

**Joint Report and Policy Recommendations**  
**on**  
**Possibilities and Prospects for a China-Japan-Korea FTA**

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**Trilateral Joint Research**

**by**

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## Executive Summary

Following the joint study on “Enhancing Trade and Investment between China, Japan and Korea,” the Development Research Center of the State Council (DRC) of China, the National Institute for Research Advancement (NIRA) of Japan, and the Korea Institute for International Economic Policy (KIEP) have embarked upon a joint research project on the “Economic Effects of a Possible Free Trade Agreement (FTA) between China, Japan and Korea” since 2003.

After the overall analysis of the subject in 2003, the three institutions conducted joint research on the sectoral effects of a China-Japan-Korea FTA (CJK FTA) covering agriculture, fishery, and major manufacturing and service sectors during 2004–2006. In 2006 they also examined other issues, including rules of origin and sensitive sectors in the FTAs concluded by China, Japan, and Korea.

Given the swiftness of change in China’s trade structure, and the speedy proliferation of bilateral FTAs involving the three countries, this year’s joint research attempted to undertake a comprehensive study on the economic effects of a CJK FTA by deepening and updating the analyses done in previous years.

Thus, after highlighting the rationales for a CJK FTA, including the positive macro-economic benefits for the three countries, this year’s study addresses the sectoral implications of a CJK FTA for major manufacturing and service industries, as well as the agriculture and fishery industries of the three countries, by analyzing their competitiveness and tariff structures, on the one hand, and the sensitive sectors reflected in the FTAs concluded by the three countries, on the other.

On the basis of this year’s study, the following policy recommendations are proposed jointly to the leaders of China, Japan, and Korea by the three institutions involved in the joint research project.<sup>1</sup>

### *Recognize the Growing Trade Interdependency between China, Japan, and Korea*

This study shows that the share of intraregional trade between China, Japan, and Korea has markedly increased in the past 15 years. In particular, China has become the

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<sup>1</sup> Business representatives of the three countries also participated in the process of this year’s research, and some government officials attended the workshops as observers; however, the recommendations do not necessarily imply official agreements between the governments of the three countries.

largest trading partner for both Japan and Korea. Although all three Northeast Asian countries have pursued active FTA policies by concluding a number of FTAs within a relatively short period of time, there is still no bilateral FTA, let alone a trilateral FTA among them. In addition to their geographic proximity, the growing trade interdependency provides an additional, powerful rationale for an FTA between China, Japan, and Korea, because it would produce greater economic benefits for all three countries.

#### *Make Manufacturing Industries More Competitive*

All three Northeast Asian countries have become leading industrial economies in the world. Thus, trade liberalization in the manufacturing industry will contribute the most to overall welfare gains by expanding the regional market, optimizing resource allocation, and creating a more competitive environment. In addition, it is consistent with the willingness of most enterprises in the three countries. A delay in the establishment of the trilateral FTA would result in rising structural adjustment costs in the three countries, as well as overcapacity in some sectors, such as steel and petrochemical industries, within the region.

#### *Face the Challenge of Agricultural and Fishery Industries*

Unlike the manufacturing sector, agricultural and fishery industries in the three countries are relatively weak. They are all major importers of agricultural and fishery products, and some of these products are heavily protected by tariff and non-tariff barriers. Agricultural and fishery sectors constitute major obstacles to forming FTAs. The weakness of these industries was also vividly reflected in the FTAs concluded by China, Japan, and Korea. Therefore, in the process of forming a CJK FTA, special attention will need to be paid to these sectors. A CJK FTA, however, could serve as a good opportunity to reform the agricultural sector and prepare the countries for global integration in agricultural trade. In order to alleviate adjustment burdens and facilitate structural adjustment, a clearly scheduled, gradual liberalization program should be devised with adequate specialization and compensation schemes for these industries.

#### *Enhance Service Industries at the World Level*

China, Japan, and Korea lag behind developed North American and European countries in services trade. Although the three countries recorded in general trade surpluses, they usually have deficits vis-à-vis the world in services trade. Liberalization of services

would raise the competitiveness of service sectors by introducing competition and improving the quality of services. In addition, since many service products are used as intermediary processes in manufacturing goods, service liberalization would also contribute to making manufacturing industries more competitive. Thus, a CJK FTA could be used as a means of raising competitiveness in the service industries of the three countries, as well as upgrading their economies.

#### *Future Agenda of the Trilateral Joint Study*

The Trilateral Joint Study on “Economic Effects of a Possible FTA between China, Japan and Korea” will be concluded in 2008 with more active, concrete, and comprehensive policy directions and policy measures that take into consideration the complexity and urgency of the issues. Therefore, for 2008 it is recommended that the study address the FTA policies of the three countries, focusing on the relations between ongoing and forthcoming bilateral FTAs of the three countries and a CJK FTA, on the one hand, and the role of three Northeast Asian countries and a CJK FTA in the process of forming a region-wide FTA in East Asia, on the other. Thus, it could produce a persuasive road map toward a CJK FTA, as well as concrete and step-by-step policy measures to achieve it.

