

PART II. Economic Effects of the JKFTA

Overview

27. The overall economic effects of a FTA can be examined from two fronts: static (short-term) effect and dynamic (long-term) effect. The static effect can be examined by measuring the interplay of the trade-creation and trade-diversion effects. The dynamic effect of a FTA would most likely result from: (1) economies of scale; (2) increased efficiency due to the intensification of competition; and (3) the use of integrated production factors, such as capital and labor, between member countries.

28. The JKFTA would expand the bilateral trade and investment through enhanced liberalization, including the abolition of tariff and non-tariff measures and strengthened bilateral cooperation. The reduction in domestic prices of imported items would result in an increase in import volume. Given the complementary trade structure of the two countries, a bilateral FTA is expected to promote intra-industry trade, and expand bilateral trade and investment.

29. In addition, the JKFTA would contribute to integrating both economies. It is noteworthy that the integrated size of the two economies accounts for virtually 17 percent of the total global GDP, while the combined population reaches 170 million. This would generate large economies of scale, contributing to efficient production and distribution in both Japan and Korea.

30. Furthermore, the JKFTA is anticipated to ameliorate the problem of over-capacity in a number of industries, contributing to an effective allocation of resources among industries. By promoting cooperation and competition between Korean and Japanese companies, the JKFTA would bring about other wide-ranging benefits, *inter alia*, surge of strategic alliances, vitalization of the economy and improved competitiveness of the industries.

31. It is anticipated that the inflow of foreign direct investment (FDI) into both countries, along with technology transfer especially into Korea will reach greater heights. Liberalization in the services sector would bring forth increased movement of people between the two countries.

PART II. Economic Effects of the JKFTA

32. In the long run, this gradual economic integration would serve as an important vehicle in pursuing necessary economic reform in both countries. In short, enhanced efficiency and productivity of both economies alike attained through the JKFTA would reinforce their economic footings in Asia, not to mention the rest of the global economy.

33. The integrated economy could make joint advances into third markets. In light of the significant economic importance of both countries in the global market, the integrated economy could set global standards in the high-tech industries by attaining critical mass. The JKFTA would also be beneficial to both sides by collectively addressing mutual concerns and reinforcing standing in the international fora. In sum, the JKFTA would significantly contribute to the economic growth of both countries.

34. Aside from the aforementioned positive effects, there may be also possible negative ones arising from the JKFTA. Most notably, difficulties may arise in some sensitive sectors in each country. In addition, there are concerns in the Korean side that the JKFTA might aggravate Korea's existing chronic trade deficit with Japan. Both sides agreed that relevant measures should be prepared to avoid excessively severe changes in several sectors of both countries while such measures should be carefully designed not to hinder the benefits of the JKFTA.

PART II. Economic Effects of the JKFTA

Studies conducted on the JKFTA

35. With the purpose of systemically studying the economic effects of the JKFTA, KIEP⁵ and IDE⁶ conducted the first joint study on the feasibility of the FTA between the two countries from 1999 to 2000.

36. The results of the study conducted by KIEP show that the FTA may have an adverse impact on Korea in the short-term through increased deficits. But, the report mentions that increased inflow of foreign direct investment would substantially augment Korea's benefits in the long-term.⁷

37. IDE's research concluded that the JKFTA would benefit both countries, especially Japan, in the short-term. Taking into consideration the long-term dynamic effect, however, IDE's study suggests that Korea's industrial productivity would increase by 10 percent to 30 percent during a 10-year period, resulting in improved welfare and trade surplus with the rest of the world.⁸

⁵ For general information on Korea Institute for International Economic Policy (KIEP), see www.kiep.go.kr.

⁶ For general information on Institute of Developing Economics (IDE), see www.ide.go.jp.

⁷ KIEP, Economic Effects of and Policy Directions for a Korea-Japan FTA (May 2000)

⁸ IDE, Toward Closer Japan-Korea Economic Relations in the 21st Century (May 2000)

PART II. Economic Effects of the JKFTA

<Table 3> Economic Impact of the Japan-Korea FTA⁹

		Static Effects		Dynamic Effects	
		KIEP	IDE	KIEP	IDE
Korea	Welfare level (%)	-0.19	0.34	11.43	7.09
	GDP (%)	-0.07	0.06	2.88	8.67
	Trade balance with Japan (US\$100 million)	-60.90	-38.85	-4.40	-24.60
	Total trade balance (US\$100 million)	-15.43	-2.7	30.14	408.00
Japan	Welfare level (%)	0.14	0.03	-	9.29
	GDP (%)	0.04	0.00	-	10.44
	Trade balance with Korea (US\$100 million)	60.90	38.85	-	24.60
	Total trade balance (US\$100 million)	-	54.79	-	182.00

Source: KIEP and IDE Reports

38. Apart from the aforementioned joint report, a number of other individual studies on the economic effect of the JKFTA have been carried out in both countries. For instance, in 2001 the KIEP carried out a study, of which the results indicated that, on the proviso that non-tariff barriers are significantly eliminated in Japan, the JKFTA would help reduce Korea's trade deficit with Japan and boost Korea's GDP by 0.22 percent to 0.33 percent in the short-term and 0.82 percent to 1.90 percent in the long-term. It is also predicted that the JKFTA would increase Korea's employment by 0.06 percent. And according to the study conducted by Korea Economic Research Institute (KERI) in 2001, Korea's trade deficit with Japan would increase up to 1.95 billion US dollars during the first 10-year period of the JKFTA, while Korea's GDP increases by 0.23 percent and employment by 0.06 percent. And in 2001, Korea Rural Economic Institute (KREI) analyzed the effect of the JKFTA on the bilateral trade on agricultural products and expected the increase of Korea's ten major exporting products¹⁰ up to 58 million US dollars in the Japanese market.

⁹ The studies conducted by each institute were based on different assumptions. The IDE assumed free movement of capital whereas the KIEP's study was based on limited capital movement across the border.

¹⁰ Kim-chi, Tomatoes, Aubergines(egg-plants), Fruits of the genus capsicum (including

PART II. Economic Effects of the JKFTA

39. In the case of Japan, according to Kawasaki's study¹¹, the JKFTA would increase Japan's GDP by 0.04 percent to 0.12 percent and Korea's GDP by 1.13 percent to 2.45 percent. In case of Nakajima¹², Japan's GDP would increase by 0.01 percent (static effect) to 0.02 percent (dynamic effect) and Korea's GDP by 0.29 percent (static effect) to 1.09 percent (dynamic effect).

pimenta), Roses, Lilies, Chestnuts, Chrysanthemums, Cucumbers, Meat of swine

¹¹ Kawasaki, K(2003), "The Impact of Free Trade Agreements in Asia", RIETI Discussion Paper Series 03-E-018, Research Institute of Economy, Trade and Industry

¹² Nakajima, T(2002), "An Analysis of the Economic Effects of a Japan-Korea FTA : Sectoral Aspects", The Journal of Econometric Study of Northeast Asia, Vol.4, No.1,2002, Economic Research Institute for Northeast Asia