

Joint Research Report and Policy Recommendations on
a Free Trade Agreement between China, Japan and Korea:
Phase II: Road to Recovery of Regional Trade and Trade Facilitation in the CJKFTA

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Trilateral Joint Research

by

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Executive Summary

Contents of the Joint Research

What are the issues?

This report presents results of the Trilateral Joint Research by the Representing Research Institutions in China, Japan and Korea on a FTA between the three countries. The Action Plan for Promoting Trilateral Cooperation among China, Japan and Korea decided in the Trilateral Summit in December 2008, includes a clause titled Joint Studies on the Trilateral FTA, stating that Joint Studies started in 2003 will reach the conclusion phase in year 2008, and further in-depth studies will begin in 2009 by the three institutions. Under the plan, we have jointly started the phase two study on a CJK FTA this year.

In embarking upon the new phase, we have identified the assessment of the impacts of the recent Global Economic Crisis on trade in Northeast Asia as an important issue of research. As indicated above, the crisis has significant implications on the economies and trade in the region both in the short- and long-run. The trend of the regional trade patterns and the policy demands for intensifying intra-regional trade is a fundamental issue for considering a CJK FTA

The joint research teams have selected trade facilitation, as another research issue on a CJK FTA. From 2003 to 2008, the joint research on a CJK FTA in the first phase covered almost all the important issues on FTAs, other than trade facilitation (see Appendix). Trade facilitation in regional trade agreements is a comparatively new issue, and has increasingly drawn attention of the policy makers in trade and investment. Naturally, a prospective CJK FTA will have characteristics of a regional agreement, which will place a focus on both cooperation and liberalization aspects. The review and study on trade facilitation measures in a FTA will address the issues.

Global Economic Crisis and a CJK FTA

China, Japan and Korea have suffered from the global financial crisis. Although most recently their economy and trade began to show some signs of recovery, their production and trade volumes still remain markedly below the pre-crisis levels. Moreover, since it is expected that the recovery will be slower in the economies of the United States and the EU, the difficulties that

the three countries are facing in their trade are likely to last for a while.

As a long-run trend, the intra-regional trade between China, Japan and Korea has become truly important for the trade of China, Japan and Korea. In particular, in terms of import, the intra-regional share has become the predominant factor for all three countries, while the relative importance of the United States and the EU as importing sources has significantly weakened. Even in terms of export, the intra-regional market is by far the most important for Korea, and has become the most important for Japan surpassing the United States. However, China is an exception. For China, the United States and the EU have become the most important export destinations ahead of the intra-regional market.

The global economic crisis brought about the macroeconomic multiplier effects in the trade of the region. First, due to the crisis, exports from all the three countries to the United States and EU declined sharply. This led to the reduction in macroeconomic production in the three countries, bringing about a contraction of their import demand. A decline in the intra-regional trade emerged. The share of intra-regional trade in each country reflected differences in damage incurred and the timing of respective recoveries. In addition, international input-output relations, analyzed below, may have also affected the outcome.

Considering the effects of the global financial crisis in terms of the broad economic categories of Chinese, Japanese and Korean exports, one notes that China suffered only moderately from the decline in exports of consumption goods to Japan and Korea, whose share actually increased in the first two quarters of 2009. Major damage in China's intra-regional exports came from the reduction in the exports of semi-finished goods to Japan and Korea. Japan and Korea maintained the high shares of intermediate goods exports in the intra-regional trade. This means that the exports of intermediate goods from Japan and Korea to China declined in proportion to other commodities. We may observe the input-output effects, by which the reduction in the export of final goods from the region led to the shrinkage of the production, bringing about the reduction of intra-regional trade of intermediate goods.

Trade Facilitation and a CJK FTA

For these two decades, a new trend in the strategy to liberalize international trade has appeared among the policy-makers as an emerging consensus: to revisit the role of trade facilitation and to use such facilitation more actively as one of the major vehicles to promote trade. Trade facilitation in the new context covers much wider areas of trade policies than ever, not limited to

customs procedures. One of the notable examples in East Asia is the APEC, which regards trade facilitation as one of two pillars for promoting trade in the region. The other example is the WTO Doha round, which assigned an important role to trade facilitation. Furthermore, recent RTAs tend to include a wider scope for trade facilitation.

The emergence of the new trend had two backgrounds. One is that the traditional tools of trade liberalization, namely tariffication and tariff cuts, whose levels were already lowered, saw a reduction in their capacity to reduce trade costs. The other is that new border management institutions and technologies attracted more attention in the promotion of international trade.

It was natural development that the proliferated RTAs also put a focus on the trade facilitation agreements. Some more recent agreements specifically include standards, technical regulations, conformity assessment procedures, and sanitary and phytosanitary (SPS) measures. The more recent agreements generally tend to cover more. Such expanded coverage includes service trade, modern customs management procedures, the adoption of international standards, and more formal and institutional mechanisms of cooperation. In addition, some bilateral/regional agreements include infrastructure development and cooperation, which cannot be covered by the multilateral trade negotiations by their nature. The wider and comprehensive coverage of the recent regional agreements provides an important lesson to the CJKFTA, in particular in the clauses of non-conventional, non-customs-related types. Also, infrastructure development and cooperation is region-specific and important for the trade between the three countries.

Non-binding agreements like APEC have gone much further in promoting trade facilitation reform than binding agreements. Also, the trade facilitation in some FTAs takes the shape of cooperation. The broad perception behind such cooperation is that it generates positive externalities and economies of scale. The trade facilitation measures that create positive externalities take stronger characteristics of international /regional cooperation, as well as trade liberalization.

Researchers suggest that there are two economic effects of trade facilitation: static or efficiency gains, and the impacts coming from imperfect competition with positive externalities and economies of scale. Empirical studies suggest the unexpectedly large economic benefits from trade facilitation measures.

Trade facilitation will bring about economies of scale and the creation of positive externalities. Often, this can be most efficiently made *regionally* and through *cooperation*. While global

provisions facilitating trade are ideal, the complexity of interests and existing localization may prevent them from being realistic. Cooperation within a regional framework would be more pragmatic. In some cases, the optimal coverage should be confined to smaller groups of countries, i.e. regions. Regional agreements in East Asia could have a much more active role in implementation, e.g. through mutual recognition, harmonization of standards and assistance, eventually the sharing of resources and joint efforts to improve the trade supply chain.