## **I. Introduction**

Following the agreement between the leaders of China, Japan, and Korea at the historic Manila Meeting in November 1999, joint research on economic cooperation between the three countries was undertaken by the Development Research Center of the State Council (DRC) of China, the National Institute for Research Advancement (NIRA) of Japan, and the Korea Institute for International Economic Policy (KIEP) in 2001.

In 2003 the three institutes embarked upon the second phase of joint research on the “Long-term Economic Vision and Medium-term Policy Direction,” initiating a project entitled “Economic Effects of a Possible Free Trade Agreement (FTA) between China, Japan and Korea.” After the overall analysis of the subject in 2003, the three institutions conducted joint research on the sectoral effects of a China-Japan-Korea FTA (CJK FTA) covering agriculture, fishery, and major manufacturing and service sectors during 2004–2006. In 2006 they also examined other important issues, including rules of origin and sensitive sectors in the FTAs concluded by China, Japan, and Korea.

The situation has changed substantially, however, since the beginning of the joint study. On the one hand, the Chinese economy continues to increase and evolve very rapidly resulting in growing interdependency between the three economies leading to significant changes in China’s trade structure. On the other hand, after belatedly joining the FTA bandwagon, these three countries have subsequently concluded a number of FTAs within a relatively short period of time. In addition, there are many ongoing FTA negotiations and studies involving the three countries.

Thus, given the swiftness of change in China’s trade structure and the speedy proliferation of bilateral FTAs involving the three countries, this year’s joint research attempts to undertake a comprehensive study on the economic effects of a CJK FTA by deepening and updating the analyses done in previous years.

The joint study will, first, examine the rationales for a CJK FTA by highlighting the growing need for a CJK FTA and by revisiting the positive macroeconomic benefits for the three countries, reflecting changes in China’s tariff rates after China’s WTO accession. Then, this year’s study will mainly address the sectoral implications of a CJK FTA on agriculture, fishery, and major manufacturing and service industries of the three countries. Using updated statistics and tariff rates, the study will compare their competitiveness and tariff structures and identify sensitive sectors reflected in the FTAs concluded by the three countries.

Furthermore, other important issues including rules of origin will also be examined.

This report will be followed next year by a comprehensive concluding report. After this year's overall analysis of the economic effects of a CJK FTA, including the study on the major industries of the three countries, next year's report will attempt to seek a road map toward a CJK FTA. In order to do this, the FTA policies of the three Northeast Asian countries will be examined. In particular, next year's study will highlight the relations between respective bilateral FTAs and a CJK FTA, as well as the role of a CJK FTA in forming a region-wide FTA.

## **II. Rationales for a CJK FTA**

### **1. Growing Needs for a CJK FTA**

When it comes to regionalism, Northeast Asia is quite different from other major economic regions. Although China, Japan, and Korea belatedly adopted regionalism, they have concluded a number of FTAs within a short period of time. Japan concluded Economic Partnership Agreements (EPAs) with Singapore, Mexico, Malaysia, the Philippines, Chile, Thailand, Brunei, and Indonesia. Korea signed FTAs with Chile, Singapore, the European Free Trade Association (EFTA), and the United States, as well as a Trade in Goods Agreement with ASEAN (excluding Thailand). As for China, it signed Closer Economic Partnership Arrangements (CEPAs) with Hong Kong and Macao, and FTAs with ASEAN, Chile, and Pakistan. In addition, there are many ongoing FTAs: some under negotiation and others in the study phase.

Yet there is still no bilateral FTA between Northeast Asian countries, let alone a region-wide FTA. Despite the absence of a regional trade agreement, however, functional economic integration seems to have proceeded rather robustly in Northeast Asia. The importance of intraregional trade between China, Japan, and Korea has risen substantially since 1990: the share of intraregional trade among these countries increased from 12.7 percent in 1990 to 23.9 percent in 2005. In other words, trade interdependency among the three Northeast Asian countries has markedly strengthened in the past 15 years.

The growing trade interdependency between China, Japan, and Korea is also reflected in each country's major trade partner rankings. In 2006 Japan and Korea were the second and fourth largest trading partners, respectively, with China. For Japan, the second and third most important trading partners were China and Korea, respectively, while China

and Japan were the largest and second largest trading partners, respectively, for Korea. Furthermore, as of June 2007, China has emerged as the most important trading partner for Japan. Thus the growing trade interdependency between China, Japan, and Korea constitutes an additional, powerful economic rationale for a CJK FTA.

