

PROSPECT AND CHALLENGES OF EAST ASIAN ECONOMIC INTEGRATION: A SOUTH KOREAN PERSPECTIVE*

CHOONG YONG AHN

Chung-Ang University

Although East Asia is regarded as one of the three major economic pillars in the world, it still has the lowest level of economic cooperation and integration compared to the EU and NAFTA. The Asian financial crisis in 1997/98 triggered a sense of “East Asian regional identity.” A “functional integration” in East Asia has already occurred in the form of FTAs and some regional monetary cooperation. Although belatedly, South Korea has taken a highly proactive multi-track FTA policy stance so that FTAs can serve as effective and expeditious trade policy tools for economic restructuring geared to sustainable economic growth and consumer welfare, jump starting the multilateral DDA process. China, Japan, and South Korea have been scrambling for an FTA with ASEAN. China-led regional FTA and Japan-led FTA in an uncooperative game are likely to generate hub-spoke bilateralism in East Asia. East Asia should work out an ASEAN + China-Japan-Korea FTA that could set the tone for East Asian integration from a long term perspective.

Keywords: Economic Integration, Regional FTAs, FTA, ASEAN, South Korea
JEL classification: F15, F42

1. INTRODUCTION

Although economic regionalism has become a worldwide phenomenon, East Asia, Northeast Asia¹ in particular, lags behind other major regions such as EU and North America. The 1990s witnessed a global wave of free trade agreements (FTAs), but East Asia largely ignored the proliferation of regional trading arrangements (RTAs).

* Prepared for Presentation at the International Symposium to celebrate the 30th Anniversary of the *Journal of Economic Development*, published by the Economic Research Institute of Chung-Ang University, October 28, 2005 at the Conference Room, the Graduate School of Chung-Ang University.

¹ In this paper, East Asia implies ASEAN and Northeast Asian economies of China, Japan and Korea (CJK). Occasionally, Northeast Asia refers to CJK plus the Russian Far East, Taiwan, Hong Kong, and Mongolia on the basis of functional linkages.

However, the Asian financial crisis in 1997-1999 triggered a sense of “East Asian regional identity.” This, in addition to increased tendencies towards intra-regional interdependence in trade and investment in East Asia is due to high growth inertia largely fueled by China, geographical proximity and sheer market forces embedded in globally emerging production fragmentation. Indeed, closer regional economic cooperation in East Asia has already occurred in the form of FTAs and regional monetary cooperation such as a currency swap agreement.

The natural response for East Asian countries toward recently rising regionalism would be the acceleration of the ongoing market-driven economic linkages as well as institutional economic integration. Then the question arises whether East Asia can reach a formal framework of trade and investment liberalization such as an East Asian FTA(EAFTA) and Asian bond market or Asian common currency, which could be the first step towards a long term goal of the formation of an “East Asia economic community”.

Since the eruption of the Asian financial crisis in 1997-1998, political leaders of the ASEAN+3 (China, Japan and Korea) have established an annual summit to address economic cooperation measures in the region. The ASEAN+3 process, which started in 1998, can be an igniting source for an EAFTA. In November 1999, the ASEAN+3 Summit released the Joint Statement on East Asian Cooperation that outlines of possible areas for regional cooperation.² The regional summit also discusses the transformation of the ASEAN+3 process into an East Asian Summit for a more enhanced institutional approach for regional cooperation. In addition to the existing ASEAN Free Trade Agreement (AFTA), the three major Northeast Asian countries - China, Japan and Korea - recently joined the rapidly proliferating FTA bandwagon. Then, within this framework and emerging trend, the idea of an EAFTA is likely to gain more momentum among member countries.

Furthermore, the 1997 Asian financial crisis brought about consensus for East Asian countries to avoid a recurrence of another regional financial shock. In particular, the framework for financial cooperation was consolidated in May 2000 by the ASEAN+3 Chiang Mai Initiative (CMI), which involves a regional currency swap to provide self-help and support mechanisms.

There are many obstacles on the road towards a full-pledged East Asian economic integration. To cite some important factors: differences in their political systems, level of economic development, historical remnants and so on. But in spite of these impediments, East Asia will need to overcome these and pursue economic integration in order to respond to the emerging trend of regionalism as well as globalism.

The EU was enlarged, encompassing ten Central and Eastern European countries and a Free Trade Area of the Americas(FTAA), which covers both North and South America,

² The areas for cooperation were diverse, including trade, investment, technology transfers, e-commerce, agriculture, small and medium-sized businesses, tourism, the development of the Mekong river basin etc.

will be realized. Given the advent of the two major economic blocs, how can East Asia react? To put simply another way, how East Asia can reach an EAFTA to begin with. All potential member countries of an EAFTA have different idea and directions to pursue a regional free trade agreement. Is there is any way to narrow the gap between the countries in respect to their perception of an EAFTA? Given the unsustainable global imbalance of transpacific trade between the United State and East Asia, how will the U.S. be involved in the East Asian integration process?

This paper attempts to discuss emerging economic integration efforts in general in East Asia with special reference to bilateral and regional FTAs and financial cooperation matters, and in particular South Korea's perspective on the East Asian integration with North Korea in the picture. Section II describes events leading up to recent developments in East Asian regionalism in terms of deepening intra-regional economic dependence and financial cooperation. Section III discusses recent development in FTA negotiations in East Asia. Section IV presents Korea's position and policy direction toward East Asian regionalism. Section V concludes with some broad policy implications for East Asian economic integration.

2. THE RISE OF INTRA-REGIONAL ECONOMIC DEPENDENCE AND FINANCIAL COOPERATION IN EAST ASIA

Even in the absence of a formal and viable integration mechanism in East Asia, East Asian economies in recent years have eye-witnessed rapidly rising trade, investment and financial interdependence. Adjacent countries tend to be associated economically closer than countries apart if political reasons do not prevent. This phenomenon could be called a "functional integration process"³ generated by sheer market forces. Most importantly, the rapidly growing China's economy since its open door policy has contributed a great deal to the intra-regional functional interdependence in East Asia as not only trade creator but also a black hole of East Asia bound FDI.

In the globalization era, many countries liberalized barriers to foreign investment partly due to continuing technical progress in transport and communications. Containerization and air freight brought a considerable speeding up of shipping, allowing countries to participate in international production network. New information and communication technologies make it easier to manage and control geographically dispersed supply chains. Information-based activities are "weightless." But distance becomes even more important in East Asia, EU, and North America! Proximity requirement of JIT (just in time) technologies and production fragmentation make

³ Without a region wide FTA framework, a diverse type of economic cooperation can take place in the areas of infrastructure, telecommunication, energy, environment, fishery, science and technologies on a bilateral or plurilateral basis. For some discussion, Lee, C.J. (2004, p. 11) and Ahn, C.Y. (1993)

geographical proximity a key determinant toward regional network for high value-added activities.

2.1. Rising Dependence in Intra-Regional Trade and Investment

Given the already institutionally integrated ASEAN FTA (AFTA), we focus on integration efforts in Northeast Asia, which shares roughly 90 percent of East Asian GDP. As seen in Table 1, East Asia accounts for about one-third of the world's population, one-fifth of the world's GDP, and about one quarter of world trade volume. Broadly viewed, East Asia is evaluated to have a similar economic potential as the EU and NAFTA in the years to come, provided that the region continues to grow and properly integrate.

Table 1. Economic Profile of East Asia in the World (2004) (Unit: %)

	Population	GDP	Trade	FDI(inflow)
East Asia*	32.2	20.1	24.5	21.2
Northeast Asia**	23.2	17.1	14.2	11.7
ASEAN	8.6	1.9	5.6	4.0
EU	6.1	29.8	36.5	30.3
NAFTA	6.8	32.6	18.1	18.3
Other	54.9	17.5	20.9	30.2
World	100.0	100.0	100.0	100.0

* East Asia is defined as ASEAN plus three (China, Japan and South Korea), Hong Kong and Taiwan.

** Northeast Asia is defined to include China, Japan and South Korea.

Sources: IMF. 2005. *Direction of Trade Statistics Yearbook*; Globalinsight. 2005. *World Overview*; UNCTAD. 2005. *World Investment Report 2005*; Taiwan's Bureau of Foreign Trade(online).

Table 2 shows the relative economic importance of key Northeast Asian countries in the world in 2004 in terms of GDP and trade. It is evident that China, Japan and Korea are key players in any integration process for East Asian economies. Northeast Asia occupied 17.1 percent of the world GDP in 2004.