In many cases, the FTAs appear to be the most suitable mechanism to achieve the benefits of trade facilitation in a region. Multilateral arrangement can also contribute to the delivery of the benefit of trade facilitation, and the solution may be optimal. But, as discussed above, the global agreement may take much longer to negotiate, and there may be much more complex conflicts/difference of interest among the members. In many cases, the majority of benefits from trade facilitation remain within the region with large trade partners. Mutual recognition sometimes has this nature. Technical standards can be also harmonized most efficiently in a region.

Policy Recommendations

Progressing Region-wide Liberalization Initiatives

It would be worthwhile here to touch briefly on the present status of East Asian-wide trade liberalization initiatives, which have an important implication in the economic, political and diplomatic context with the CJK FTA. In East Asia, ASEAN tended to precede China, Japan or Korea in forming FTAs. As repeatedly pointed out, the trade liberalization initiatives between the three countries lag behind ASEAN. Three “ASEAN plus one” FTAs have been already formed. Two research studies on region-wide FTA, namely an East Asia Free Trade Agreement (EAFTA) among ASEAN+3 countries and a Comprehensive Economic Partnership for East Asia (CEPEA) among ASEAN+6 countries, have been finished and their final reports have been submitted to the AEM+3 Consultation and AEM+6 Working Lunch on August 15, 2009. On both occasions, the Ministers agreed to recommendations in the EAFTA and CEPEA Study and decided to establish four working groups and commence governmental discussions on rules of origin, tariff nomenclature, customs-related issues, and economic cooperation.

China, Japan and Korea, take dominant shares in East Asia, in terms of economic magnitude, population, and trade and investment. Huge amounts of direct investment have flowed from Japan and Korea toward ASEAN, as well as toward China. With the accumulation of external

production assets, huge production networks have been established in East Asia. The networks in East Asia, however, will not work efficiently under the limited framework of “ASEAN plus ones”. Even at present, dominant share of trade and investment flows in the region are among China, Japan and Korea. The optimal formation of production network will be only possible when an FTA is achieved among China, Japan and Korea. With this background, it is concerned that the trade liberalization initiative among the three countries lags behind any other region-wide initiatives in East Asia

It also deserves referring to the CJK Trilateral Investment Treaty, which is under negotiation. The free trade and investment are complementary to each other. In the region, once CJK FTA and CJK Investment Treaty are both established in place, the two agreements are expected to significantly make a solid foundation of economic growth and prosperity in the region.

Policy Recommendations

Recommendation 1: To Share the Common Policy Direction toward Further Liberalizing Regional Trade

The intra-regional trade has become the crucial element for China, Japan and Korea. As seen in the analytical part of this report above, the trade structure of the three countries at present has fragility to depend excessively on the final demand of the United States and Europe. Although most recently their economy and trade began to show signs of recovery, their production and trade volumes still remain markedly below the pre-crisis levels. Moreover, since it is expected that the recovery will be slower in the economies of the US and the EU, the difficulties that the three countries are facing in their trade are likely to last for a while. To compensate for the slowing demand in the US and the EU, a larger regional market will be needed. This is also desirable in the longer-term with shrinking global imbalances.

Ensuring a liberalized environment is one of the essential factors to expedite the economic recovery and sustain the economic growth in the region. A CJK FTA creating a larger market will certainly boost further the already-important intra-regional trade and investment, and raise efficiencies of their economies. The research teams recommend that the three countries should share the common policy direction toward further liberalizing regional trade policies. A CJK FTA will be an essential component to pursue the policy direction.

Recommendation 2: To Take Advantage of Trade Facilitation in a CJK FTA.

Trade facilitation has drawn increasing attention as an effective tool to reduce trade costs. The recent FTAs in the world tend to include trade facilitation measures with wider coverage. Trade facilitation has characteristics of international cooperation, as well as trade concession. Some of the trade facilitation measures, such as harmonizing various trade-related procedures and standards, have a nature of economies of scale and positive externality. A CJK FTA will provide a good opportunity to materialize such benefits. Empirical studies found that some trade facilitation measures would create large economic benefits to all the parties.

The research teams recommend that a CJK FTA should take advantage of trade facilitation. A recommendable approach is “step-by-step”. The initial agreement of the CJK FTA would better include some effective trade facilitation measures, limited to cross-border issues. But others may be negotiated and implemented afterward as the matters of regional cooperation. To ensure that the approach functions properly, it is recommended that the initial agreement of the CJK FTA also stipulate institutional set-ups, such as periodical meetings, to review and negotiate the trade facilitation measures in the future.

Recommendation 3: To Upgrade Joint Research on the CJK FTA by Commencing Discussion among three government officials

The joint research teams reaffirm the importance of a regional FTA among China, Japan and Korea. In the future, the CJKFTA would ensure the liberalized trade environment in the region. The liberalized environment will greatly contribute to ensuring the economic recovery in East Asia, as well as developing a strong source of macroeconomic final demand in the region. With this understanding, the joint research teams recommend the leaders and governments of the three countries to support the formation of the CJK FTA.

In particular, it is recommended that discussion on the CJK FTA should be commenced among three government officials, by reforming the present mechanism to official discussion in government level from the next year. This will enable to start the discussion on a CJK FTA among the government officials, in addition to business and academia participants.

Recommendation 4: To Maintain and Further Utilize the Existing Mechanism of Academic Trilateral Joint Research.

The CJK Trilateral Joint Research started in 2001. The current mechanism enabled the joint

research teams to conduct independent economic research on important trade and investment issues in the region. The present mechanism will be able to continue to serve the CJK leaders meeting to identify and review important issues in the region in the future. In addition to the above recommendation of upgrading the joint research on CJK FTA to government level, we recommend that the leaders and governments of the three countries maintain and further utilize the existing mechanism of academic trilateral joint research, aside from the separated and upgraded government level trilateral joint research on a CJK FTA.

1. Introduction

The Global Economic Crisis and Trade in Northeast Asia

The global financial crisis that originated in the United States last year did not take much time to turn into a global economic crisis affecting the real economy worldwide. The GDP of most countries contracted significantly in the fourth quarter of last year and the first quarter of this year. It was, however, trade that suffered the most. Trade volumes have declined further than production levels in many countries. The short-term impacts of the crisis on Northeast Asian economies, and their trade in particular, have also been quite enormous, even though the levels of damage varied between China, Japan and Korea. Furthermore, given the intensity of the crisis, it may also bring about significant changes in global trade patterns in the long-run.

