

Joint Report and Policy Recommendations
concerning
A Free Trade Agreement among China, Japan and Korea

December 11, 2006

Trilateral Joint Research

conducted by

Development Research Center (China)
National Institute for Research Advancement (Japan)
Korea Institute for International Economic Policy (Korea)

Executive Summary

Introduction

Since 2003, three research institutes representing China, Japan and Korea have jointly undertaken a study on a possible Free Trade Agreement among the three countries (termed a “CJKFTA” below). Following an assessment of the macroeconomic impact of a CJKFTA and a survey of businesses in 2003, the three institutes conducted sector studies ranging over the agriculture, automobile, electronics, fisheries, textile, and steel sectors and sections of the service sector in 2004 and 2005.

Continuing their study of a CJKFTA in 2006, the institutes decided to extend the previous sector studies to cover a broader area of the service sector. They also decided to examine other important issues, including rules of origin (ROOs) and sensitive sectors in the existing Free Trade Agreements (FTAs) concluded by China, Japan, and Korea. This report first presents a general perspective on regional trade agreements in Northeast Asia, followed by the major findings of the joint study of the research issues for 2006. Finally the report presents the conclusions of the study together with policy recommendations.

Summary Conclusion of the Joint Study in 2006

Our joint research from 2003-2005 identified major macroeconomic benefits from an FTA among China, Japan and Korea. The CJKFTA will be a win-win-win strategy for the three countries, bringing macroeconomic benefits to them all. Business surveys indicated that the majority of the business sector of the three countries generally supported early realization of a CJKFTA. Our industrial impact studies identified various policy implications, issues and challenges, but the general conclusion was that a CJKFTA would be desirable and any measures required to overcome the difficulties in achieving it should be considered.

The study conducted in 2006 has implied that China, Japan and Korea should pursue a strategy aiming at early establishment of a high-quality CJKFTA. Broad coverage in a CFKFTA, including service trade liberalization, would bring greater

benefits to all the countries. The service sector of each of the countries generally displays a comparative disadvantage, and improvement of productivity will be a challenge to each, in particular in important areas such as logistics and the wholesale and retail trades. On the other hand, extensive exemptions of service industries from a CJKFTA would weaken the effect of enhanced competition achieved through trade liberalization, thus reducing the overall benefits provided to the three countries by the FTA.

China, Japan and Korea have each been extensively involved in signing and negotiating FTAs with other partners. The rules of origin (ROOs) of the FTAs concluded by the three countries might be incompatible with each other. Incompatibility between the ROOs and the resulting increase in trade costs would seriously reduce the economic benefits of a CJKFTA as well as an East Asia-wide FTA. The existence of incompatible ROOs in the FTAs, together with numerous exempted items, would impede the establishment and functioning of cost-effective production networking in East Asia.

Joint Policy Recommendations¹

Recommendation 1: Reaffirm that the formation of a CJKFTA should be achieved as a mid-term goal

Our joint report in 2005 recommended that the formation of a CJKFTA should be established as a mid-term goal. The joint research in 2006 identified an increasing need to reaffirm this recommendation, given the increasing pursuit of FTAs by the three countries, in addition to reaffirming the necessity of considering a region-wide FTA in East Asia.

Recommendation 2: Recommendations from the Study in 2006

Based on the findings of joint research in 2006, the three representative

¹ These recommendations do not necessarily imply official agreements between the governments of the three countries.

institutes jointly offer the following policy recommendations:

a. A CJKFTA should include liberalization of the service industries

Service trade among China, Japan and Korea is increasing in importance. A CJKFTA should include extensive liberalization of the service industries, in particular in the important areas, such as logistics and the retail and wholesale trades.

b. The governments of China, Japan and Korea should endeavor to minimize incompatibilities between the ROOs in the FTAs concluded by the countries

China, Japan and Korea should be aware of the importance of minimizing the incompatibilities between their FTAs in terms of rules of origin (ROOs). Information concerning the ROOs in FTAs that are under negotiation or have been agreed upon should be exchanged among the three countries.

c. The number of excluded items in a CJKFTA should be minimized

The number of exceptional items exempted from tariff concessions should be minimized to the extent possible. This is extremely important in ensuring economic benefits from such an FTA. It would be pragmatic, however, to allow limited transition periods before liberalization and to introduce compensation schemes, so as to mitigate short-term adverse impact and ensure broad-based domestic support.