Table 2. Northeast Asian Countries' Share of Global GDP and Trade (2004) (Unit: %)

	GDP	Intra-trade	Trade	Exports	Imports
Korea	1.7	-	2.6	2.7	2.4
China	4.0	-	6.5	6.8	6.1
Japan	11.4	-	5.5	6.2	4.8
Korea, China, Japan	17.1	23.9	14.5	15.8	13.3
Korea, China, Japan, Hong Kong	17.5	35.2	17.3	18.6	16.1

Sources: Calculated from IMF, *Direction of Trade Statistics Yearbook*, 2005; Standard & Poor's DRI, *World Economic Outlook*, 2005.

Trade among three Northeast Asian countries shared 14.5 percent of the world trade total in 2004. When adding Hong Kong to China, Japan and Korea, they occupied 17.3 percent. Intra-trilateral trade between Korea, China and Japan shared 23.9 percent of their total trade with the world in 2004. With Hong Kong included, intra-regional trade reached 35.2 percent.⁴

The deepening trade interdependency within Northeast Asia is more distinct when we look at the trade intensity index (Table 3). The trade intensity index of a country is usually used to estimate the degree of trade linkage with another country.

Table 3. Dynamics of the Intra-Regional Trade Intensity Index in East Asia

	Year	China	Japan	Korea	ASEAN
Korea	1980	0.08	2.39	-	1.97
	1985	0.06	2.23	-	1.56
	1991	0.78	2.61	-	2.02
	1996	2.84	1.88	-	2.03
	2001	3.22	1.98	-	1.92
China	1980	-	2.90	0.12	2.00
	1985	-	3.30	1.01	3.20
	1991	-	2.17	0.32	1.16
	1996	-	3.17	0.79	0.88
	2001	-	3.21	2.02	1.19
Japan	1980	3.71	-	3.59	3.05
	1985	3.18	-	2.47	1.98
	1991	1.52	-	2.79	2.41

⁴ Countries have performed trade transactions with China partially through Hong Kong; therefore, each country's intra-regional trade might be overestimated.

	1996	1.88	-	2.57	2.63
	2001	1.98	-	2.86	2.59
ASEAN	1980	1.02	3.64	1.42	-
	1985	1.63	3.61	1.90	-
	1991	1.12	2.71	1.54	-
	1996	1.12	2.18	1.28	-
	2001	1.40	2.45	1.71	-

Notes: ¹ The trade intensity index of *Country I* is defined as

$$TII_{ij} = \frac{X_{ij}/X_i}{M_j/M_w},$$

where X_{ij} is export from country i to j , X_i is total export of *Country I*, M_j is total import of country j , M_w is world total import. TII_{ij} compares export from *Country I* to j divided by total export of *Country I* to the ratio of import of country j divided by total world import. If TII_{ij} is greater than 1 then *Country I* and j are related more closely than others. The index was computed using IMF, *Direction of Trade Statistics Yearbook* (various issues).

² ASEAN data represent Indonesia, Malaysia, Philippines, Singapore and Thailand.

As shown in Table 3, the trade intensity index of Korea with China was 0.08 in 1980. After the diplomatic normalization between China and Korea in 1992, the figure increased rapidly from 0.78 in 1990 to 3.22 in 2001, continuously intensifying the economic cohesion between the two countries.

However, the trade intensity index between Korea and Japan declined from 2.39 in 1980 to 1.98 in 2001, showing that the intensity between the two countries has slightly weakened over time. The trade intensity index of Japan with Korea continued to fall, eventually stagnating: starting from 3.59 in 1980, the index fell to 2.47 in 1985, stagnating at 2.86 in 2001. The trade intensity index of Japan with China also shows a drastic decrease and stagnation: starting from 3.71 in 1980, the indexes declined 1.52 in 1991 and were stagnant at 1.88 in 1996 beyond.

ASEAN's trade intensity with China, Japan and Korea remained nearly unchanged except for a substantial decrease between ASEAN and Japan. It should be noted that the intra-regional trade intensities among the three countries were all greater than one, indeed very high in absolute magnitude. This high trade intensity among the three countries reflects the intensified interdependence in terms of intra-regional trade.

Table 4 and Figure 1 compare the intra-regional trade shares of main economic blocs including Northeast Asia. NAFTA increased its intra-regional trade share from 37.2 percent (1990) to 43.6 percent (2002). ASEAN's intra-regional trade has remained at nearly constant level of around 38 percent since the mid-1990s after a sharp rise during the 1990-95 periods. At the same time, Northeast Asia saw an increase of intra-regional trade share from 12.7 percent to 23.9 percent from 1990 to 2004. The EU's intra-regional trade had the highest ratio among the main regional economic blocs with

around 60 percent over the last two decades (Table 4 and Figure 1).

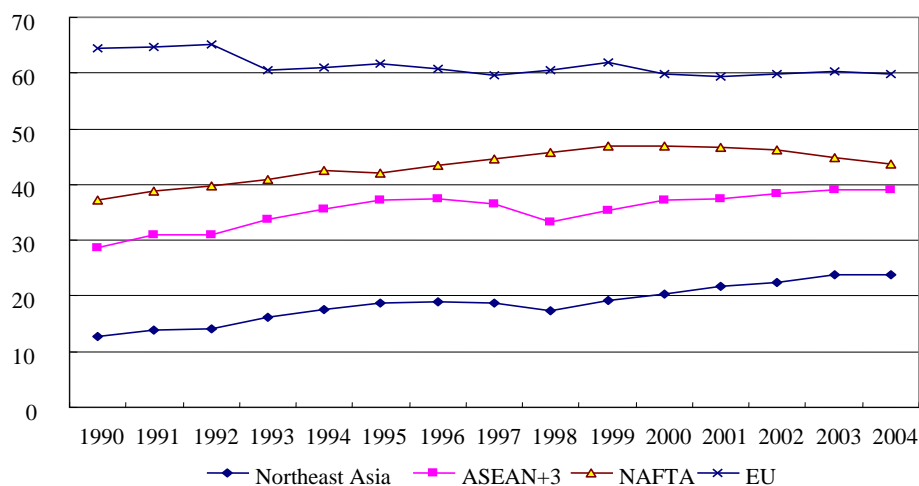
Table 4. Main Economic Blocs' Share of Intra-regional Trade (Unit: %)

	1990	1995	1998	2000	2002	2003	2004
Northeast Asia	12.7	18.6	17.4	20.3	22.4	23.7	23.9
ASEAN+3	28.6	37.1	33.3	37.3	38.4	38.9	39.0
NAFTA	37.2	42.0	45.7	46.9	46.1	44.9	43.6
EU	64.5	61.6	60.5	59.8	59.9	60.4	59.8

Notes: ¹ EU: Fifteen Western European countries. ² NAFTA: United States, Canada and Mexico. ³ Northeast Asia: China, Japan and Korea.

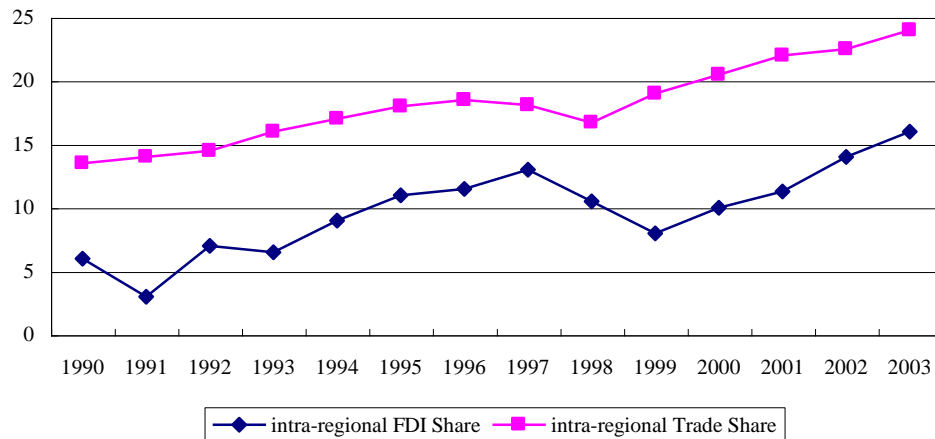
Source: IMF, *Direction of Trade Statistics Yearbook*, 2005.

Figure 1 shows that the intra-regional trade shares in Northeast Asia and ASEAN+3 increased rapidly in the 1990s. Compared to EU and NAFTA at 60 percent and near 50 percent respectively, which were nearly constant in the late 1990s, the intra-regional trade shares in Northeast Asia as well as ASEAN are still quite low. As Scalapino's (1991) natural economic territory states, when formal economic agreements such as FTAs are introduced in Northeast Asia, intra-regional trade and the subsequent economic gains are expected to increase due to trade creation effects and augmented investment on the basis of geographic proximity and expected reduction of logistic costs.



Source: IMF, *Direction of Trade Statistics Yearbook*, 2005.