Most recently, we are beginning to witness some positive signs towards a recovery, even though those signs still appear fragile. Against the backdrop of uncertainties in the wake of the global financial crisis and growing worldwide regionalism, it seems important to assess the impacts of the crisis on the trade patterns of the three Northeast Asian countries and consider future directions for them to increase intra-regional trade and enhance economic cooperation in Northeast Asia.

The Second Phase of Joint Research on CJKFTA: What are the issues?

This report is to present the results of the Trilateral Joint Research by the Representing Research Institutions in China, Japan and Korea on an FTA between the three countries. The Action Plan for Promoting Trilateral Cooperation among China, Japan and Korea, decided at the Trilateral Summit in December 2008, includes a clause titled Joint Studies on the Trilateral FTA, stating that Joint Studies started in 2003 will reach the conclusion phase in the year 2008, and *further in-depth studies will begin in 2009* by the three institutions. Under the plan, we have jointly started the phase two study on a CJK FTA this year.

In embarking upon the new phase, we have identified the assessment of the impacts of the recent Global Economic Crisis on trade in Northeast Asia, as an important issue of research. As indicated above, the crisis has had significant implications for the economies and trade in the region both in the short- and long-run. The trend in regional trade patterns and the policy demands for intensifying intra-regional trade are fundamental issues for considering an FTA between China, Japan and Korea (CJK FTA).

The joint research teams have selected trade facilitation as another research issue on a CJK FTA. From 2003 to 2008, joint research on a CJK FTA in the first phase covered almost all the important issues on FTAs, other than trade facilitation (see Appendix). Trade facilitation in regional trade agreements is a comparatively new issue, and has increasingly drawn the attention of policy makers in trade and investment. Naturally, a prospective CJK FTA will have the characteristics of a regional agreement, which will place a focus on both cooperation and liberalization aspects. The review and study on trade facilitation measures in an FTA will address the issues.

Structure of the Report

The second and third sections cover the global economic crisis and the road to recovery in Northeast Asia, and trade facilitation and a CJK FTA, respectively. Some remarks follow on the progress in other East Asian region-wide liberalization initiatives. Four specific policy recommendations to the leaders and governments conclude the report.

2. Global Economic Crisis and the Road to Recovery in Northeast Asia

After a brief review of the impacts of the global financial crisis on world economy and trade, this section examines its impacts on trade in China, Japan and Korea by comparing the recent trade data with the trends prior to the crisis. Then comes an analysis on the changes in the trade patterns of China, Japan and Korea with major trading partners before and in the wake of the crisis, seeking to find out the structure of their exports in terms of broad economic categories. Lastly, some implications conclude the section.

Impacts of the Global Financial Crisis on Trade in China, Japan and Korea

The world's trade in goods had a tendency to increase more rapidly, even though it used to fluctuate more widely than the world's industrial production, before the global financial crisis. However, in the wake of the global financial crisis, the fall in world exports was much more severe than that of the world's industrial production. In February 2009, world exports declined by 30.0 percent on a year-on-year basis, while the world's industrial production decreased by 13.6 percent.

Most forecasting institutions predict that the impact of the global financial crisis on the world

economy and trade will become severe and generally more devastating for advanced economies. According to the World Bank, global GDP is expected to contract by 1.7 percent in 2009, which would be the first decline in world output on record, and volumes of world trade in goods and services are expected to drop 6.1 percent in 2009, with a significantly sharper contraction in trade volumes of manufactured products.¹ Then, in June this year, the World Bank announced a gloomier outlook. It predicted that the global economy would decline this year by about 2.9 percent and that the economies in high-income nations would contract by a total of 4.2 percent this year. According to the International Monetary Fund (IMF),² world output is expected to contract by 1.4 percent in 2009, and that of developed countries by 3.8 percent, while the OECD Economic Outlook predicted that the world real GDP would decline by 2.2 percent in 2009 and grow 2.3 percent in 2010.³

Table 1. Forecasts of World GDP and Trade for 2009

(Percent)

	WTO (March 2009)	IMF (July 2009)	World Bank (June 2009)	OECD (June 2009)
World GDP ¹⁾	-	-1.4	-2.9	-2.2
Developed countries	-	-3.8	-4.2	-
Emerging and developing countries	-	1.5	1.2	-
World Trade	-9.0	-12.2	-9.7	-16.0
Developed countries ²⁾	-10.0	-15.0	-	-15.6
Emerging and developing countries ³⁾	-3.0 to -2.0	-6.5	-	-17.0 to -16.4

Notes: 1) Annual percent change at constant prices.

2) and 3) represent export growth rates.

Sources: International Monetary Fund (July 8, 2009); OECD (June 2009); World Bank (June 2009); World Trade Organization (March 23, 2009).

With regard to world trade, the forecasting institutions predicted an even sharper decline than global GDP. As shown in Table 1, the WTO predicted that it would shrink by 9.0 percent in 2009, while according to the World Bank and the IMF, it is expected to contract by 9.7 percent and 12.2 percent, respectively. The OECD Economic Outlook forecasted that world real trade would shrink by 16.0 percent in 2009 and grow 2.1 percent in 2010.

Trends in Trade of China, Japan and Korea

¹ World Bank. *Global Economic Prospects 2009*. Forecast Update, March 30, 2009.

² IMF. 2009. *World Economic Outlook*, April.

³ *OECD Economic Outlook*. Volume 2009/1 No.85, June. The economies of the United States, Euro area and Japan are expected to shrink by 2.8 percent, 4.8 percent, and 6.8 percent, respectively, in 2009, and grow by 0.9 percent, 0.0 percent, and 0.7 percent, respectively, in 2010.

(1) Exports

Annual trade data show that both the exports and imports of China, Japan and Korea have increased rapidly from 2001 to 2008. China showed the fastest growth, while Japan's trade growth rate was relatively slow among the three countries. The exports of China, Japan and Korea together also continued to increase until the third quarter of 2008. Exports from all three countries began to decline in the fourth quarter of 2008 and contracted markedly in the first quarter of 2009 before rising in the second quarter of 2009. However, in the second quarter of 2009, the levels of exports from China, Japan and Korea were still much lower than those of the same period last year. The year-on-year export growth rates of China, Japan and Korea amounted to -23.5 percent, -34.0 percent and -20.4 percent, respectively, in the second quarter of 2009.

