenario 1: No China-ASEAN or Japan-ASEAN FTA.
- Scenario 2: A China-ASEAN FTA is concluded.
- Scenario 3: Both a China-ASEAN FTA and Japan-ASEAN FTA are concluded.
- Scenario 4: A China-ASEAN FTA, Japan-ASEAN FTA and Japan-Korea FTA are concluded.

#### **Main results of analysis**

##### **a. Influence on GDP**

It has been analyzed that Korea will be the country seeing the largest benefits from a CJK FTA. These gains, however, would mostly be obtained by the restructuring of non-competitive sectors. According to a simulation, Korea's GDP is likely to grow by 1.29-4.73 percent, but its agriculture is expected to shrink by 8-10 percent.

Table 5: Influence of CJK FTA on GDP

Country	GDP (%)
China	0.03-1.05
Japan	0.03-0.16
Korea	1.29-4.73

A CJK FTA can yield more economic benefits for all three countries than bilateral FTAs between China, Japan and Korea.

Table 6: The Effects of Bilateral FTAs between China, Japan, Korea and CJK FTA on National GDP

(Unit: %)

	China-Japan FTA		China-Korea FTA		Japan-Korea FTA		CJK FTA	
	TL	TL&CA	TL	TL&CA	TL	TL&CA	TL	TL&CA
China	0.27	1.11	0.12	0.45	-0.01	-0.03	0.34	1.29
Japan	0.05	0.12	-0.00	-0.04	0.01	0.04	0.06	0.13
Korea	-0.05	-0.26	0.76	1.76	0.22	0.92	0.94	2.45

Note: 1) TL and CA stand for trade liberalization and capital accumulation, respectively.

The effects of capital accumulation, including FDI, are expected to be much larger than those of trade liberalization. Therefore, the effects of an FTA would depend on the improvements made to the investment environment, such as improved trading systems and enhanced transparency, promoting FDI and inducing domestic investment. Neither a China-ASEAN FTA nor a Japan-ASEAN FTA has an apparent influence on the preparation of a CJK FTA. They are seen to have a relatively greater negative effect on China than Japan.

Table 7: Influence of CJK FTA on the GDPs of China and Japan

	Scenario 1		Scenario 2		Scenario 3	
	TL	TL&CA	TL	TL&CA	TL	TL&CA
China	0.34	1.29	0.05	1.05	0.03	1.02
Japan	0.06	0.13	0.09	0.14	0.03	0.16

Note: 1) TL and CA stand for trade liberalization and capital accumulation respectively.

A CJK FTA after the conclusion of a China-ASEAN FTA and Japan-Korea FTA could be a barrier to Japan's GDP growth in the short-term, but would be more favorable in the mid- and long-term.

#### **b. Influence on industrial production**

Automobile and textile production is expected to decrease in China while clothing, agriculture and electronics are expected to show an increase in production. Agricultural production in Japan and China is expected to decrease while much of the industrial production is seen to increase.

Table 8: The Influence of CJK FTA on Industrial Sector

	China	Japan	Korea
Growth Sector	Clothing, agricultural products, electronics, processed food	Machinery, textiles, automobile, electronics	Petrochemicals, processed food, textiles
Depressed Sector	Automobile, textiles, metals	Agricultural products, clothing, marine products	Other transportation equipment, automobile, electronics

#### **c. Influence on trade**

The trade volume of member countries is expected rise with a CJK FTA. In the case of China, exports to Japan will increase by some 50 percent compared to exports in 2002 and exports to Korea will nearly double. It is estimated that Japan's exports to China and Korea will increase by \$18.8-31.6 billion and \$9-19.4 billion, respectively, thus marking an export increase rate of 55-75 percent in the estimated year (2002). Korea's exports to



China and Japan are expected to increase by \$8.5-12.1 billion and \$8.3-10.3 billion, respectively.

Table 9: The influence of CJK FTA on Trade

(Unit: \$ billion)

Exporter/Importer	China	Japan	Korea
<b>China</b>	n/a	20.47-25.38	12.51-15.12
<b>Japan</b>	18.78-31.64	n/a	9.04-19.44
<b>Korea</b>	8.48-12.14	8.30-10.27	n/a

The main export products exported from China to Japan and Korea that will see an increase are expected to be clothing, agricultural products, processed foodstuffs and electronics. Japan is expected to see an export increase in automobile, electronics, machinery and steel while Korea is projected to see an export increase in textiles, petrochemicals, electronics and processed foodstuffs.