Figure 1. Intra-Regional Trade Share of Main Economic Blocs



Sources: Ministry of Commerce, Industry, and Energy, Korea , *Trends of FDI*, 2005; Bank of Korea, *FDI Statistics*, various issues; Office of External Trade and Economic Cooperation, *Yearbook of External Economy & Trade*, various issues; China Statistics Press, *China Statistical Yearbook*, various years; UNCTAD, *World Investment Report*, various issues; IMF, *Direction of Trade*, 2005; www.jetro.go.jp/ec/j/trade.

Figure 2. Intra-Regional FDI and Trade Share among Korea, China and Japan

As another indicator of increased economic interaction in Northeast Asia, intra-regional direct foreign investment (FDI) has also increased to take advantage of reduced production costs and to secure the expanded market. Figure 2 shows that after 1990, FDI among China, Japan and Korea increased rapidly until the mid-1990s but declined during the Asian financial crisis. Since 1999, however, trilateral FDI have risen sharply again. It should be noted that the cross-border movement of trade and investment in Northeast Asia seems to be mutually reinforcing each other. Therefore, the introduction of regional FTAs and follow-up market expansion will not only increase intra-regional FDI, but also attract foreign investment outside East Asia.

2.2. Financial Cooperation in East Asia

Above all, the single greatest push for East Asian regionalism was the financial crisis of 1997-1999. Many East Asians felt that they were let down by the West during the Asian crisis. In their view, western banks and other financial institutions had created and exacerbated the crisis by pulling out their funds from the region (Yip (2001)) Bergsten (2000) suggests that “another motivation for Asian regional initiatives is the failure of the existing international economic institutions to provide East Asia with a role consistent with its economic progress.” The relationship between Asian financial crisis and regionalism has also been explored in studies by Bergsten (2000), Eichengreen

(2002), Yamazawa (2001), Yip (2001), Park (2003), Kwack, Ahn, and Lee (2004), Kawai (2005), and Ahn and Cheong (forthcoming).

In addition to the deepening of the functional integration process in terms of trade and investment in East Asia, there has also been a remarkable development in the area of financial cooperation. The Asian financial crisis has provided East Asian economies with a new perspective on regional cooperation matters. As a self-help and liquidity support mechanism for regional financial cooperation, the Chiangmai Initiative (CMI)⁵ was a significant turning point. The search for a regional financial cooperation mechanism that could forestall future crises is now gathering momentum and opening the door to possible significant policy-led integration in East Asia (Henning (2000)).

Bergsten (2000) foresees that because of the financial crisis and the nondiscriminatory nature of financial cooperation, East Asia's institutional economic cooperation or potential integration movement might come first in the financial area. As a follow-up to the ASEAN+3 CMI, there is a critical need for East Asian countries to establish an institution that allows mutual consultation regarding exchange rates, interest rates, and foreign exchange reserve policy.

As during the Asian financial crisis, if the channels of contagion cannot be blocked off through multilateral cooperation at an early stage of crisis, countries with insufficient foreign reserves might not be able to survive financial crisis. Without sound financial institutions and adequate regulatory regimes, East Asian financial markets will remain vulnerable to external shocks. In this context, three pillars of liquidity assistance - monitoring, surveillance and exchange rate coordination - are essential elements for regional financial and monetary cooperation.

However, the development of regional financial cooperation and its related institutions will be evolutionary, as evident in the case of European monetary integration. A shallow form of financial cooperation may comprise no more than a common foreign reserve pooling or mutual credit arrangement such as bilateral swaps. In connection with regional trade facilitation, some kinds of shallow financial cooperation are conceivable without any commitment to exchange rate coordination under which exchange rates of the participating countries are pegged to each other or vanish through the adoption of a common currency. Although a full-fledged form of monetary integration is not viable at this stage, East Asia may begin to examine the feasibility and desirability of cooperation and coordination in exchange rate policies. This is particularly so since the Chinese yuan has abandoned its dollar pegged exchange rate system since July 2005.

After the Asian financial crisis, Fischer (1999) suggested that greater exchange rate flexibility would be desirable in the future, while others suggested more stable exchange rates against the yen might be preferable (Ohno (2000)). However, McKinnon (2001)

⁵ At the ministerial meeting of the ASEAN+3 during the 33rd annual meeting of the Asian Development Bank (ADB) in May 2000, participants agreed to the CMI to expand the ASEAN currency swap as well as existing bilateral currency swaps.

suggested a modified East Asian dollar standard to curb hot money inflows while observing a resurrection of the East Asian dollar standard and continuing stability of the dollar exchange rate in the post-crisis period. In order to facilitate further ongoing intra-regional trade in East Asia, a stable and coordinated exchange rate mechanism must be in order.

In order to expedite the CMI process, Japan has been playing a leading role in terms of both the number of bilateral swap agreements (BSAs) and amounts committed under the BSAs: Japan concluded six agreements (with Korea, China, Indonesia, Malaysia, the Philippines and Thailand) and is currently negotiating another agreement with Singapore. Korea, which concluded four agreements with China, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA, is also expected to conclude BSA negotiations with Indonesia (see Table 5).

Table 5. Progress on the Chiangmai Initiative (As of September 30, 2003)

BSA	Currencies	Conclusion Dates	Amount (US\$)
Japan-Korea	USD/Won	July 4, 2001	\$7 billion (a)
Japan-Thailand	USD/Baht	July 30, 2001	\$3 billion
Japan-Philippines	USD/Peso	August 27, 2001	\$3 billion
Japan-Malaysia	USD/Ringgit	October 5, 2001	\$3.5 billion (a)
PRC-Thailand	USD/Baht	December 6, 2001	\$2 billion
Japan-PRC	Yen/Renminbi	March 28, 2002	\$3 billion equivalent
PRC-Korea	Won/Renminbi	June 24, 2002	\$2 billion
Korea-Thailand	USD/Baht	June 25, 2002	\$1 billion
Korea-Malaysia	USD/Ringgit	July 26, 2002	\$1 billion
Korea-Philippines	USD/Peso	August 9, 2002	\$1 billion
PRC-Malaysia	USD/Ringgit	October 9, 2002	\$2 billion
Japan-Indonesia	USD/Rupiah	February 17, 2003	\$3 billion
PRC-Philippines	USD/Peso	Negotiation completed	\$1 billion
Japan-Singapore	Under negotiation		
PRC-Indonesia	Under negotiation		
Korea-Indonesia	Under consideration		

Note: (a) The US dollar amounts include the amounts committed under the New Miyazawa Initiative - \$5 billion for Korea and \$2.5 billion for Malaysia.

Most East Asian countries that are willing to participate in regional financial cooperation agree in principle that the CMI needs to be supported by an independent monitoring and surveillance system. The system should be able to 1) monitor economic

performances in the region, 2) serve as an institutional framework for policy dialogue and coordination among the members and 3) impose structural and policy reform on the countries drawing from the BSAs.

As East Asian economies grow more open and interdependent, they are becoming vulnerable to international disturbances, given the high degree of capital mobility across countries in the world. The spread of capital mobility makes it difficult for a single small country to keep its pegged exchange rates. Forming a single currency region may be desirable. Currently, such a currency area is a very distant prospect. The lack of political commitment and experience with regional cooperation in East Asia are decisive factors against the formation of a common currency area in the near future.

Then, a transition process, akin to the formation of a quasi-monetary bloc, remains a viable option for East Asia. Kwack, Ahn and Lee (2003) suggest that a new organization be formed to assess necessity and implement steps necessary for the formation of a quasi-monetary union. The coordinating institution should provide the framework for implementing unified systems with proper monitoring system for flexible exchange rates and flexible inflation target to all member countries. At present, however, flexible exchange rate systems together with flexible inflation targets are suitable to attain the objectives of lowering the costs of external shocks and keeping inflation low.

If the systematic implementation of financial coordination and the coordinating institution can establish a quasi-monetary bloc, it may lead to political and economic convergence among the East Asian countries. Creating greater political and economic convergence is a necessary process to establish common monetary standards. Increasing intra-regional trade, a regional FTA and regional cross-border capital investment will contribute toward the formation for a common currency area, as discussed in Kwack, Ahn and Lee (2003).

3. RECENT DEVELOPMENT OF FTAS IN EAST ASIA

Recently, there has been growing interest in FTAs in East Asia while experiencing a rapid functional integration process. The newly emerging enthusiasm for pursuing FTAs in East Asia can be attributed to a set of factors: proliferation of worldwide regionalism, the EU and NAFTA intensified integration process, the East Asian financial crisis, East Asia's awareness of the need to boost economic cooperation, China's WTO accession, competitive FTA initiatives by China and Japan and the expansion of East Asian policymaker networks through various meetings.