Admittedly, there exist many obstacles to a CJK FTA. Among them, most commonly cited obstacles are usually non-economic factors, such as remnants of past conflicts, rivalry between China and Japan, and a lack of community spirit in the region. In the context of the recent proliferation of bilateral FTAs and growing interest in a region-wide FTA in East Asia, however, this study proposes that, by reversing this way of thinking, we can turn these obstacles into a rationale for a CJK FTA. It argues that, in pursuing a CJK FTA, Northeast Asian countries can reduce political tensions among each other and play a key role in East Asian community building.

## **2. Simulation on Economic Impacts of a CJK FTA**

The joint research project assessed the economic impacts of a CJK FTA by means of a computable general equilibrium (CGE) model, aiming at providing a revised estimate to the 2005 report of the Trilateral Joint Research.

The new 2007 simulation updates the model database, adjusting for the changes in the tariff rates after 2001 (mainly the tariff reductions arising from China's WTO accession) and the economic growth of the countries in the world.

The simulation results generally indicate the same direction and similar magnitude of economic effects as those of our 2005 study, confirming that an FTA among China, Japan, and Korea will be a win-win-win strategy bringing about macroeconomic benefits to all members. The estimated gains of real gross domestic product (GDP) are 0.30 percent, 0.41 percent, and 5.26 percent for China, Japan, and Korea, respectively. If grains are exempted from tariff concessions, however, the benefits become smaller for Japan and Korea.

One should note that the benefits in the model simulation here are underestimated. The benefits of the FTA would be much larger, because the FTA would promote the formation of a production network in East Asia, thereby materializing scale merits.

As is the case for all trade liberalization policies, a CJK FTA will create both winners and losers in industrial sectors. The sector-based estimate underscores the fact that the government should seriously consider remedial measures to cushion the damage.

### III. Sectoral Implications of a CJK FTA

#### 1. Manufacturing Industries

##### *Closer Industrial Linkage between China, Japan and Korea*

The manufacturing industry has played a significant role in the economic development of China, Japan, and Korea. According to WTO statistics, in 2005 the total exports of manufactured products in these countries exceeded US\$1.5 trillion, about 20.6 percent of the world total, and each country realized huge trade surpluses in the trade of manufactured goods.

For 2001–2005, the ratio of intraregional trade among the three Northeast Asian countries rose from 21.8 percent to 23.9 percent. Meanwhile, intraregional investments increased from 9.8 percent to about 14 percent.

Along with more active mutual investments, the degree of intra-industrial trade (IIT) among the three countries is also rising, mainly in chemicals, textiles, apparel, steel, machinery equipment, and electronics. In 2005 the level of IIT between Japan and Korea was much higher than that between China and Japan or China and Korea, while the IIT level between China and Korea enjoyed the most significant growth (about 30 percentage points) compared with that in 2002.

##### *Competitiveness Analysis of Major Industries*

To analyze competitiveness of the major manufacturing industries in the three countries, two indices are used: revealed comparative advantages (RCA), which shows competitiveness in the international market, and regional RCA (RRCA), which indicates comparative advantages in regional trade. To analyze development trends, a comparison was made between 2002 and 2005 concerning the industrial competitiveness of the three countries.

Table 1. International Competitiveness of the Major Industries in China, Japan, and Korea (2002-2005)

	China's RCA		Japan's RCA		Korea's RCA	
	2002	2005	2002	2005	2002	2005
Agriculture	0.46	0.38	0.05	0.05	0.15	0.13
Fishing	1.42	<b>1.44</b>	0.19	<b>0.26</b>	0.66	0.47
Petrochemicals	0.50	<b>0.52</b>	0.76	<b>0.83</b>	0.74	<b>0.84</b>
Textiles	3.05	<b>3.09</b>	0.31	0.30	1.72	1.05

Iron & Steel	0.85	<b>1.03</b>	1.33	1.31	1.35	<b>1.40</b>
Machinery	1.27	<b>1.38</b>	1.35	<b>1.41</b>	1.14	0.95
Electronics	1.41	<b>1.59</b>	1.50	1.45	1.88	<b>1.99</b>
Automobiles	0.18	<b>0.23</b>	2.16	<b>2.26</b>	1.02	<b>1.42</b>

Source: UN COMTRADE Database, HS 2002 version.

Note: HS classifications: Agriculture: Chapter 1–2, 4–15, 17–24; Fishing: Chapter 3, 16; Textiles: Chapter 50–63; Petrochemicals: Chapter 28–40; Iron & Steel: Chapter 72–73; Machinery: Chapter 84; Electronics: Chapter 85; Automobiles: Chapter 87.

The results show that the major manufacturing industries in China, Japan, and Korea enjoy different degrees of competitiveness. In general, China enjoys low labor costs, large economies of scale, and large production capacities. Thus, its comparative advantages are concentrated in labor-intensive industries or processing links, such as textiles and electronics. By contrast, Japan and Korea boast stronger technological abilities and research and development capabilities, which offer them stronger comparative advantage in capital-intensive and technology-intensive industries, such as automobiles and machinery for Japan, and electronics and petrochemicals for Korea.