Among the three countries, Japan seemed to have suffered the most in terms of export contraction. Japan's export level shrank by 40.3 percent, and 34.0 percent, respectively, in the first and second quarter of 2009 compared to the same period last year. Additionally, China's export level in the fourth quarter of 2008 remained still higher than the previous year by 4.3 percent, while that of Japan and Korea contracted by 9.4 percent and 9.9 percent, respectively.

(2) Imports

The imports of China, Japan and Korea showed a similar trend as their exports. They continued to grow until the third quarter of 2008 before going down sharply in the fourth quarter of 2008 and the first quarter of 2009. However, there were several differences. First, Japan's imports began to decline later than those of China and Korea. Second, in the second quarter of 2009, Japan's imports continued to decrease, whereas both Korea and China's imports began to recover. Third, Korea's imports, unlike its exports, seemed to recover slowly. As of the second quarter of 2009, Korea's import level was still lower than that of the same period last year by 36.2 percent, while China's imports were only 20.4 percent below the level of the previous year.

Intra-regional Trade Has Become Important in Northeast Asia: Long-term Trends in Trade Shares

The intra-regional share in the exports of China, Japan and Korea increased from 11.1 percent in 1990 to 20.6 percent in 2004, except during the Asian financial crisis periods, before

diminishing to 18.8 percent in 2007. It went up slightly to 19.5 percent in 2008. Meanwhile, the shares of the United States and the EU decreased from 27.9 percent and 18.1 percent, respectively, in 1990 to 17.3 percent and 15.6 percent, respectively, in 2008. ASEAN's share fluctuated, but represented 10.2 percent in 2008, which was almost at the same level as 10.3 percent in 1990.

The intra-regional share in the imports of China, Japan and Korea rose from 14.0 percent in 1990 to 28.1 percent in 2004 before diminishing to 25.4 percent in 2008. ASEAN's share went up from 10.7 percent in 1990 to 12.8 percent in 2003 before slightly diminishing to 11.9 percent in 2008. Meanwhile, the shares of the United States and the EU shrank from 21.3 percent and 15.6 percent, respectively, in 1990 to 8.5 percent and 10.0 percent, respectively, in 2008.

Overall, the intra-regional trade between China, Japan and Korea has become truly important for the trade of China, Japan and Korea. In particular, in terms of imports, the intra-regional share has become the predominant factor for all three countries, while the relative importance of the United States and the EU as importing sources has significantly weakened. Even in terms of exports, the intra-regional market is by far the most important for Korea, and has become the most important for Japan, surpassing the United States. However, China is an exception. For China, the United States and the EU have become the most important export destinations, ahead of the intra-regional market.

Effects of the Crisis on the Decline in Trade of China, Japan and Korea with Major Trading Partners

(1) Exports

As shown in the previous section, **China's** exports started to recover in the second quarter of 2009. The intra-regional share (that of Japan and Korea) in China's exports continued to shrink in the first three quarters of 2008. The trends were reversed in the fourth quarter of 2008 and the first quarter of 2009 before contracting again to 12.5 percent. The share of the United States remained the same in the wake of the global financial crisis in late 2008, but increased in the first quarter of 2009, while the share of the EU, that has seen a rising trend, decreased in the first two quarters of 2009. The imports of the United States and the EU from China reduced after the latter half of 2008. However, the intra-regional exports from China, particularly to Japan, were hit harder than her exports to the US and the EU in the second quarter of 2009. This showed that Japan suffered from a shrinkage of import demands that was larger than the United States and

the EU.

The intra-regional share (that of China and Korea) in **Japan's** exports shrank in the fourth quarter of 2008 before getting larger in the first two quarters of 2009 to reach 28.0 percent in the second quarter of 2009. On the other hand, the share of the United States rather decreased in the first two quarters of 2009, while the share of the EU diminished in the second quarter of 2009. This indicates that the imports of China and Korea from Japan were hit less severely than those of the US and the EU and started to recover in the first half of 2009.

The intra-regional share (that of China and Japan) in **Korea's** exports contracted in the fourth quarter of 2008 before recovering in the first two quarters of 2009 to record 28.6 percent in the second quarter of 2009. This is due to the recovery of China's imports from Korea. The shares of the United States and the EU rose in the fourth quarter of 2008, but they contracted in the first two quarters of 2009.

(2) Imports

The intra-regional share of **China's** imports increased in the fourth quarter of 2008 and the first quarter of 2009 before coming down to the previous level in the second quarter of 2009. The shares of the United States and the EU also showed a similar pattern. The intra-regional share of **Japan's** imports got bigger in the wake of the global financial crisis, reversing the diminishing trends that have existed since 2006. In addition, the shares of both the US and the EU increased since the fourth quarter of 2008. The intra-regional share of **Korea's** imports also showed a growing pattern. They increased since the fourth quarter of 2008, confirming the continuation of the rising trends that existed prior to the crisis. Imports of Japan and Korea from China, despite the crisis, declined to a lesser degree during the crisis period.

As for the intra-regional share in the imports of China, Japan and Korea, this increased in the wake of the global financial crisis, amounting to 25.8 percent in the second quarter of 2009, reversing the diminishing trends since 2005. The shares of the United States and the EU also became more important in the second quarter of 2009 than before the crisis, also reversing the previous trends.

Overall, we can observe the macroeconomic multiplier effects in the trade of the region. First, due to the crisis, exports from all three countries to the United States and the EU declined sharply. This led to a reduction in macroeconomic production in the three countries, bringing

about a contraction of their import demands. A decline in intra-regional trade emerged. The shares of intra-regional trade reflected the differences in the received damage and timing of the recovery of each country. In addition, international input-output relations, analyzed below, may have also affected the outcome.

Commodity-based Analysis: Longer-term Trends

We highlight some characteristics of the exports of China, Japan and Korea, as a region and as individual countries, that could be useful in drawing policy implications for the future of intra-regional trade by analyzing yearly data on structures of their exports to major trading partners in terms of broad economic categories.