There are approximately 162 cases of various regional trade agreements reported officially to the WTO at the end of 2003. Of the total existing arrangement, 135 cases were established after 1990, 102 of which were reported after the launch of the WTO in January 1995.

Table 6. Number of FTAs in the World

	1955-60	1961-70	1971-80	1981-90	1991-95	1996-2000	2001-2005
New	3	3	11	10	33	39	63
Cumulative	3	6	17	27	60	99	162

Note: As notified to WTO and effective as of May 5, 2005

Source: WTO CRTA.

Accommodating the rising regionalism, East Asian countries, especially Northeast Asian countries, have rushed towards competitive sub-regional FTA negotiations. Japan's FTA with Singapore went into effect in February 2002. China offered tariff reduction to less-developed ASEAN members effective 2004 on 500 agricultural products under the Early Harvest Package. In November 2004, China and ASEAN announced the conclusion of market access to manufacturing product in their bilateral FTA, leaving investment and market opening for the services sector to be negotiated. Meanwhile, Japan also made it clear that it plans to promote an FTA with ASEAN within the next 10 years. Korea began to implement an FTA with Chile in April 2004, and concluded the negotiation for an FTA with Singapore in April 2005. Currently, Korea is pursuing bilateral FTAs with Japan, European Free Trade Area (EFTA), and ASEAN respectively. As a consequence, it appears that China, Japan and Korea have been making "love calls" with AFTA⁶ for respective FTAs. Recently, ASEAN members have been discussing bilateral FTAs with Japan, Korea, India and CER (an FTA between Australia and New Zealand) respectively.

An East Asian FTA was proposed by the East Asian Vision Group (EAVG)⁷ in a report to the ASEAN+3 Summit in 2001, and the issue has been an important agenda item at the succeeding ASEAN+3 Summit meetings. The East Asian Study Group (EASG), which was assigned to follow up the proposals by the EAVG, also proposed mid to long-term cooperative measures and additional subjects for study in its final report at the ASEAN+3 Summit at Phnom Penh in 2002. Some of the measures

⁶ The main regional trade agreement in East Asia is the AFTA. Initially composed of six member countries including Malaysia, Indonesia, Thailand, the Philippines, Singapore and Brunei, AFTA was formed as a result of the fourth ASEAN Summit meeting in 1992. With Vietnam joining in 1995, Myanmar and Laos in 1997 and Cambodia in 1999, AFTA developed into a regional trade agreement overseeing the entire Southeast Asian region.

⁷ The East Asian Vision Group was composed of 26 representatives from 13 member countries (two representatives per country) and was assigned to produce a report for East Asian economic cooperation. The Vision Report was reported to the ASEAN+3 Summit held in Brunei Darussalam in November 2001. The report recommends that East Asia should pursue economic integration through the liberalization of trade and investment, developmental and technological cooperation, and information technology (IT) development.

proposed in the report are the transformation of the ASEAN+3 Summit to the East Asia Summit, the establishment of an East Asia Investment Area and an East Asian FTA. Through the official studies by EAVG and EASG, the members of ASEAN+3 began to realize the need for an FTA as a means of promoting economic integration in the region in the long-term in response to the ever-deepening economic integration in North America and Europe and to introduce institutional measures for trade and investment liberalization in the region.

Table 7 summarizes a web of FTAs in progress in East Asia. One of the most important developments towards an East Asian FTA is China's progressive approach to East Asian regionalism. The biggest advantage for China regarding its FTA policy is that once China's leaders promote an FTA within a certain region, the government can make rapid progress under its socialist system of centralized decision-making. This contrasts with Japan and Korea, where FTA negotiations could be obstructed by vulnerable industries and diverse interest groups. When China realizes the economic necessity of an FTA and believes that the internal and external conditions are ready, it will promote FTAs with its neighboring countries in Northeast Asia in addition to ASEAN. The on-going trilateral study⁸ on an FTA between China, Japan and Korea will be an important momentum for Korea's FTA policy in addition to that of China.

Table 7. Regional FTAs in Progress

FTAs	Progress				
	Discussion	Joint Study	Negotiations	Conclusion	Implementation
AFTA					V
AFTA-China				V	
AFTA-Japan			V		
AFTA-Korea			V		
AFTA-India		V			
AFTA-U.S.	V				
China-Japan-Korea	V				
East Asian FTA	V				
Japan-Chile		V			
Japan-Canada		V			
Japan-Mexico				V	
Japan-Taiwan	V				
Japan-Singapore					V
Korea-Canada		V			

⁸ Korea Institute for International Economic Policy (KIEP), China's Development Research Center (DRC) and Japan's National Institute for Research Advancement (NIRA) have undertaken a three years' joint study on the economic impact of trilateral FTAs, beginning in 2003.

Korea-Chile					V
Korea-EFTA			V		
Korea-India		V			
Korea-Japan			V		
Korea-MERCOSUR					
Korea-Mexico		V			
Korea-New Zealand		V			
Korea-Singapore				V	
Korea-Thailand		V			

Source: Cheong (2003) and updates

Japan had not paid serious attention to the formation of preferential trading blocs until 1998, emphasizing its consistent efforts to maintain free trade under the multilateral trading system. Japan established its first FTAs with Singapore in January 2002 and completed an FTA negotiation with Mexico in late 2004. It seems that “Japan, playing catch up with China, seeks a piece of the Free Trade Area pie.”⁹ In other words, instead of playing a leading role in promoting East Asian regionalism, Japan was reacting passively to China's FTA policy.

Korea's Ministry of Foreign Affairs (MOFA) had also held a negative position toward regionalism until 1998. However, as Korea and Chile announced their plan to proceed with an FTA and China and ASEAN suddenly agreed to launch FTA negotiations within a concrete timeframe, Japan began to show a strong interest in entering into an FTA with Korea.

The development of leaders' networks has been an important factor in accelerating recent talks on East Asian regionalism. The ASEAN+3 Summit first took place in 1997 when former Malaysian Prime Minister Mahathir unofficially invited the political leaders of China, Japan and Korea to ASEAN's 30th anniversary. This event sparked the acceleration of discussions on intra-regional economic cooperation and consolidation in East Asia.

After the financial crisis, East Asian countries realized the limit of an export-oriented developmental policy, mainly targeting the U.S. market (Ahn (2001, 2003)). Being heavily dependent on the U.S. market made East Asia vulnerable to negative effects stemming from the depression of the U.S. economy and growing U.S. trade deficit and a stagnating world economy. Regarding this aspect, Munakata (2001) points out that the East Asian regional market should be integrated to stimulate its own regional demand. While East Asian countries are concerned about the industrial “hollowing out” triggered by China, they hope to make the most of China's economic growth. Moreover, as the stagnation of the world economy causes a substantial reduction of East Asia's exports to

⁹ Quoted from the editorial of the *New Straight Times* in Singapore on November 6, 2002.

other regions, the incentive for East Asian countries to expand exports to China has been growing.

While promoting an East Asian FTA, East Asian economies are likely to face tricky issues at hand, such as the economic gap between member countries and a leadership issue over the region. However, China and Japan, the two hegemonic powers in the region have different interests and hence different strategies for economic integration in East Asia. Some crucial differences in the economic and military status of the two countries suggest that even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia. (Ahn (1996), Cheong (2002))

4. SOUTH KOREA'S POSITION TOWARDS EAST ASIAN REGIONALISM

Until quite recently, South Korea's FTA policy has been defensive. South Korea has approached the FTA policy to avoid the opportunity cost of being left out of the general trend. However, very recently South Korea took a more proactive FTA policy stance so that FTAs can serve as an effective and expeditious trade policy tool for economic restructuring geared to sustainable economic growth and consumer welfare. As Schott (2005) point out, FTAs provide an "insurance policy" against new protectionism at home and abroad by substantially raising the cost of reversing free trade reforms mandated by the regional pacts. Such an insurance policy would create greater confidence in the "lock in" effect of the FTA on domestic policies.

During the past three decades or so, South Korea has achieved a remarkable economic growth through export-based industrialization. In fact, South Korea has been one of greatest beneficiaries of the post-war global trade liberalization. With the ever-increasing number of global FTAs, South Korea believes that an FTA could be an essential and effective tool not only to secure foreign markets but also to induce a competitive market environment for domestic firms.

South Korea realizes that the trade creation effects due to FTAs in East Asia are larger than trade diversion effects. A crucial benefit of FTAs comes from the formation of a larger market. Monopolistic competition with increasing returns provides member countries with "economies of scale" and "economies of diversity" of final products.

Through FTAs, South Korea can introduce greater competition and high global standard to ensure the necessary transition towards a high value-added economy. South Korea's FTA partners also wish to provide mutual economic cooperation in their respective niche markets in a win-win framework. Furthermore, South Korea would like to bring in certain new rules of a WTO-plus nature established through FTAs, which may also serve as a tested precursor to the multilateral disciplines, enhancing economic competitiveness even further.