For 2002–2005, most industrial sectors in China improved their competitiveness in both global and regional trade. The comparative advantages of automobiles and electronics in Korea also improved considerably, especially in regional trade. In fact, the RRCA of the Korean automobile industry in 2005 even exceeded that of Japan due to the dramatic export growth from Korea to China. The competitiveness of the textiles and machinery industries, however, had somewhat decreased. Of the three countries, Japan enjoys the greatest competitive advantages in most manufacturing industries, except the electronics industry, where its RRCA value is slightly lower than that of Korea. There were no significant changes to Japanese industries, either internationally or regionally, in recent years.

### *Tariff Regimes in China, Japan, and Korea*

According to the *World Tariff Profile 2006*, the simple average applied tariff rate of the manufacturing industry in Japan is 2.8 percent, lower than those of Korea (6.6 percent) and China (9 percent). Regarding the tariff structure, the proportion of zero-tariff products in Japan is 41 percent, much higher than those of Korea (13.3 percent) and China (8.5 percent). The proportion of high-tariff products (average tariff levels above 15 percent) in China has decreased to 16 percent in 2006, but is still higher than those of Japan (13.6 percent) and Korea (9.2 percent).

Tariff rates for most manufactures in China are higher than those in Japan and Korea. Due to China's the policy of zero tariffs on processing trade, however, the average applied tariff level in China is significantly reduced to about the same level as that in Korea.

*Implications of a CJK FTA on Manufacturing Industries*

Based on the CGE simulation (production effects and trade effects) and empirical analyses taking into account the industrial linkages within the same industry, as well as input-output relationships between different industries, the sectoral implications of a CJK FTA are summarized in Table 2. The plus and minus signs indicate competitive pressures in the short term compared to the benchmark scenario.

Table 2. Cross-Sector Industrial Impacts of a CJK FTA

	China	Japan	Korea
Textiles	–	+	+
Apparel	+	–	+
Electronics	+	/	+
Machinery Equipment	–	+	–
Iron & Steel	/	+	+
Automobiles	–	+	–
Petrochemicals	–	+	+

China's apparel industry would greatly benefit from trade liberalization, although its man-made filament and fabrics producers might be adversely affected by Japanese and Korean counterparts. In other sectors, Chinese enterprises will, in the short term, face greater pressures due to weak competitiveness and higher tariff levels. In fact, the automobile and petrochemical industries are likely to become the most sensitive industrial sectors in China.

In most manufacturing industries, Japan is likely to become the largest beneficiary from trade liberalization among the three countries. The only exception is the textile industry in Japan, which is expected to encounter pressures from accelerating structural adjustment. Moreover, certain chemical and electronic products from Korea would also exert competitive pressures on Japanese enterprises.

The overall development and technology levels of Korea's manufacturing industry lie between Japan and China. Thus, with the exception of the electronics industry, which will

benefit considerably, the trilateral FTA will produce both pros and cons for the other industries. After tariff elimination, Korea's exports to China are likely to grow significantly in automobiles, petrochemicals, and steel, but Korean enterprises will face more fierce competitive pressures from Japan in the automobile and machinery industries, as well as from China in the textile industry.

In general, tariff elimination will generate both trade creation and trade diversion effects. Furthermore, there are other factors affecting the implications of a CJK FTA on manufacturing enterprises, such as cross-border investments, timing of trade liberalization, various competitiveness levels between multinationals and small and medium-sized companies, as well as between upper-stream and lower-stream sectors within an industry. All of these factors may possibly generate even greater dynamic effects, including efficiency gains or short-term losses, for enterprises.

## **2. Agriculture and Fishery Industries**

### *Agriculture*

The agricultural sectors in China, Korea, and Japan have many commonalities, but they also represent the main obstacles for the three countries to opening their markets. In addition, all three countries are major importers of agricultural products and are major trading partners with one another in terms of agricultural products. The circumstances of the agricultural sectors in each country, however, are very different. Therefore, there exist widespread concerns over the effects of a CJK FTA on each country's agricultural sector.

The trilateral joint study conducted in 2004 concluded that China's agricultural sectors would expand overall in output, except in forestry. It also showed that Japan would experience difficulties after a CJK FTA, while Korea would experience a positive overall effect in its agricultural sectors, even though it was likely to lose out in cereals, other agricultural products, and forestry. Based on various quantitative analyses, the study suggested that the key to conducting successful negotiations on agricultural issues is to seek commodities that have comparative advantages within each respective sector and promote so-called intra-industry trade. It also argued that the agricultural sector should be included in the list of tariff reductions and other treatments in a CJK FTA despite some obvious difficulties.