As shown in Table 2, the shares of consumption goods in **China's** exports to major trading partners all shrank for the period between 1995 and 2007, while the shares of intermediate goods and capital goods in its exports to them all increased during the same period. However, in terms of levels, the shares of intermediate goods in China's exports to the CJK region and ASEAN remained higher than those to other regions. For the same period, the structure changes in **Japan's** exports differed significantly depending on trading partners. For Japan's intra-regional export to the CJK region and ASEAN, the share of intermediate goods increased and its level remained high, while the share of capital goods decreased. The main characteristics of the structure of **Korea's** exports seem to be as follows: first, the rising importance of capital goods in Korea's exports to all major trading partners, second, the share of consumption goods exports decreased, and third, the share of intermediate goods exports has been higher to the CJK region and ASEAN than those to other regions.

**Table 2. Share of Exports of China, Japan and Korea by Production Process
with Major Trading Partners**

(Percent)

Region	Goods		China		Japan		Korea		CJK	
			1995	2007	1995	2007	1995	2007	1995	2007
Intra (CJK)	Intermediate Goods	Parts	5.9	19.8	26.5	31.3	18.4	36.5	18.3	28.2
		Semi-finished	26.5	28	36.9	39.9	46.5	36.8	35.9	34.6
	Capital Goods		7	17.6	30.7	19.9	9.2	20.3	18.4	19.1
	Consumption Goods		50	30.8	4.1	3.7	24.2	4.4	22.9	14.2
	Dual Use Goods		0	0	1.1	2	0.4	0.8	0.6	0.9
ASEAN	Intermediate Goods	Parts	10.7	23.6	41.8	39.4	34.3	32.5	37.5	31.3
		Semi-finished	41.3	32.6	23.4	33.4	43.2	37	28.6	33.7

	Capital Goods		16.8	26.4	28	20.6	15.2	25.1	24.7	23.9
	Consumption Goods		25.2	15.8	3.8	3.8	5.6	3.1	6.2	9
	Dual Use Goods*		0.1	0	2.8	2.2	1.4	1.8	2.3	1.2
EU	Intermediate Goods	Parts	5.5	14.2	31.8	30.7	33	17.8	27.2	18.9
		Semi-finished	26.3	20.5	14	15.5	14.7	13.9	16.3	18.4
	Capital Goods		13.9	34.5	33.4	24	25.9	44.2	28.7	32.8
	Consumption Goods		49.7	30	8.2	11.3	13.8	6.2	16.6	22.3
	Dual Use Goods*		0	0.2	12.6	18.2	12.5	17.7	10.3	7
USA	Intermediate Goods	Parts	6.4	13.7	37.4	27.7	41.9	25.6	33.5	19.6
		Semi-finished	13.7	15	11.4	12.2	11.1	17.3	11.7	14.3
	Capital Goods		16.1	32.2	27.1	19.1	20.2	28.8	24.4	27.5
	Consumption Goods		61.4	38.7	6.3	8.2	19.9	8.7	16.4	25.5
	Dual Use Goods*		0	0	17.8	32.6	6.7	19.5	13.5	12.9

Note: We identified each product by stage of production based on the Broad Economic Categories (BEC) Classification released by the United Nations. *"Dual use goods" in the table means "automobiles," which cannot be classified into either industrial or consumer goods.

Source: Calculated by the Authors using the COMTRADE Database [online].

In sum, Table 2 indicates that intermediate goods occupied a dominant portion in the intra-regional trade of the three Northeast Asian countries as well as in their exports to ASEAN, while their shares were relatively less important for the United States and the EU in 2007. Among the trade with the three Northeast Asian countries, the shares of intermediate goods exports were notably higher from Japan and Korea to China. On the other hand, the shares of dual use goods (i.e. automobiles) for intra-regional trade and ASEAN were only 0.9 percent and 1.2 percent, respectively, in 2007, whereas they represented 12.9 percent for the United States and 7.0 percent for the EU in 2007. In other words, until recently, the three countries exported mainly intermediate trade goods among themselves and to ASEAN, while they exported mainly final goods to the United States and the EU.

Commodity-based Analysis: Impacts of the Global Financial Crisis on Exports

When it comes to the effects of the global financial crisis in terms of broad economic categories in the exports of China, Japan and Korea, China suffered only moderately from the decline in the exports of consumption goods to Japan and Korea, whose share actually increased in the first two quarters of 2009. The major damage in her intra-regional exports came from the reduction in the exports of semi-finished goods to Japan and Korea. Japan and Korea maintained high shares of intermediate goods exports in intra-regional trade. This means that the exports of intermediate goods by Japan and Korea to China declined by almost the same

proportion to other commodities. We may observe the input-output effects, by which the reduction in the exports of final goods from the region led to a shrinkage in production, bringing about a reduction in the intra-regional trade of intermediate goods.

Implications

China, Japan and Korea have suffered from the global financial crisis. Although most recently their economies and trade have begun to show some signs of recovery, their production and trade volumes still remain markedly below the pre-crisis levels. Moreover, since it is expected that the recovery will be slower in the economies of the United States and the EU, the difficulties that the three countries are facing in their trade are likely to last for a while.

Thus, in the short-term, to compensate for the slowing demand in the United States and the EU, a larger regional market will be needed. In the long-term, since the United States is not expected to continue to absorb rising imports from the Northeast Asian countries, it will be necessary to create an enlarged regional market in Northeast Asia or East Asia.

Furthermore, given the fact that the three countries export mainly intermediate goods among themselves and to ASEAN (albeit with some exceptions), while they export mainly final goods to the United States and the EU, in particular, a larger regional market for final goods should be sought after.

Therefore, China, Japan and Korea should turn this global financial crisis into an opportunity to form a China-Japan-Korea FTA (CJK FTA). It is well-known that Europe started its regional economic integration process after World War II, and more recently, the Asian financial crisis prompted the East Asian countries to consider more seriously economic regionalism, and gave birth to the ASEAN+3 framework.

3. Trade Facilitation and the CJK FTA

There is no common definition of trade facilitation in the existing international agreements. The definitions depend on the purpose, scope and direction of the agreements, and can naturally vary with each other. For instance, according to the Asia Pacific Economic Cooperation (APEC) in 2002, trade facilitation generally refers to the simplification, harmonization, use of new technologies, and other measures to address procedural and administrative impediments to trade. While the APEC's agreements are non-binding, the coverage of trade facilitation was wide and

challenging. Compared to this definition, the WTO for instance narrowly defines trade facilitation as the simplification and harmonization of international trade procedures.