Despite its economic success, South Korea has continuously suffered from "Korea discount problem" mainly due to inter-Korean hostilities between South and North and

more seriously North Korean nuclear crisis¹⁰. The diplomatic resolution of North Korean nuclear standoff and the subsequent economic development of North Korea is essential to bring peace and prosperity to Northeast Asia. South Korea also might utilize the East Asian regionalism for North Korea to be enticed to join the integration process. If North Korea takes an open door policy, Korean peninsular can trigger some business hub functions¹¹ in Northeast Asia.

4.1. Multi-track approach

At present, South Korea is pursuing FTAs on a multi-track¹² basis in terms of trade policy strategy, in parallel with multilateral liberalization, highly comprehensive level in terms of contents, and broadly supported FTAs in terms of process. Consequently, South Korea's FTA policy should be a building block toward multilateral DDA process. In a nutshell, South Korea seeks to promote FTAs that are consistent with WTO rules and also comprehensive in their coverage including services, investment, government procurement and intellectual property right, while restructuring its economy to changing external environment.

South Korea formulated an FTA roadmap in September 2003 and revised it in May 2004 as shown in Table 8. According to the roadmap, some notable features are discussed below. South Korea at present has been pursuing actively FTAs with more than 20 countries. As the first FTA, South Korea and Chile entered into force, realizing some intended mutual gains between two countries.¹³ Already South Korea-Singapore FTA and South Korea-EFTA recognized the products from the Gaesong Industrial Zone near the DMZ line in North Korea as originating from South Korea. It should be noted that South Korea completed the FTA review discussions with the U.S. so that two countries can understand each other's FTA policies. A South Korea-U.S. FTA is likely to make the nature of East Asian integration more open regionalism and to carry significant implications for U.S.-South Korea security relations.

¹⁰ After seeing the six party agreement on a possible diplomatic solution of North Korea nuclear issues in September in Beijing, the Fitch upgraded South Korea's sovereign credit rating by one notch to A+.

¹¹ South Korea has developed the concept of a Northeast Asian business hub. By fully exploiting its geoeconomic location, South Korea can well serve as a bridge between the Pacific Ocean economy and the continental economy to create high value-added activities in logistics, finance, and R&D innovations.

¹² Remarks made by Kim Han-Soo, Director-General for FTA, Ministry of Foreign Affairs and Trade, at "FTA Breakfast Meeting: World Knowledge Forum 2005" sponsored by Maeil business Daily paper, Waker Hill Hotel, Seoul, October 11, 2005

¹³ After the Korea-Chile FTA into effect, South Korea enjoy now the "well-being" effect due to increased wine consumption at affordable price. The market share of Chilean wine rose to 16.1 percent in 2004, overtaking the share of Italian and U.S. wines, while South Korea sold more cellular phone in Chile. Thus, a win-win situation has occurred in two countries.

Table 8. South Korea FTA Roadmap as of October 2005*

FTA partner	Status	Notable Effects from Korea's point view
Korea-Chile	Into force May, 2004	Mutual gains
Korea-Singapore	Signed August, 2005	GIZ** products as originating
Korea-Mexico	To begin negotiation SECA in September 2005	Gateway to U.S. from South Korea & Latin America
Korea-ASEAN	Under negotiation and Expected to complete soon	Trade expansion and competitive with China and Japan
Korea-EFTA	Concluded in September 2005	Gateway to Europe
Korea-Japan	Negotiated six rounds but halted in negotiation due to agricultural sector	A core regional FTA
Korea-Canada	Began negotiations in July 2005	win-win effect and enhancing transpacific link
Korea-China	Conducted joint study	A core regional FTA
Korea-China-Japan	Conducting joint study	Key to Northeast as well as East Asian integration
Korea-U.S.A	Passing a "smell test"	Strengthening transpacific economic linkage and security alliance
Korea-MERCOSUR	Conducting joint study	To expand market and stable acquisition of resource
Korea-India	Conducting joint study	To expand market with a rapidly growing large economy

* Compiled by author from various government documents

** GIZ means Gaesong Industrial Zone

4.2. Sequencing of Regional FTA Web and Leadership Issue¹⁴

There are several possible ways to promote an East Asian FTA. Under current conditions, it may be difficult to promote an FTA covering the whole East Asian region in the short term, because of diverse interests of major economic players. Therefore, as the second best alternative, simultaneous and/or piecemeal East Asian FTAs should be

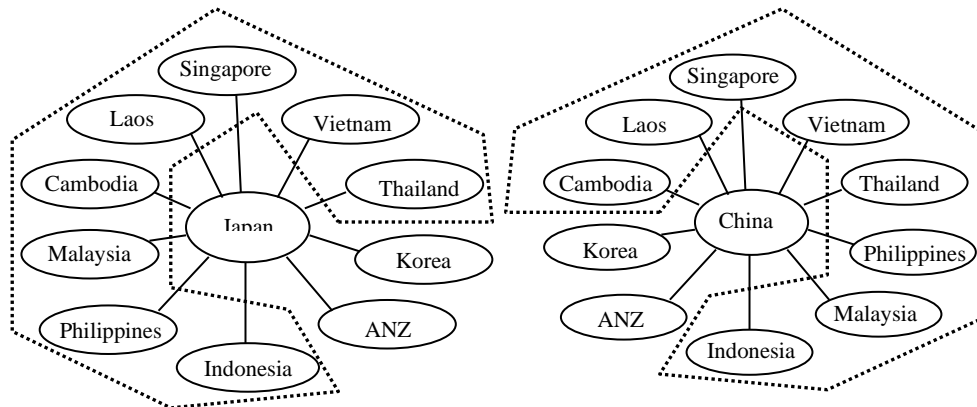
¹⁴ This subsection heavily draws from Ahn and Cheong (forthcoming in *Japanese Economic Review*)

phased in starting with the FTAs currently being discussed. For example, each country in Northeast Asia can form a bilateral FTA with ASEAN and gradually develop and expand the bilateral FTAs into an East Asian FTA. Another scenario is to establish an East Asian FTA based on bilateral FTAs currently under active negotiation. These bilateral FTAs will contribute to sub-regional trade liberalization and increase the need for an East Asian FTA while fostering a foundation for it as long as diverse bilateral FTAs contain more or less uniform rules of origin.

However, a consolidation of different FTAs could be tremendously difficult since the different trade regulations, especially rules of origin, under various bilateral FTAs will have to be standardized into one agreement. Cheong (2002) argues that it is highly unlikely that an East Asian FTA will evolve by itself as a result of amalgamation of bilateral FTAs. In addition, there is a possibility that the competition between China and Japan, with both currently vying for regional leadership, may be intensified through bilateral FTAs with ASEAN, making an East Asian FTA more difficult.

As Baldwin¹⁵ suggests in his 1994 study of the European trade arrangement, there is a danger that a hub-and-spoke bilateralism that China and Japan respectively might develop. If this happens, “this arrangement tends to marginalize the spoke economies both economically and politically.” It also leads to a profusion of FTAs that can make the whole region less attractive to foreign direct investment - an effect that might be called, in an Asian context, the “noodle bowl problem,” creating a bicycle pattern of East Asian FTAs as shown in Figure 3.

¹⁵ For details, see Baldwin (2005) and Baldwin (1994).



Source: Baldwin (2003)

Figure 3. A Possible FTA Pattern: East Asian Bicycle

The third option is to have Northeast Asia create a China-Japan-Korea (CJK) FTA rather than having multiple bilateral FTAs and then to move in the direction of consolidating with AFTA. On a purely economic point of view, amalgamation of CJK FTA and AFTA together would be more realistic approach than realizing through a web of bilateral FTAs. Wanandi (2000) supports this approach to the East Asian FTA by presenting that East Asia is able to establish an FTA across the region in the mid to long-term through bilateral negotiations and through activation of sub-regionalism in East Asia. He emphasizes that AFTA and a Japan-Korea FTA will play the most important role in forming an East Asian FTA.

Discussions on a CJK FTA and Japan-Korea FTA negotiations have been carried out simultaneously starting from 2003. The Korea-Japan FTA has been stalled after the six rounds of negotiations. At present, South Korea are not ready to discuss Korea-Japan FTA given the low level of agricultural sector opening, which Japan has shown informally. As Baldwin (2005) perceives, Korea and Japan FTA would serve as a core FTA toward East Asian trade integration as a benchmark framework for a CJK FTA in the mid-term and an East Asian FTA in the long term. Thus, when Japan and Korea form an FTA, it should be designed with China in mind as a potential partner not in a distant future. If Japan is not ready to accept CJK FTA negotiations, South Korea might pursue its FTA negotiations with China simultaneously along with the Korea-Japan FTA. Indeed, Kinumaki (2005) suggested that South Korea, free from “historical liabilities” can play an intermediating role by combining Korea-Japan FTA and Korea-China FTA together so that an CJK FTA could be established, leading toward an East Asian FTA.