The current study finds that the share of China, Japan, and Korea's imports in world agricultural imports is substantial. In addition, as the major import items are also major

export products, the three countries can pursue intra-industry trade. The cooperation among these three countries is essential for stable food supply in the region. An FTA between the three countries could serve as a good opportunity to reform the agricultural sector and prepare the countries for global integration in agricultural trade. The effects of a CJK FTA will depend on the methods adopted to reduce or eliminate trade barriers in the three countries. Its success also depends on the coverage of so-called sensitive items. The most important thing to recognize, however, is that under a CJK FTA, the agricultural sectors in each country will face mounting challenges from around the world; thus, a CJK FTA could serve as a basis for agricultural reform.

### *Fisheries*

China, Japan, and Korea are the world's top producers both in terms of capture fishery production and aquaculture fishery production. In 2004 the total fishery production of three countries accounted for 38.9 percent of the world's total production. In addition, these three countries comprised a relatively large part of world fishery trade, accounting for 12.4 percent of the world's fishery export market and 26.5 percent of the import market.

Japan's tariff rates are lower compared to the other two countries for all fishery products. Korea imposes the highest tariff rates on fishery products among the three countries; its tariff rates on almost all fishery products are higher by 15 percent, except live fish, frozen fish and fish fillets, and other fish meats. The level of China's tariff rates on fishery products is between those of Japan and Korea. Overall, the three countries impose relatively high tariffs on processed fish products compared to other types of fishery products.

In order to identify sensitive items in the fisheries industries of China, Japan, and Korea, the study adopts a four-step approach, which is comprised of a variety of competitiveness analyses. For 2002–2005, 26 percent of the items that China traded with Japan were classified as sensitive items, while 37 percent of the items that China traded with Korea were identified as sensitive. In Japan's case, sensitive items represented 84 percent and 54 percent of all trade fishery products vis-à-vis China and Korea, respectively. Korea is in a similar position with Japan in that most of its items are just as uncompetitive against China, though it does have some advantages over Japan. The shares of Korea's sensitive fishery items vis-à-vis China and Japan amounted to 71 percent and 44 percent, respectively.

Given the levels of tariff rates and the dependence of trade in the CJK fishery market,

it is likely that the negative impacts of a CJK FTA will be greater in Korea, followed by Japan, and widening their trade deficits. On the other hand, China can expect a positive impact from a CJK FTA, since the demands from Japan and Korea, China's top fishery export destinations, are likely to increase. Additionally, since certain items (HS 0302 and HS 0303) were revealed to be sensitive for all three countries in our sensitivity test, a longer transitional period may be required for these items.

### **3. Service Industries**

#### *Competitiveness and Sensitive Sectors*

Service products have different characteristics from non-service products, such as simultaneity, imperfect information, and handling as intermediate goods.<sup>2</sup> The different characteristics of products bring about different modes of trade. One of the major differences is the greater difficulty in measuring trade restrictions on services than restrictions on trade in goods. Restrictions on trade in goods usually take the form of tariffs, which are reflected in the prices of the goods, while restrictions on services trade usually take the form of government regulation. Many types of government regulations affect the price of services, but it is often hard to quantify or measure the extent of the restrictions on trade in services. Similarly, trade costs and the benefits of removing such restrictions are difficult to analyze. Under these constraints, this study explores the comparative trade advantages and sensitive sectors among service sectors in China, Japan, and Korea.

Not only do China, Japan, and Korea share comparative advantages in trade in goods, but also relative disadvantages in services.<sup>3</sup> Not all service sectors in China, Japan, and Korea, however, have comparative trade disadvantages, and the trade competitiveness of services in China, Japan, and Korea differs from product to product.<sup>4</sup> China displayed trade competitiveness in travel and communication services for almost the entire period from 1994 to 2005 and in other business services and government services after 2000. Japan showed

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<sup>2</sup> Simultaneity of production and consumption demands close spatial proximity. As the measurement of the quality of service products is determined by individual preferences and the provider's experience, less objective evaluations and greater difficulty in measuring the quality often result in imperfect information. Service products, such as management consulting, accounting services, and financial services are normally used as intermediate products in final goods.

<sup>3</sup> The volume of services trade in China, Japan, and Korea is less significant in world trade than the volume of trade in goods. In addition, China, Japan, and Korea recorded service trade deficits, whereas other countries that rank highly in terms of services trade, e.g. the USA, the UK, and France, recorded surpluses. This implies that China, Japan, and Korea have a comparative disadvantage in services.

<sup>4</sup> These findings are from the Relative Revealed Comparative Trade Advantage (RTA) indices for 1980–2005.

competitiveness in government services for nearly the entire period and in royalty and license fee services after 2003. Korea, on the other hand, was competitive in transport services and government services, as well as in construction and financial services, for almost the entire period after the late 1990s.

Similarly, the sensitive sectors differ from country to country. Based on certain assumptions regarding comparative trade indices and qualitative analysis of the General Agreement on Trade in Services (GATS), the sensitive sectors are identified as follows: Transportation, financial, personal, cultural, and recreational services in China; transportation and communication services in Japan; insurance, personal, cultural, and recreational services in Korea.