Table 10: Major Export Products Expected to Increase in CJK FTA

Exporter/Importer	China	Japan	Korea
China	n/a	Clothing, agricultural products, processed foodstuffs, textiles, machinery	Agricultural products, processed foodstuffs, textiles, clothing, electronics
Japan	Automobile, machinery, electronics, textiles, steel	N/a	Machinery, electronics, petrochemicals, steel, automobile
Korea	Textiles, petrochemicals, clothing, machinery, electronics	Processed foodstuffs, agricultural products, textiles, clothing, petrochemicals	n/a

The three countries can expect economic benefits from a CJK FTA that will grow when free trade is correlated with improvements to their investment environments. Therefore, a CJK FTA should be implemented as a comprehensive agreement involving investment and services and trade rules.

According to the Trilateral Joint Research Team's questionnaire survey of business enterprises, a large proportion of the respondents supported the idea of establishing a FTA

among China, Japan and Korea<sup>1</sup> (85 percent in China, 79 percent in Japan and 71 percent in Korea<sup>2</sup>).

FTAs bring about conflicts of interest among domestic interest groups, making it difficult to maintain the momentum for implementing a FTA. Political compromise should be found within the vastly differently political ideologies and economic development levels of the three countries in order to conclude a CJK FTA.

Confidence building between the member countries is expected to be the most important prerequisite for a CJK FTA. To this end, more joint research between the three countries should be encouraged in the political and diplomatic sectors as well as in the economic field.

## **VI. The Future Prospects of Economic Integration in Northeast Asia**

Due to the political and economic characteristics of the region, Northeast Asian economic integration is being achieved sporadically, focusing on areas where cooperation is in dire need for public interest rather than focussing on systematic integration. That is, economic integration in the region was first advanced in areas where mutual interests could be fully realized, rather than an institutional integration. There remain issues to be solved such as cooperation overlap and efficiency because bilateral cooperation such as Japan-Korea, China-Korea and China-Japan, as well as and China-Japan-Korea trilateral cooperation are intertwined.

Northeast Asian economic cooperation does not yet have a solid foundation, making voluntary participation a main issue. In addition, the lack of restrictions on content that has been agreed upon means that a mid- to long-term roadmap for cooperation has not been set.

Fortunately, regular trilateral sessions have been held since the launching of the annual 1999 ASEAN+3 Summits, and the cooperation framework of the Northeast Asian region has been established. It seems that Northeast Asian economic integration will precede around various cooperative channels for the time being. Furthermore, cooperation in the fields of finance, industry, environment, science and technology, along with energy, logistics and railroads/transportation is expected to increase further. Major players in the Northeast Asia economic cooperation will be China, Japan and Korea, but this group will

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<sup>1</sup> The Trilateral Joint Research Project is being performed by the Development Research Center of the State Council (DRC) in China, the National Institute for Research Advancement in Japan (NIRA) and the Korea Institute for International Economic Policy (KIEP).

<sup>2</sup> Detailed information can be found in the Appendix.

expand to encompass Taiwan, Far East Russia and North Korea in the mid to long term. Consolidating cooperation in these fields will become the basis of the Northeast Asian economic integration.

Regardless, Northeast Asian economic integration will be difficult to achieve with only cooperation based on the necessity of each field. Countries within the area must fulfill systematic market integration and have formal institutions for cooperation. Only then can economic integration be bound to mid- to long-term expectations. When cooperation expands into other fields and the reliability of implementing cooperative projects increases, cooperation will advance to a higher level. In this regard, the establishment of a Northeast Asian FTA will be the starting point for the full-scale Northeast Asian economic integration. An FTA should first be established among the core countries, including other countries later.

In this light, the negotiations surrounding the Japan-Korea FTA next year should not be approached from the narrow view of a bilateral agreement, rather, they should be designed with the idea of a comprehensive Northeast Asian FTA. In addition, the government should take part in the ongoing China-Japan-Korea FTA research. Discussions on the China-Japan-Korea FTA will press forward as the leaders of the three countries to conduct this study at the China-Japan-Korea Summit in October 2003 in Bali, Indonesia. According to Chinese Xinhua News Agency (October 7, 2003), the three countries agreed to strengthen cooperation and the protection of intellectual property rights through the promotion of public awareness, personnel exchanges, experience sharing and law enforcement. It has also been agreed upon that the three countries would “explore, in a timely manner, the direction of a closer future economic partnership among the three countries.”

In light of the international trade environment, Northeast Asian economic integration is expected to press forward. The importance of expanding domestic markets in Northeast Asia to compensate for global economic stagnation is increasing. As the Cancun WTO Ministerial Meeting failed to produce an agreement on the DDA negotiation modality, the main trading partners are expected to look into regional trade arrangements, and the expansion of regionalism will promote economic integration, even for Northeast Asian countries. Improving U.S.-China relations will contribute to this economic integration, too.