At this point, China’s role is becoming more critical than ever in designing an East Asia wide FTA. Rather than participating in an FTA of Japan-Korea-AFTA led by Japan, China might pursue China-led East Asian regionalism by first concluding an FTA with ASEAN and extending it to South Korea. Indeed, this path has already emerging.

In addition to the technical difficulties involved in consolidating multiple FTAs, the sequencing of FTAs in East Asia can raise serious and often non-economic issues such as the hub-and-spoke problem, regional leadership struggles and political instability. Moreover, without a clear understanding of the problems these issues could lead to, it will be difficult to construct a policy direction for East Asian economic cooperation.

In general, countries tend to aspire to become a regional FTA hub country so that they can improve competitiveness by importing the most suitable raw materials from multiple spokes free of tariffs, further attracting foreign direct investment inflows. Moreover, in a new FTA discussion, a hub country has the advantage of settling existing agreements that or can establish an agreement favorable to itself. In a specific region, a hub country could also display its political and economic leadership. This is one of the reasons why China is promoting an FTA with ASEAN and Japan is also promoting respective bilateral FTAs with Korea and ASEAN.

Cheong (2002) estimated the growth impacts of various FTA combinations using a computable general equilibrium model.¹⁶ His results show that the economic growth effects of trade liberalization (TL) alone are moderate, but introducing capital accumulation effects (CA) together with TL substantially increases the economic growth benefits (Table 9). For example, when the incremental growth effects are estimated under the scenario of a China-Korea FTA, the GDP of China and Korea would increase by 0.12 percent and 0.76 percent respectively, considering the effects of trade liberalization only. However, if the effects of both trade liberalization and capital accumulation are considered together, the GDP of China and Korea would increase by 0.45 percent and 1.76 percent respectively. The analysis shows that greater economic growth would be derived under a regional FTA like CJK or East Asia FTA.

Table 9. Incremental Growth Impacts of FTAs in East Asia (Unit: %)

<i>FTAs in Northeast Asia</i>								
	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
ASEAN	-0.03	-0.36	-0.02	-0.19	-0.01	-0.08	-0.06	-0.59
ROW	-0.00	-0.06	-0.00	-0.06	-0.00	-0.02	-0.01	-0.12

¹⁶ Needless to say, a FTA model should be built in a dynamic context and needs to specify an investment equation in particular to take the expanded market into consideration. Any FTA modeling becomes difficult to reflect plurilateral arrangements. Given a static CGE model, the expected rate of capital is considered in specifying investment equation to estimate capital accumulation effects due to increased investment for an expanded market. For the estimation of growth effects of various FTA combinations, see Cheong (2002).

FTAs in East Asia

	ASEAN- China FTA		ASEAN-Japan FTA		ASEAN-Korea FTA		East Asian FTA	
	TL	TL&CA	TL	TL&CA	TL	TL&CA	TL	TL&CA
China	0.076	0.441	-0.02	-0.12	-0.01	-0.07	0.36	1.39
Japan	-0.007	-0.076	0.04	0.09	-0.01	-0.05	0.10	0.17
Korea	-0.025	-0.177	-0.04	-0.20	0.13	0.65	1.01	2.84
ASEAN	0.229	2.077	0.43	3.19	0.41	2.17	0.73	4.00
ROW	-0.004	-0.075	-0.01	-0.05	-0.00	-0.04	-0.02	-0.22

Note: TL and CA refers to growth effects of trade liberalization and capital accumulation respectively

Source: Cheong (2002)

Under a Northeast Asian FTA, South Korea is expected to gain relatively higher economic growth compared to China or Japan. South Korea is forecast to gain relatively more growth benefits from a CJK FTA than from a bilateral FTA with either China or Japan. As with other FTAs, it is estimated that South Korea can realize greater growth due to capital accumulation effects rather than trade liberalization effects under an FTA with Japan. In addition, Korea can achieve higher growth gains under an East Asian FTA than under a CJK FTA. Based on this simulation result, it can be said that large-scale FTAs, such as an East Asia FTA, will be preferred to small-scale FTAs in East Asia.

Regarding an East Asian FTA, competitive regionalism can be a problem. China and Japan are pursuing FTAs competitively for securing the leadership position in East Asia. Considering the rivalry between China and Japan, Japan's reluctant position towards an FTA with China, among others, East Asia may end up with two meaningful large-scale FTAs (the Japan-Korea FTA and the China-ASEAN FTA) in the near future. Japan and China may try to strengthen their leadership positions through their own FTAs with Korea and ASEAN, respectively, rather than making efforts to form an East Asian FTA by consolidating the two large scale FTAs. This may have unstable and destructive consequences for East Asian regionalism in the future. This situation should be avoided in East Asia. If neither Japan nor China can play an FTA hub function, the East Asian economic may suffer from Baldwin (2003)'s spoke trap.

One of ways to avoid the competitive leadership issue in East Asia is to form a trilateral FTA between China, Japan and South Korea. European experience shows that stronger economic cooperation reduces political conflicts substantially. The trilateral FTA can be an important stepping-stone for an East Asian FTA and the follow-up integration process. Due to regional characteristics, an East Asian FTA may be realized only if it is promoted from a long-term perspective.

East Asian countries will face many economic and non-economic obstacles while pursuing region-wide economic integration. Among the economic challenges, there are substantial differences in stages of economic development, trade barriers and market opening of agriculture. Non-economic factors might be more critical. Regardless of how

important the CJK FTA is in terms of economic gains and strategic aspects, the three countries have different political, social and historical perspectives. Unfortunately, mutual distrust among the three Northeast Asian countries is the most crucial factor impeding the conclusion of a political decision. As Ohnishi and Yin (2002) pointed out, that building trust among the people of the three countries, rather than presenting empirical evidence of economic benefit, is the necessary step to realizing a Japan-Korea FTA or CJK FTA.

4.3. Easy Things First

East Asian economies, especially China, Japan and Korea, need to overcome historical animosities and to enhance mutual trust building in order to accelerate on-going closer economic cooperation in East Asia. Therefore, an easy thing first policy is very important for China, Japan and South Korea rather than being empty handed while pursuing bilateral or trilateral FTAs among China, Japan, and South Korea. Three economies have shown common interests to cooperate each other in energy and environmental issues, technology transfer, and fishery cooperation.

Other forms of trilateral cooperation also exist. First of all, common standards for customs, production technology, product regulations, E-commerce, distribution, and after-sales services can be expanded across countries in the region. Even if these standards are in conflict with the standards of North America or the EU, the Asian countries can gain leverage during international standardizing negotiations by presenting a unified front (Igawa and Kim (2001)). This could be an incentive for East Asian Economies to carry on not only in-house restructuring but also multilateral negotiations. Perhaps, “easy things first” strategy could contribute to trust building process among East Asian economies.

4.4. Amalgamation of North Korea into East Asian Integration

Both the end of the global cold war regime and the Asian financial crisis have opened up among the countries of Northeast Asia a completely new avenue for economic and cultural exchanges leading toward eventually an Northeast Asian economic community. For example, both the rapidly increasing trade between China and South Korea and between South Korea and Russia, and the Chiangmai Initiative for regional financial cooperation are the cases in point. During the cold war era, the bilateral trade between two Koreas, South Korea and the two former socialist giants were virtually non-existent.

On the basis of purely geographical proximity, Northeast Asia here could be functionally redefined to include Japan, South and North Korea, three Northern provinces of China namely Jilin, Heilongjiang, and Liaoning, Mongolia, and the Far Eastern part of Russia. Undoubtedly, the economies of Northeast Asian countries are crucially interconnected with the U.S., ASEAN, and other Pacific rim countries.

Extra-regional economies need to be considered in any attempt to formulate a regional economic integration roadmap to take the advantage of the “economies of diversity” inherent in Northeast Asia.

In the post-cold war era, Northeast Asia seems to offer highly favorable conditions to reinforce a “natural economic territory”¹⁷ to promote a regional economic cooperation. By definition of “natural economic territory”, North Korea should be included in designing a regional integration fabric (Ahn (1993)). A natural economic territory is formed basically by market forces through cutting across political and administrative boundaries rather than forming an official regional cooperation body. Paul Krugman (1991) indicated that near-neighbors usually trade a lot with each other compared to the countries being far apart. Evidence from EU, NAFTA and ASEAN supports this hypothesis.