### *Implications*

Liberalization of services not only introduces competition and improves the quality of services through maximization of cross-border resource allocation processes, but also facilitates trade in goods, as many service products are used as intermediate products in the production of final goods. Removing all restrictions on service trade is infeasible, however, as they are consistently tied to domestic regulations and the benefit from inter-sectoral externalities may exceed cost from regulations in service trade.

In addition, we should take into consideration the following four aspects in liberalizing trade in services. First, finance, distribution, construction, real estate, transportation, information, and tourism are very significant service sectors among the three countries in terms of trade volume and value. There is a great deal of potential for further liberalization in these areas, and there would be considerable merit in discussing them in trilateral talks. The way in which China, Japan, and Korea cooperate in these sectors may be the key to the creation of an effective, future FTA among these countries.

Second, due to their intangible and non-storable characteristics, services are often provided through business offices established in the market where they are consumed. Therefore, we should carefully examine what kind of services require a commercial presence and what form of business organization is suitable in each service sector.

Third, all three countries basically lack comparative advantages in services trade. If a country liberalizes services in a CJK FTA and is committed to another FTA in which the principle of most-favored-nation (MFN) treatment is prescribed, with a large country that has

a comparative advantage in services trade, it may suffer from an inundation of imports in services. Thus, a wider range of influences beyond the three countries should be taken into consideration.

Finally, China has a limited number of comprehensive FTAs that include commitments in services. There is no stringent schedule of commitments in services; therefore, we should act flexibly in determining which service sectors to liberalize and the appropriate liberalization process.

#### **IV. Important Issues of a CJK FTA Viewed from the Concluded FTAs of China, Japan, and Korea**

##### **1. Tariff Concession Structures and Sensitive Goods**

This study also analyzes the tariff concession structures of FTAs that the three countries have previously concluded, that is, the tariff concessions in three of China's FTAs (with ASEAN, Chile, Pakistan), three of Japan's EPAs (with Singapore, Mexico, Malaysia), and five of Korea's FTAs (with Chile, Singapore, EFTA, ASEAN, the US). In doing so, it attempts to identify the sensitive items for each country. In the analysis, those tariff items with a phase-out period of ten years or more, as well as those items under quantitative restrictions, deferred negotiations, and exclusions, are classified as sensitive items.

The tariff concession structures adopted by China, Japan, and Korea can be divided into two types: an ASEAN type and individual-item type. The ASEAN type includes the China-ASEAN FTA, China-Pakistan FTA, and Korea-ASEAN FTA. The rest of the FTAs are individual-item types. The ASEAN type, basically, divides items into the Normal Track and Sensitive Track depending on sensitivity. Furthermore, the Sensitive Track encompasses two subcategories: Sensitive List and Highly Sensitive List. The individual-item type literally imposes an individual tariff elimination schedule to each item.

After scrutinizing the tariff concession structures and sensitive items of the three countries' previously concluded FTAs at the HS 6-digit level, this study confirms that there are 17 common sensitive items for all three countries, 35 common items between China and Japan, 36 common items between China and Korea, and 142 common items between Japan and Korea. The common sensitive items of all three countries include 14 agricultural items and 3 processed foods. Among the 35 common sensitive items between China and Japan,

there are 29 agricultural items. Among the 36 common sensitive items between China and Korea, agricultural items also make up the largest share with 19 items, followed by processed foods with 7 items. Among the 142 common sensitive items between Japan and Korea, agricultural products also have the largest share with 118 items, followed by fishery products with 21 items, and processed foods and tobacco with 3 items. Meat appears to be the most sensitive agricultural product with 27 items, followed by dairy products with 21 items.

The analysis shows that the three countries could minimize conflicts in FTA negotiations by adopting intricate and subdivided categories, as in the Japan-Malaysia and Korea-EFTA FTAs, and varying phase-out periods, as in the China-Pakistan FTA. The analysis on FTAs concluded by China, Japan, and Korea also reveals that agricultural items, fishery products, processed foods and tobacco, wood, chemicals, machinery, and rubber products may be the sensitive items during negotiations.<sup>5</sup>

## **2. Rules of Origin**

Rules of Origin (ROO) are an inseparable part of FTAs and are an important way to protect members' interests by preventing roundabout trade. Due to the complexity in production and trade, however, it is difficult to establish the proper method for determining ROO. Therefore, it will be very meaningful to analyze the experience of major trading blocs, such as the EU, NAFTA, and ASEAN, and learn about the features of current free trade arrangements established by China, Japan, and Korea for the purpose of studying and designing the ROO for a prospective CJK FTA.

Because of the complexity in production, it is not possible for many manufactured goods to be wholly produced within the home country; rather, some foreign materials and parts must be used. For these products, the principle of substantial transformation can be applied to determine whether they have satisfied the minimum requirements to warrant origin status.