It is highly possible that China is anticipated to become more actively involved in economic integration in Northeast Asia in near future.<sup>3</sup> By 2005, China will have

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<sup>3</sup> The Chinese Xinhua News Agency (October 7, 2003) reported that China proposed holding a seminar in China next year on “Revitalizing Northeast Asia and Northeast Asian cooperation.” China has begun to implement the strategy of “Revitalizing Northeast Asia,” which will provide a new opportunity for cooperation between the three countries. Government officials and people from all occupations from Japan and South Korea will attend the seminar.

completed implementing the tariff reductions and economic reforms stipulated when it joined the WTO. China is required to reduce its average tariff rate for manufacturing sectors from 16.8% of 1999 to 10.1% by 2005. Once China settles all its domestic issues, it will be ready to face FTA issues more progressively. Second, China will be more responsive against economic integration in other regions. As negotiations for the WTO's DDA progress slowly, major trading countries will pay attention to regional economic integration. Third, China will be more progressive with the establishment of its first FTA with ASEAN next year. One of advantage of China in pursuing FTAs is that if the Chinese (communist) government recognizes the importance of economic integration, China will automatically move forward, as has already been revealed in the China-ASEAN FTA.

Korea, which is aiming to become a Northeast Asia economic hub, must set up conditions for the free movement of goods and resources in Northeast Asia as well as improve the internal business environment. As for improving external conditions, the China-Japan-Korea FTA could be an effective method of doing so. Considering China and Japan's rivalry relationship, Korea's role as mediator is crucial in the Northeast Asian economic integration.

On the other hand, there are many barriers standing in the way of Northeast Asian economic integration. Economically, there are gaps in the levels of development among the countries, and they differ in their trilateral economic development strategies. Politically, there are factors such as historical issues, China-Japan confrontations, and military and security issues with China. However, as seen in the case of Europe, overcoming political barriers by converting confrontational relationships into cooperative ones will be requisite for economic integration.

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## Appendix: The Joint Business Survey on a CJK FTA<sup>4</sup>

The Trilateral Joint Research Team conducted a questionnaire survey of business enterprises from April to June 2003. During the survey period, the same questionnaires, translated into local languages, were sent to 1,650, 1,920, and 2,461 business enterprises in China, Japan and Korea respectively. The enterprises were either listed large or medium- sized firms, or firms with trade or investment relations in one or both of the other countries concerned. Therefore, the survey is not an opinion poll, reflecting the opinions of all groups of the societies of the three countries. The number of valid responses was 203 (12.3 percent), 346 (18.0 percent) and 203 (8.2 percent) in China, Japan and Korea respectively. The rates of response appeared rather modest, and the results should be treated with a certain caution.

In general, a large proportion of the respondents supported the idea of establishing an FTA among China, Japan and Korea (Table A.1). The percentage of respondents answering “Support” to this question was 85 percent in China, 79 percent in Japan, and 71 percent in Korea.

Table A.1: Do you agree or disagree with the idea of an FTA  
among China, Japan and Korea?

(Unit:%)

	China	Japan	Korea
Approval	85.3	78.7	70.9
Objection	1.5	5.9	13.3
Conditional approval or objection	13.2	14.2	15.8

The respondents who supported the FTA were then asked for their opinion on the most appropriate time to launch the FTA negotiations. An early launch of FTA negotiation was generally supported (Table A.2).

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<sup>4</sup> This part is taken from the Joint Report and Policy Recommendations on Strengthening Economic Co operation among China, Japan and Korea by Trilateral Joint Research of Development Research Center of China, National Institute for Research Advancement of Japan and Korea Institute for International Economic Policy of Korea. The report was presented to the Leaders of China, Japan and Korea at Bali, Indonesia, October 2003.

Table A.2: When would it be best to launch of the FTA negotiation among the three countries?

(Unit:%)

	China	Japan	Korea
As an immediate action (as soon as possible)	47.4	46.7	23.6
Along a short-term plan (within 3 years)	35.9	32.5	45.8
Along a medium-term plan (within 5 years)	14.6	18.0	25.7
Along a long-term plan (within 10 years)	2.1	2.0	4.9

Regarding the reasons enterprises supported the FTA (Table A.3), the highest percentage of respondents in all three countries chose the answer “Because an FTA will bring expansion of exports to the other two countries”, with 70 percent in China, 67 percent in Japan, and 69 percent in Korea.

Table A.3: What is the reason of your approval? (Multiple answers)

(Unit:%)

	China	Japan	Korea
The FTA will bring expansion of exports to other two countries	69.8	66.7	68.8
Reduction in cost of customs and procedures	55.7	66.7	51.4
Reduction in importation cost from other two countries	63.0	46.7	45.8
Reduction in transaction cost with affiliated or subordinated company in other two countries	14.6	38.0	22.2
The FTA will promote cultural and personnel exchange, therefore it brings about political stabilization of this region	47.4	20.4	34.7
The FTA will promote investment from other two countries	59.4	3.9	5.6
Benefit from specialization within three countries	48.4	29.0	26.4
Stabilization of import and (or) export prices	35.4	17.3	30.6
Other	3.1	2.7	1.4