Judging from the recent economic performance of Northeast Asia, there has been a growing recognition that Northeast Asia could enhance its inborn complementarities to create an open natural economic territory. The potential of becoming a new growth pole by cultivating natural economic linkages existing in Northeast Asia, indeed, signifies the theme of “the Age of the Pacific”. However, Northeast Asia has suffered from inherent geo-political risks originating from the North Korean nuclear stand off. Fortunately, the 4th six party talks held in Beijing in September 2005 produced a breakthrough for a negotiated settlement. Unlike the agreed framework between the U.S. and North Korea, the other four nations have played a respective role to bring North Korea to a promise to give up nuclear weapons.

In order to induce North Korea into an open door policy regime, the Gaesong Industrial Zone (GIZ)¹⁸ just over the DMZ in North Korea carries special implications for inter-Korean economic cooperation. The project could be a viable scheme for two Koreas in a win-win situation. South Korea’s SMEs can utilize North Korea workforce at a very cheap wage rate while bringing in South Korea’s under-utilized or unutilized excessive capacities. More importantly, South Korea can induce North Korea on a learning curve of market economy. As the Korea-Singapore FTA recognized the products from GIZ as originated from South Korea, the GIZ products in future expanded operation area should not be a stumbling block for a possible U.S.-Korea FTA provided that North Korea implements what she promised in the six party talks in resolving the

¹⁷ The concept of the “natural economic territory” here is defined, following basically Professor Scalapino’s idea (1993), as an intended utilization of natural economic links of adjacent regions of neighboring countries on the basis of geographical closeness and inherent complementarities of different factor endowment and different level of development.

¹⁸ The GIZ covers a total of 6,611 hectares under a 12 year construction period. There are three stages of development. At present, 15 SME companies from South Korea as pilot projects are producing cooking wares, watches, and shoes. “Strategic materials” are prohibited to bring into the GIZ as North Korea is listed on a terrorist country.

nuclear issues. Once the GIZ can expand as scheduled, it will take South Korea closer to its goal of becoming a regional business hub, spurring the “physical integration of the two Koreas by making more viable investments in the transportation, energy, telecommunication infrastructure.

4.5. South Korea-U.S. FTA

So far, East Asian countries have achieved high economic growth through increased exports to the U.S. market. However, since the U.S. demand for imports may wane with fierce competition in its markets and its growing trade deficit, it is time for East Asia to create its own demand for sustainable growth. The establishment of an East Asian FTA presents an effective way to go about creating this demand. Considering the deepening process of both EU and NAFTA, an East Asian FTA is likely to improve the economic and social stability of East Asia and contribute to strengthening the region’s presence in the international community.

The positions of non-Asian countries could significantly affect East Asia’s economic integration. Above all, the United States has a high stake in East Asia’s economic integration policy in terms of security. According to Cooper (2002), the United States does not expect that an East Asian FTA will be possible in the near future, and neither the U.S. Congress nor the U.S. administration has clarified their positions on the issue yet. Development of East Asia’s regionalism is anticipated to have both positive and negative economic effects on the United States. The United States could support the East Asian FTA if it benefits from the improvement of the East Asian trading system and serves as a significant building block toward WTO, DDA negotiations.

However, as Schott and Goodrich (2001) indicated, there is a chance that the United States might suffer a loss from an East Asian FTA that excludes the United States. For that reason, current initiatives in East Asia will elicit the U.S. counter response (Schott, 2005). As promoting a CJK FTA or establishing an East Asian FTA might induce conflicts with non-Asian countries like the United States, East Asian countries might need to look into strategies to resolve possible conflicts with non-Asian countries by promoting an open East Asian regionalism.

In the process of East Asian integration, Barshefsky and Gressen(2005) maintained the position that the U.S. should keep its central place in the Pacific economy. The U.S. FTA with Singapore and partially negotiated one with Thailand are a start but scale matters. They further suggest that regardless of the DDA outcome, ambitious agreement should be negotiated with the major ASEAN countries, South Korea, and Japan. Schott(2005) also advocated the U.S.- South Korea FTA for mutual gains.

Korea might need to consider its FTA policy together with regional security issues. In particular, Northeast Asian economic integration is expected to have a very positive effect on the security of the Korean peninsula. Measures to persuade North Korea to participate in the East Asian integration process should also be examined. From Korea’s point of view, an FTA with the United States is also one of the targets to be

accomplished in the medium to long-term. A South Korea-U.S. FTA needs to be considered not only in terms of economic aspects, but also militarily and in terms of security.

In order to carry forward an East Asian FTA on a pan-regional level inclusive or exclusive of the USA, it is necessary to set up an institution such as the tentatively named Organization for East Asia Economic Cooperation (OEAECE). In this regard, the forthcoming East Asian Summit of ASEAN+3+India, Australia, and New Zealand is crucial in determining the future course of East Asian regionalism. It will also assess liberalization schedules under the East Asian FTA, trade rules, industrial cooperation and other cooperative measures. The expanded East Asian Summit might address the perception of the East Asian FTA among member countries and to assess regional relations with the United States and other non-Asian countries.

5. CONCLUSIONS AND POLICY IMPLICATIONS

Although it is regarded as one of the three major economic pillars in the world, East Asia still has the lowest level of economic cooperation and integration when compared to the EU and NAFTA. Economies in East Asia should therefore recognize the need for strengthening regional economic cooperation to utilize a “partnership from differences.” Although there are difficulties in establishing intra-regional free trade areas in Northeast Asia due to a hegemonic leadership competition in the region and historical legacies, Northeast Asian countries need to recognize the necessity of economic integration while observing FTAs being proliferated worldwide and experiencing great difficulty from such economic shocks as the Asian financial crisis in 1997.

East Asian countries have been remarkably successful in nurturing manufacturing sectors able to compete in international markets under export-led development regimes. Recent East Asian enthusiasm for regional FTAs is likely to enhance regional manufacturing efficiency. East Asian economies were less successful in developing the financial sector; hence financial weakness persisted even during the years of high performance. To make the current recovery more permanent and a proven buffer against external shocks in the future, East Asian countries have to strengthen their financial markets (Ito (2001)).

The Asian financial crisis in the late 1990s ushered in a new era for East Asian economic cooperation. The CMI has already set the tone for regional financial cooperation. Regional FTAs in East Asia that have been completed or in progress are likely to add renewed momentum to the on-going integration process. The two forces will accelerate the “long march” toward an East Asian Community. Although East Asia embarked upon a regional economic integration process later than the EU and NAFTA processes, both the Asian financial crisis, subsequent restructuring and on-going regional FTA initiatives are likely to reinforce each other. To make this happen, East Asia’s quest for regional integration should proceed following the WTO regime.

East Asia has great potential to match the EU or NAFTA provided that East Asian countries, with their huge diverse economic and political backgrounds, can reconcile whatever differences they may have to achieve region-wide growth dynamism within a sustainable framework. Indeed, FTAs are international agreements of like-minded countries. Any possible “spaghetti bowl” or “noodle bowl” effects due to the possible complexity of preferential rules of origin or excessive competition for regional hegemonic leadership need to be avoided. In particular, a China-led FTA and a Japan-led FTA in an uncooperative game are likely to generate a hub-spoke bilateralism in East Asia. East Asia should work out an ASEAN+CJK FTA that could set the tone for East Asian integration from a long-term perspective.

China and Japan have been and continue to be important economic and political leaders in East Asia, and each has problems that will need to be resolved before asserting economic and political leadership in Asia. Both will play a leading role, with neither dominating the Asian transition process. The absence of single clear leadership or coordinated dual leadership might prevent East Asian nations from forming a regional FTA and/or a common currency bloc, but there will still be room for the pursuit of regional trade integration and monetary and financial cooperation.

East Asian economies have undertaken restructuring efforts as evident in the cross-border investment and trade facilitation measure and behind-the border structural reform agenda while South Korea hosted the 2005 APEC meetings. Japan has actively pursued development of special economic zones for deregulation. China has also strengthened legal and institutional reform to comply with the level playing field requirements after accession to WTO. South Korea has also proposed a vision for a Northeast Asian business hub by making serious commitment to becoming a transparent and “international best practice” economy (Ahn (2003)). Similar developments with varying degrees are also observable in ASEAN. Various structural reforms underway in East Asia in line with the WTO principles are likely to set a positive tone for a closer economic cooperation towards East Asian community, which will accelerate multilateral liberalization as addressed in the Doha Development Agenda.

REFERENCES

- Ahn, Choong Yong (1993), “Economic Cooperation in Northeast Asia: Feasible or Illusion ?” *Journal of Economic Development*, 18(1).
- _____ (1996), “Korea-Japan Partnership in a Dynamic but Turbulent East Asian Economy,” *Kokusai Geizai*, Japan Society for International Economics, 47(2).
- _____ (2001), “A Search for Robust East Asian Development Models after the Financial Crisis: Mutual Learning from East Asian Experiences,” *Journal of Asian Economics*, 12(3).