There are three methods to determining substantial transformation. The first is change in tariff classification (CTC), the second is the value-added (VA) method, and the third is specific manufacturing processes (SP). All three methods have their own advantages and disadvantages. Therefore, most FTAs adopt a combination of these methods to formulate ROO, often with concrete rules for different products. FTA ROO often contain cumulation

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<sup>5</sup> This recommendation must be taken with a grain of salt, because, so far, China has not concluded an FTA with any major industrial country.

and tolerance provisions that are designed to make ROO more flexible and less stringent.

The EU and NAFTA represent two main systems of ROO in the world today. The common feature of both systems is that they are based on product-specific rules, with CTC as the main method, supplemented by VA and SP. The difference is that the EU is able to connect all different preferential trade agreements through diagonal cumulation, thereby creating a pan-European system centered on the EU. Different from these two systems, the AFTA adopts uniform, value-added ROO with low, regional value-content requirements and full cumulation.

China has already signed preferential trade agreements with several countries and regions. The ROO in these agreements can be split into two groups. Those in the CEPAs with Hong Kong and Macao are based on product-specific rules with specific manufacturing processes as the principal method for determining product origin, supplemented by CTC and, to a lesser extent, VA rules, which require a local content of 30%. Those in other FTAs signed by China, including the China-ASEAN FTA (CAFTA), Chin-Pakistan FTA, and China-Chile FTA, are all based on a uniform value-added method with regional content set at 40%. Full cumulation is allowed in the CAFTA, and bilateral cumulation is allowed in the other two FTAs.

Japan has signed EPAs with Singapore, Mexico, Malaysia, the Philippines, Chile, Thailand, and Brunei. The ROO in these agreements are very similar in content and structure. They all use CTC as the principal rule. Some products require VA, and regional content is set from 40 percent to 60 percent, with lower levels of local content required in later agreements. In general, ROO in the EPAs with ASEAN countries are highly consistent.

Korea has signed FTAs with Chile, Singapore, the EFTA, and the US. Overall, the ROO in these agreements are very consistent. The principal method for determining substantial transformation is CTC, supplemented by a VA method. Textile and apparel products use specific manufacturing processes, as in many other agreements.

From the experience of major trading blocs in the world and that of China, Japan, and Korea, it is evident that the ROO in different trade agreements are quite disparate. A single country may even adopt different ROO with different trade partners, which can lead to increased complexity in ROO and higher administrative and compliance costs. The liberalizing effect of regional trade agreements may be reduced as exporters forego the opportunity to use preferential access.

Therefore, a ROO system covering all three countries, China, Japan, and Korea, is

obviously much better than one that consists of three bilateral sets of ROO. In addition, because the present and potential free-trade partners of the three countries are mostly in East Asia, the design of the ROO in a CJK FTA must take into account the connectivity and harmonization of the ROO with these partners in order to meet the long-term goal of East Asian integration.

### **3. Basic Principles of Services**

Japan has a wealth of experience in negotiating FTAs with both positive and negative approaches. Although Korea prefers to adopt a negative approach, since its first FTA was based on such an approach, it applied a positive approach to its FTA with the EFTA. Korea and Japan appear to have little difficulty adopting either method. China, on the other hand, has no experience using a negative method, since all its service chapters prescribe a positive approach. A positive list approach may be an appropriate option, but a negative type of approach is also a good option in terms of transparency and effectiveness. With regard to the classification of services, a CPC can be utilized as a mutual standard.

Since all three countries are members of the WTO, the basic principles incorporated in the CJK FTA can follow GATS. It is essential to incorporate the basic principles, such as market access, national treatment, most-favored-nation treatment, and transparency, in the trilateral FTA. In particular, MFN treatment should be mandatory, and not merely a loophole provision. It is also critical to improve the level of transparency in order to minimize disputes arising from ignorance or misunderstanding of the rules and regulations as much as possible. If possible, a standstill provision or a ratchet clause should be inscribed.<sup>6</sup> It is highly desirable to create a more effective agreement than GATS by changing the present provisions in GATS for the better and adding new practical principles.

### **4. Overview of Other Remaining Issues**

At a preliminary stage, the joint research reviewed the provisions and chapters promoting harmonization and adjustment of the rules in the existing FTAs of the three countries. This study covers the provisions on intellectual property rights, competition policies, government procurement, antidumping (AD) and countervailing duties (CVD),

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<sup>6</sup> The standstill provision prevents contracting governments from introducing any new laws and regulations that reduce the present, agreed-upon degree of liberalization measures. A ratchet clause states that parties to the agreement cannot adopt any retrograde policies once they have opened a market toward the liberalization of trade in services.

safeguard (SG) mechanisms, and sanitary and phytosanitary (SPS) measures.