This section reviews and surveys the significant roles of trade facilitation both theoretically and empirically, and seeks possible application to a CJK FTA. The review looks first at the scope, coverage and economic rationale of trade facilitation in the regional trade/cooperation agreements. This also includes a brief review of the trade facilitation initiatives in the WTO and APEC. The second part of the section reviews the economic effects of various trade facilitation measures. The third part concludes the section with some consideration of trade facilitation in FTAs.

Trade Facilitation: Its Revisited Roles

Bilateral or regional cooperation has been the standard modality to facilitate international trade in the history of trade liberalization after the War. The multilateral approach in trade facilitation emerged as an active initiative only recently, since the new round of trade negotiation in the World Trade Organization (WTO). Until then, bilateral or regional initiatives had been the major arena of trade facilitation. However, such bilateral/regional cooperation in trade paid attention only to the natural bi-products of the regional trade agreements (RTAs), namely those which closely relate to the tariff enforcement, such as customs procedures and the cooperation between customs administrations.

For these two decades, a new trend in the strategy to liberalize international trade has appeared among the policy-makers as an emerging consensus: that is, to revisit the roles of trade facilitation and to use it more actively as one of the major vehicles to promote trade. The trade facilitation in the new context covers much wider areas of trade policies than ever, not limited to customs procedures. One of the notable examples in East Asia is the APEC, which regards trade facilitation as one of the two pillars to promote trade in the region. Another is WTO Doha round, which gave an important role to trade facilitation. Furthermore, recent RTAs tend to include a wider scope of trade facilitation.

The emergence of the new trend had two backgrounds. One is that the traditional tools of trade liberalization, namely tariffication and tariff cuts, whose levels were already at low levels, relatively lost their power to further reduce the trade costs. The other is that new border management institutions and technologies attracted more attention to promote international trade. It was a natural development that the proliferated RTAs also put a focus on the trade

facilitation agreements.

In several older FTAs in the world, trade facilitation resided in the chapters of customs procedure and administration in somewhat narrower definitions. Some more recent agreements, however, specifically include standards, technical regulations, conformity assessment procedures, and sanitary and phytosanitary (SPS) measures. The more recent agreements generally tend to cover more. Such expanded coverage includes service trade, modern customs management procedures, the adoption of international standards, and more formal and institutional mechanisms of cooperation. In addition, some bilateral/regional agreements include infrastructure development and cooperation, which cannot be covered by the multilateral trade negotiations by their nature. The wider and comprehensive coverage of the recent regional agreements provides an important lesson to the CJKFTA, in particularly in the clauses of non-conventional, non-customs-related types. Also, infrastructure development and cooperation is regional-specific and important for the trade between the three countries.

Trade Facilitation Agenda in International/Regional Fora

(1) APEC

The APEC adopted in 2001 the Shanghai accord, a policy package consisting of trade facilitation measures. This targeted a 5% reduction in trade transaction costs by 2006 for all the member economies. APEC agreed in Busan in 2005 to a further reduction of trade transaction costs by 5% in the period of 2007-2010. The second Trade Facilitation Action Plan of APEC (TFAP II) includes the four areas of Customs Procedures, Standards and Conformance, Business Mobility and Electronic Commerce (Table 3). Its most salient features include its non-binding nature and ambitions.

Table 3: Menu of Actions and Measures of Trade Facilitation in APEC TFAP II

Customs Procedure
1. Time Release Survey
2. Implement APEC Framework based on the WCO Framework of Standards
3. Simplification and Harmonization on the Basis of the Kyoto Convention
4. Paperless and/or Automation of Trade-related Procedures
5. Harmonization of Tariff Structure with the HS Convention
6. Appropriate, Transparent and Predictable Trade-related Procedures
Standards and Conformance
1. Align APEC Economies' Domestic Standards with International Standards; Implement Good

2. Achieve Recognition of Conformity Assessment in Regulated and Voluntary Sectors.
3. Technical Infrastructure Development
4. Ensure the Transparency of the Standards and Conformity Assessment of APEC Economies
Business mobility
1. Streamline And Standardise Procedures to Enhance Business Mobility
2. Enhance the Use of Information and Communications Technology
Electronic commerce
1. Removing barriers to electronic commerce
2. Speed the use of E-Commerce

(Source) APEC

(2) WTO

The WTO covers some limited components of trade facilitation. As discussed, by nature the focus of the WTO tends to relate to the movement of goods. Specifically, GATT Articles V, VIII and X are the related provisions which deal with freedom of transit for goods, fees and formalities connected with importation and exportation, and publication and administration of trade regulation, respectively.

In particular, in the process of WTO negotiation about Article VIII, Korea proposed the “Single Window” system, which allows parties involved in trade and transport to lodge standardized information and documents with a single entry point to fulfill all import, export, and transit related regulatory requirement. Japan and Korea proposed “Pre-arrival processing” as a measure to simplify release and clearance of goods, that requires the WTO members to maintain or introduce administrative procedures of customs and other relevant border agencies to accept and examine import documentation by trader prior to the arrival of the goods. China proposed to adopt modern custom practices, such as using risk assessment techniques and to carry out post-clearance audits. Risk assessment is defined as the systematic application of management procedures and practices providing customs and other relevant border agencies with the necessary information to address movements or consignments in a way to prevent risk.

China, Japan and Korea have generally the same policy direction with the trade facilitation of the WTO negotiation, namely to expedite the movement, release, and clearance of goods. The three countries also share the idea of capacity building and technical assistance to developing countries to enable them to implement commitments.

Trade Facilitation and Regional Trade Agreements (RTAs)

There is increasingly a tendency toward the sophistication of provisions concerning trade facilitation in RTAs. But, the effective focus tends to be still placed on customs procedures and sometimes additionally on standards. Most often, the provisions of existing RTAs remain relatively unspecific in trade facilitation. In particular, clear and measurable objectives largely do not exist. The APEC Shanghai Accord, while the action is actually not classified as RTAs, is an exception.