- _____ (2003), "The Newly Emerging Economic Order in Northeast Asia and Vision of Korea as a Business Hub," *Joint U.S.-Korea Academic Studies*, 3.
- Ahn, Choong Yong, Takatoshi Ito, Masahiro Kawai, and Yung Cul Park (2003), *Financial Development and Integration in East Asian*, Conference Proceedings 03/02, Korea Institute for International Economic Policy.
- Ahn, Choong Yong, Richard E. Baldwin, and Inkyo Cheong (2005), *East Asia Economic Regionalism: Feasibilities and Challenges*, N.Y: Springer.
- Ahn, Choong Yong, Inkyo Cheong, Yukiko Fukagawa, and Takatoshi Ito (2005), *Korea-Japan FTA: Toward a Model Case for East Asian Economic Integration*, Policy Analysis 05/01, Korea Institute for International Economic Policy.
- Ahn, Choong Yong, and Inkyo Cheong. (forthcoming), "A Search for Closer Economic Relations in East Asia," *The Japanese Economic Review*.
- Ahn, Hyungdo, Changjae Lee, and Hongshik Lee (2005), "An Analysis of China-Japan-Korea FTA: A Sectoral Approach," presented at 16th U.S.-Korea Academic Symposium (New Paradigms for Transpacific Collaboration), University of Washington, Korea Economic Institute, and Korea Institute for International Economic Policy, October.
- Baldwin, R.E. (1994), *Toward an Integrated Europe*, London:CEPR.
- _____ (2003), "The Spoke Trap: Hub and Spoke Bilateralism in East Asia," Northeast Asian Study Series, 04/02, Korea Institute for International Economic Policy.
- _____ (2005), "Asian Regionalism: Promises and Pitfalls," in Ahn, Choong Yong, Rochard E. Boldwin, and Inkyo Cheong ed. *East Asian Economic Regionalism: Feasibilities and Challenges*, N.Y :Springer.
- Barfield, Claude, and Jason Bolton (2005), "Korea, the U.S., China and Japan: The Rise of Asian Regionalism," *Pacific Focus*, XX(1), 179-255.
- Barshefsky, Charlene, and Edward Gresser (2005), "How to Handle the China Challenge", *Asian Wallstreet Journal*, September.
- Bergsten, Fred (2000), "Towards a Tripartite World," *The Economist*, July.
- Cheong, Inkyo (2003), "Regional Economic Integration in Northeast Asia: Present and Future," presented at the Fourth Korea-OECD Joint Conference on "Korea as a Business Hub of Northeast Asia: Potentials and Policy Recommendations," held in Seoul, October.
- _____ (2005), "Evaluation of Recent Progress of FTAs in East Asia: A Korean Perspective," in Ahn, Choong Yong, Rochard E. Boldwin, and Inkyo Cheong ed. *East Asian Economic Regionalism: Feasibilities and Challenges*, N.Y:Springer.
- Cooper, Caroline (2002), "U.S. Views of East Asian Economic Cooperation," presented at the KIEP FTA Study Seminar, Seoul, KIEP.
- Eichengreen, Barry (2003), "What to Do with the Chiang Mai Initiative," *Asian Economic Papers*, 2(1), 1-49.
- Feenstra, Robert C (2003), *Advanced International Trade: Theory and Evidence*, Princeton University Press.
- Fischer, Stanley (1999), "On the Need for a Lender of Last Resort," Address to the

- American Economic Association, New York, January.
- Henning, C. Randall (2002), *East Asian Financial Cooperation*, Washington D.C.: IIE.
- Hutabarat, Pos. M (2005), "ASEAN-FTA in East ASIA," presented at the FTA session, World Knowledge Forum 2005, October.
- Igawa, Kazuhiro, and Bonggil Kim (2001), "A Note on Possibilities about Japan-Korea Free Trade Area: A Theoretical and Strategic Approach," mimeo, Kobe University.
- IMF (2002), *Direction of Trade Statistics Yearbook*.
- Ito, Takatoshi (2001), "Growth, Crisis, and the Future of Economic Recovery in East Asia," in Joseph E. Stiglitz, and Shahid Yusuf, ed. *Rethinking the East Asian Miracle*, New York: Oxford University Press.
- Kar, Yiu-Wong (2005), "Economic Integration in Northeast Asia: Challenges and Strategies for South Korea," presented at 16th U.S.-Korea Academic Symposium entitled New Paradigms for Transpacific Collaboration, University of Washington, Korea Economic Institute, and Korea Institute for International Economic Policy, October.
- Kawai, Masahiro (2005), "East Asian Economic Regionalism: Progress and Challenge," *Journal of Asian Economics*, 16, 29-55.
- King, Philips, and Sharmila King (2004), *International Economics and International Economic Policy*, McGraw-Hill Irwin.
- Kinumaki, Yasushi (2005), "Prospects for East Asian Economic Integration: A Dreamy Illusion or A Practical Actuality," presented at the FTA session World Knowledge Forum.
- Kwack, Sung Yeung, Choong Yong Ahn, and Young-Sun Lee (2003), "Monetary Cooperation in East Asia: Exchange Rate, Monetary Policy and Financial Market Issues," *Policy Analysis*, 03/01.
- Kwan, Chi Hung (1999), "Towards a Yen Bloc in Asia," *Nomura Research Institute Quarterly*, 8(2), 2-13.
- Lee, Chang Jae (ed.) (2004), *Strengthening Economic Cooperation in Northeast Asia*, Korea Institute for International Economic Policy.
- McKinnon, Ronald I. (2001), "After the Crisis, the East Asian Dollar Standard Resurrected: An Interpretation of High-Frequency Exchange Rate Pegging," in Joseph E. Stiglitz, and Shahid Yusuf ed. *Rethinking the East Asian Miracle*, Oxford University Press, New York.
- MOFA (Ministry of Foreign Affairs, Japan) (1998), *Blue Book on Diplomacy 1998*, 1, Tokyo.
- Munakata, Naoko (2001), "Focus on the Benefits Not Threats of Regional Economic Integration," *PacNet Newsletter*, Jakarta, CSIS, November.
- ____ (2002), "Seize the Moment for East Asian Economic Integration," *PacNet Newsletter*, Jakarta, CSIS, February.
- Ohnishi, Hiroshi, and Qing Zhu Yin (2002), "Effects of the Japan-Korea and Japan - Korea-China FTA Estimated by an Northeast Asian Model," presented at the Northeast Asian Economics Association Annual Meeting, Seoul, February.

- Ohno, Kenichi (2000), "Exchange Rate Management in Developing Asia: Reassessment of the Pre-Crisis Soft Dollar Zone," ADBI Working Paper 1, Asian Development Bank Institute, Tokyo.
- Park, Young Chul (2003), "Towards a Market-Oriented Financial Development Strategy," in C.Y. Ahn, *et al.* ed. *Financial Development and Integration in East Asia*, KIEP.
- Scalapino, R.A. (1991), "Northeast Asia: The Risk and Opportunities," in J.S. Suh, ed. *Northeast Asian Economic Cooperation: Perspectives and Challenges*, Korea Institute for International Economic Policy.
- Schott, Jeffrey J., and Ben Goodrich (2001), "Reflections on Economic Integration in Northeast Asia," presented at the 2001 KIEP/NEAEF Conference, Honolulu, Hawaii, August.
- Schott, Jepprey J. (2005), "Free Trade Agreements: New Opportunities and Challenges," presented at the FTA session, World Knowledge Forum, October.
- Standard and Poor's DRI (2003), *World Economic Outlook*.
- Yamazawa, Ippei (1995), "Japan-Korea Partnership in a Dynamic Asia Pacific Economy," Proceedings of the Summer Policy Conference of the Korea International Economic Association, June.
- Yip, Wei Kiat. (2001), "Prospects for Closer Economic Integration in East Asia," *Stanford Journal of East Asian Affairs*, 1, 106-111.
- Wanandi, Jusof. (2000), "East Asian Institution Building," remarks made at the 2000 annual meeting of the Trilateral Commission in Tokyo, www.trilateral.org.
- World Bank. (1993), *The East Asian Miracle- Economic Growth and Public Policy*, London:Oxford University Press.

Mailing Address: Department of Economics, Chung-Ang University 221 Heukseuk-Dong, Dongjak-gu Seoul 156-756, Republic of Korea. Tel: 82-02-820-5490, Fax: 82-02-812-9718. E-mail: cyahn@cau.ac.kr

Manuscript received October 2005; final revision received November 2006.