Regarding intellectual property rights, the coverage and contents of the relevant provisions vary by FTA and EPA: some have TRIPS-plus and some have no provisions at all. Most FTAs and EPAs in China, Japan, and Korea mention the importance of competition as an objective of the agreements; however, not all the FTAs and EPAs have provisions or chapters on this subject.

Given the plurilateral nature of the WTO Government Procurement Agreement, the standpoint of the FTAs and EPAs toward government procurement issues differs among the parties to the FTAs and EPAs. Provisions and chapters relating to antidumping and countervailing duties (AD/CVD) enhance the rights and obligations under the WTO agreements. Some of the FTAs and EPAs exempt application of the AD/CVD measures and/or filing cases related to dispute settlement.

Although each FTA or EPA has a general SG mechanism, except for the Korea-Chile FTA, provisions regarding the period of application, reapplication, and validity of SG measures, as well as those stipulating the relationship between bilateral and global SG differ among the FTAs and EPAs. Most FTAs and EPAs merely reaffirm the SPS obligations and rights already contained within the WTO, except that some FTAs and EPAs provide refined consultation mechanisms and detailed procedures for notification and communication between parties.

Given the different nature of the individual FTAs/EPAs in terms of parties, coverage, timing, sequence, etc., provisions and chapters in each element of the studied FTAs/EPAs have different characteristics, as well as similar or identical stipulations.

## **V. Joint Policy Recommendations**

On the basis of these analyses and discussions with business people and specialists, the following policy recommendations are proposed to the leaders of China, Japan, and Korea by the three institutions involved in the joint research project.<sup>7</sup>

### *Recognize the Growing Trade Interdependency between China, Japan, and Korea*

This study shows that the share of intraregional trade between China, Japan, and

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<sup>7</sup> Business representatives of the three countries also participated in the process of this year's research, and some government officials attended the workshops as observers. The recommendations, however, do not necessarily imply official agreements between the governments of the three countries.

Korea has markedly increased in the past 15 years. In particular, China has become the largest trading partner for both Japan and Korea. Although all three Northeast Asian countries have pursued active FTA policies by concluding a number of FTAs within a relatively short period of time, there is still no bilateral FTA, let alone a trilateral FTA among them. In addition to their geographic proximity, the growing trade interdependency provides an additional, powerful rationale for an FTA between China, Japan, and Korea, because it would produce greater economic benefits for all three countries.

#### *Make Manufacturing Industries More Competitive*

All three Northeast Asian countries have become leading industrial economies in the world. Thus, trade liberalization in the manufacturing industry will contribute the most to overall welfare gains by expanding the regional market, optimizing resource allocation, and creating a more competitive environment. In addition, it is consistent with the willingness of most enterprises in the three countries. A delay in the establishment of the trilateral FTA would result in rising structural adjustment costs in the three countries, as well as overcapacity in some sectors, such as steel and petrochemical industries, within the region.

#### *Face the Challenge of Agricultural and Fishery Industries*

Unlike the manufacturing sector, agricultural and fishery industries in the three countries are relatively weak. They are all major importers of agricultural and fishery products, and some of these products are heavily protected by tariff and non-tariff barriers. Agricultural and fishery sectors constitute major obstacles to forming FTAs. The weakness of these industries was also vividly reflected in the FTAs concluded by China, Japan, and Korea. Therefore, in the process of forming a CJK FTA, special attention will need to be paid to these sectors. A CJK FTA, however, could serve as a good opportunity to reform the agricultural sector and prepare the countries for global integration in agricultural trade. In order to alleviate adjustment burdens and facilitate structural adjustment, a clearly scheduled, gradual liberalization program should be devised with adequate specialization and compensation schemes for these industries.

#### *Enhance Service Industries at the World Level*

China, Japan, and Korea lag behind developed North American and European countries in services trade. Although the three countries recorded in general trade surpluses,

they usually have deficits vis-à-vis the world in services trade. Liberalization of services would raise the competitiveness of service sectors by introducing competition and improving the quality of services. In addition, since many service products are used as intermediary processes in manufacturing goods, service liberalization would also contribute to making manufacturing industries more competitive. Thus, a CJK FTA could be used as a means of raising competitiveness in the service industries of the three countries, as well as upgrading their economies.

#### *Future Agenda of the Trilateral Joint Study*

The Trilateral Joint Study on “Economic Effects of a Possible FTA between China, Japan and Korea” will be concluded in 2008 with more active, concrete, and comprehensive policy directions and policy measures that take into consideration the complexity and urgency of the issues. Therefore, for 2008 it is recommended that the study address the FTA policies of the three countries, focusing on the relations between ongoing and forthcoming bilateral FTAs of the three countries and a CJK FTA, on the one hand, and the role of three Northeast Asian countries and a CJK FTA in the process of forming a region-wide FTA in East Asia, on the other. Thus, it could produce a persuasive road map toward a CJK FTA, as well as concrete and step-by-step policy measures to achieve it.

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