Some of the trade facilitation provisions in RTAs/FTAs can be preferential, which provide the concession only to the partners of the agreements, while others may be non-discriminatory, Most-Favored-Nations (MFN) type. As frequently observed in the FTAs between the industrialized countries, the preferential trade facilitation measures can take a negotiation role to exchange concessions. But, researchers have found little evidence of trade facilitation provisions going against non-discriminatory principles. RTAs often reaffirm and reinforce the MFN principles and promote the formulation of international standards. Non-binding agreements like APEC have gone much further in promoting trade facilitation reform than binding agreements. Also, the trade facilitation in some FTAs takes the shape of cooperation. The broad perception behind such cooperation is that it generates positive externalities and economies of scale. The trade facilitation measures that create positive externalities take stronger characteristics of international/regional cooperation, as well as trade liberalization.

Economic Effects of Trade Facilitation

(1) Theoretical Review

A literature has grown to assess the economic impacts of trade facilitation measures. Two aspects of the economic impact exist in the facilitation of trade flows at the regional level. First, the static or efficiency gains of preferential trade facilitation emerge through better allocation of factors. Second, there will be impacts coming from imperfect competition with positive externalities and economies of scale.

(1-1) Static Effects

Assuming that trade facilitation efforts are conducted on a preferential basis, it plays like reductions in tariff. The preferential and discriminatory reduction of trade barriers can lead to not only welfare-increasing creation of trade, but also trade diversion negative welfare effects

where the loss of the domestic rent (away to foreign exporters) is not compensated by the benefits from lower prices due to the liberalization. These two opposite effects may possibly add up to a trade creation effect. As long as there are some domestically obtained rents, and the trade facilitation increases the weighted-average volume of trade, the total welfare will increase.

However, we also need to think about whether the implicit protection by Non-Tariff Barriers (NTBs) afforded to domestic industries by higher trade costs prior liberalization is generating domestic rents or not. Unlike the case of tariffs, where the rents are totally captured by the domestic authorities, there is no straightforward answer to the question. An example of the tariff-like NTBs is border fees such as consular or transit fees, which more than cover the real costs, and may be raised with a revenue objective. Lack of facilitation provides scope for such interests to surcharge importers and exporters or to provide poor quality services, resulting in delay, loss of goods, and corruption. In some instances such rents are directly created by the public sector. In other cases, it is indirectly the complexity and lack of transparency of administrative processes that favor the emergence of operators that can work out the system and charge fees for such services.

In many real situations of trade facilitation, however, there will be only small domestic rents and therefore the static effect of trade facilitation limits to the reduction of the import prices, i.e. trade cost effect only. This contrasts with tariff reduction where the risks of trade diversion are much higher. Trade facilitation lowers trade costs, and this benefits consumers of imported goods who pay lower prices. Also, trade facilitation is often non-discriminatory, which then results in eliminating all risk of trade diversion.

(1-2) Effects from Imperfect Competition

Trade facilitation will bring about benefits through the realization of economies of scale and the creation of positive externalities. The impacts are especially important for regional trade facilitation. For example, duplication inevitably takes place in the procedures of regional trade because each country demands similar requirements. If national rules differ, the costs and uncertainty increase.

It would be particularly important in the regional context of East Asia that the formation of production networks heavily rely on the positive externalities in the region. Standards, recognitions and other regulations, as well as customs procedures, had better be harmonized, streamlined and coordinated among the involving countries.

(2) Empirical Studies

There are several studies assessing the effects of some components of trade facilitation measures, such as standards and customs procedures. General results of these empirical researches are that the economic benefits are unexpectedly large from the trade facilitation measures. More recently, standards and technical regulations are an increasingly prominent part of the international trade policy debates. As many of the least-developed countries have duty-free access to major developed-country markets, the trade effects of NTBs have assumed greater importance. Analysis has focused on how standards and regulations affect trade costs and export prospects for developing country firms exporting into developed markets. For instance, a study finds that testing procedures and lengthy inspection lower the exports of developing countries by 9 and 3 percent, respectively, and that standards reduce the likelihood of exporting to more than three markets by 7 percent. In a study on the effects of mutual recognition agreements for testing procedures and harmonization initiatives, it was found that the agreements are effective in promoting developing country exports. Another study finds that internationally harmonized standards exert less of an impact than non-harmonized standards on African exports. Overall, these studies demonstrate that standards have an effect on both the volume of exports from firms and the number of firms engaged in exporting.

There are a few references for estimating the overall welfare gains of trade facilitation, or removal of NTBs. An empirical study endeavors to quantify the impact of NTBs at the global level, using the GTAP model. This reference made use of an estimated dataset of *ad valorem* equivalent of NTBs, made by the World Bank. This dataset indicates that the NTBs are high. For example, the tariff and NTBs are 6.9% and 15.5% in Japan, 13.2% and 9.4% in China. Complete removal of NTBs invokes, according to their simulation, large welfare gains, comparable to large-scale tariff reductions, bringing about 1% of GDP to Japan, and 3% of GDP to China. The impacts are as large as estimated gains from CJK FTA tariff removal.

Trade Facilitation and Regional Free Trade Agreements

As shown above, trade facilitation will bring about economies of scale and the creation of positive externalities. Often, this can be most efficiently made *regionally* and through *cooperation*. While global provision to facilitate trade is ideal, the complexity of interests and existing localization may make it unrealistic. Cooperation within a regional framework would be more pragmatic. In some cases, the optimal coverage should be confined to smaller groups of

countries, i.e. regions. Regional agreements in East Asia could have a much more active role in implementation, e.g. through mutual recognition, harmonization of standards and assistance, and eventually the sharing of resources and joint efforts to improve the trade supply chain.

In many cases, the FTAs appear to be the most suitable mechanism to achieve the benefits of trade facilitation in a region. Multilateral arrangement can also contribute to the delivery of the benefit of trade facilitation, and the solution may be best at first. But, as discussed above, a global agreement may take much longer negotiation time, and there may be much more complex conflicts/differences of interest among the members. In many cases, most of the benefit from trade facilitation remains within the region with large trade partners. Mutual recognition sometimes has this nature. Technical standards can be also harmonized most efficiently in a region.

Policy Recommendations

Progressing Region-wide Liberalization Initiatives

It would be worthwhile here to touch briefly on the present status of East Asian-wide trade liberalization initiatives, which have an important implication in the economic, political and diplomatic context with the CJK FTA. In East Asia, ASEAN tended to precede China, Japan or Korea in forming FTAs. As repeatedly pointed out, the trade liberalization initiatives between the three countries lag behind ASEAN. Three “ASEAN plus one” FTAs have been already formed. Two research studies on region-wide FTA, namely an East Asia Free Trade Agreement (EAFTA) among ASEAN+3 countries and a Comprehensive Economic Partnership for East Asia (CEPEA) among ASEAN+6 countries, have been finished and their final reports have been submitted to the AEM+3 Consultation and AEM+6 Working Lunch on August 15, 2009. On both occasions, the Ministers agreed to recommendations in the EAFTA and CEPEA Study and decided to establish four working groups and commence governmental discussions on rules of origin, tariff nomenclature, customs-related issues, and economic cooperation.

China, Japan and Korea, take dominant shares in East Asia, in terms of economic magnitude, population, and trade and investment. Huge amounts of direct investment have flowed from Japan and Korea toward ASEAN, as well as toward China. With the accumulation of external production assets, huge production networks have been established in East Asia. The networks in East Asia, however, will not work efficiently under the limited framework of “ASEAN plus

ones”. Even at present, dominant share of trade and investment flows in the region are among China, Japan and Korea. The optimal formation of production network will be only possible when an FTA is achieved among China, Japan and Korea. With this background, it is concerned that the trade liberalization initiative among the three countries lags behind any other region-wide initiatives in East Asia

It also deserves referring to the CJK Trilateral Investment Treaty, which is under negotiation. The free trade and investment are complementary to each other. In the region, once CJK FTA and CJK Investment Treaty are both established in place, the two agreements are expected to significantly make a solid foundation of economic growth and prosperity in the region.

Policy Recommendations

Recommendation 1: To Share the Common Policy Direction toward Further Liberalizing Regional Trade

The intra-regional trade has become the crucial element for China, Japan and Korea. As seen in the analytical part of this report above, the trade structure of the three countries at present has fragility to depend excessively on the final demand of the United States and Europe. Although most recently their economy and trade began to show signs of recovery, their production and trade volumes still remain markedly below the pre-crisis levels. Moreover, since it is expected that the recovery will be slower in the economies of the US and the EU, the difficulties that the three countries are facing in their trade are likely to last for a while. To compensate for the slowing demand in the US and the EU, a larger regional market will be needed. This is also desirable in the longer-term with shrinking global imbalances.

Ensuring a liberalized environment is one of the essential factors to expedite the economic recovery and sustain the economic growth in the region. A CJK FTA creating a larger market will certainly boost further the already-important intra-regional trade and investment, and raise efficiencies of their economies. The research teams recommend that the three countries should share the common policy direction toward further liberalizing regional trade policies. A CJK FTA will be an essential component to pursue the policy direction.

Recommendation 2: To Take Advantage of Trade Facilitation in a CJK FTA.

Trade facilitation has drawn increasing attention as an effective tool to reduce trade costs. The

recent FTAs in the world tend to include trade facilitation measures with wider coverage. Trade facilitation has characteristics of international cooperation, as well as trade concession. Some of the trade facilitation measures, such as harmonizing various trade-related procedures and standards, have a nature of economies of scale and positive externality. A CJK FTA will provide a good opportunity to materialize such benefits. Empirical studies found that some trade facilitation measures would create large economic benefits to all the parties.

The research teams recommend that a CJK FTA should take advantage of trade facilitation. A recommendable approach is “step-by-step”. The initial agreement of the CJK FTA would better include some effective trade facilitation measures, limited to cross-border issues. But others may be negotiated and implemented afterward as the matters of regional cooperation. To ensure that the approach functions properly, it is recommended that the initial agreement of the CJK FTA also stipulate institutional set-ups, such as periodical meetings, to review and negotiate the trade facilitation measures in the future.

Recommendation 3: To Upgrade Joint Research on the CJK FTA by Commencing Discussion among three government officials

The joint research teams reaffirm the importance of a regional FTA among China, Japan and Korea. In the future, the CJKFTA would ensure the liberalized trade environment in the region. The liberalized environment will greatly contribute to ensuring the economic recovery in East Asia, as well as developing a strong source of macroeconomic final demand in the region. With this understanding, the joint research teams recommend the leaders and governments of the three countries to support the formation of the CJK FTA.

In particular, it is recommended that discussion on the CJK FTA should be commenced among three government officials, by reforming the present mechanism to official discussion in government level from the next year. This will enable to start the discussion on a CJK FTA among the government officials, in addition to business and academia participants.

Recommendation 4: To Maintain and Further Utilize the Existing Mechanism of Academic Trilateral Joint Research.

The CJK Trilateral Joint Research started in 2001. The current mechanism enabled the joint research teams to conduct independent economic research on important trade and investment issues in the region. The present mechanism will be able to continue to serve the CJK leaders

meeting to identify and review important issues in the region in the future. In addition to the above recommendation of upgrading the joint research on CJK FTA to government level, we recommend that the leaders and governments of the three countries maintain and further utilize the existing mechanism of academic trilateral joint research, aside from the separated and upgraded government level trilateral joint research on a CJK FTA.

Appendix: Research Issues and Achievement in the First Phase of Trilateral Joint Research on a Possible Free Trade Agreement between China, Japan and Korea

2000

- The joint research on “Strengthening the Economic Cooperation among China, Japan and Korea” was officially launched as the joint study on “Enhancing Trade and Investment between China, Japan and Korea.”

2003

- The three institutes embarked upon a new phase of joint research on “Long-term Economic Vision and Medium-term Policy Direction.”
- The three institutions started a research on the impact of an FTA between China, Japan and Korea on the macro-economies of the three countries. Business survey and macroeconomic assessments were conducted.

2004-05

- The three institutes conducted joint research on the “Sectoral Implications of a CJK FTA,” covering agriculture, fishery, and major manufacturing and service sectors.

2006

- The three sides examined other important issues, including rules of origin and sensitive sectors in the FTAs concluded by China, Japan and Korea.

2007

- The study in 2007 addressed 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.

2008

- The joint research covered three aspects: the three countries’ FTA policies, the obstacles and expectations of a CJK FTA, and the role of the three Northeast Asian countries and the CJK FTA for a region-wide FTA in East Asia.
- The first phase of the joint research on a CJK FTA concluded.

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