Recommendation 3: Research Agenda in 2007

Recognizing the importance and the urgency of forming a CJKFTA, the three institutes jointly recommend that the remaining important research issues should be completed in 2007, to enable China, Japan and Korea to design an ambitious and high-quality CJKFTA. At the same time, the three institutes recommend that government officials from China, Japan, and Korea be invited as observers of the process of joint research in 2007. It is also recommended that all the participants in the joint study in 2007 give serious consideration to how to further advance the study, and that the results of these considerations be reflected in the 2007 report.

Introduction

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Continuing their study of a CJKFTA in 2006, the institutes decided to extend the previous sector studies to cover a broader area of the service sector. They also decided to examine other important issues, including rules of origin (ROOs) and sensitive sectors in the existing Free Trade Agreements (FTAs) concluded by China, Japan and Korea.

This report first presents a general perspective on regional trade agreements in Northeast Asia (Section I), followed by the major findings of the joint study regarding the research issues for 2006 (Section II). Section III presents the conclusions of the study together with policy recommendations.

I. Free Trade Agreements in Northeast Asia: General Perspective

Before they joined the trend towards the establishment of FTAs in the early 2000s, China, Japan and Korea had lagged well behind other countries and regions in this area. By contrast, the European Union and the North American Free Trade Agreement (NAFTA) region have become major regional trade blocs, remarkable for their depth of economic integration and the broad scope of their liberalization measures. Their regional and global economic and political influence has increased in tandem with the expansion of their memberships, which has raised concerns in China, Japan and Korea.

China, Japan and Korea are each now actively pursuing FTA, in particular with ASEAN countries (See Table 1). In 2002, Japan concluded its first FTA, the Japan-Singapore New-Age Economic Partnership Agreement (JSEPA), with Singapore. Japan and Korea commenced negotiations towards an FTA in 2003. Since the conclusion of the JSEPA, Japan has signed three more FTAs, with Mexico (2004),

Malaysia (2005) and the Philippines (2006), and has reached agreements in principle concerning major elements of bilateral Economic Partnership Agreements (EPA) with Thailand (September 2005), with Chile (September 2006) ,and with Indonesia (November 2006). Since April 2005, the countries have also been negotiating an FTA with ASEAN as a whole.

Table 1: Free Trade Agreements Concluded or under Negotiation by China, Japan and Korea (as of November 2006)

| China | | Japan | | Korea | |
|-----------|--------|-------------|--------|-----------|--------|
| ASEAN | Nov-02 | Singapore | Jan-02 | Chile | Feb-03 |
| Hong Kong | Jun-03 | Mexico | Sep-04 | Singapore | Aug-05 |
| Macao | Oct-03 | Malaysia | Dec-05 | EFTA | Dec-05 |
| Chile | Nov-05 | Philippines | Sep-06 | ASEAN* | Apr-06 |
| Pakistan | Nov-06 | | | | |
| NZ | Dec-04 | Korea | Dec-03 | Japan | Dec-03 |
| GCC | Apr-05 | Thailand | Feb-04 | Canada | Jul-05 |
| Australia | May-05 | ASEAN | Apr-05 | Mexico | Feb-06 |
| Singapore | Oct-06 | Indonesia | Jul-05 | India | Mar-06 |
| | | Chile | Feb-06 | USA | Jun-06 |
| | | Brunei | Jun-06 | | |
| | | GCC | Sep-06 | | |

Source: Survey by authors (as of November 2006).

Note 1: The upper half of the table shows concluded FTA; dates indicate the date of signing of the agreements. The lower half of the table shows FTA under negotiation; dates indicate the date of commencement of negotiations.

Note 2: The asterisk (*) indicates a Trade in Goods Agreement.

Note 3:GCC is the abbreviation for Gulf Cooperation Council.

China signed the Framework Agreement on Comprehensive Economic Cooperation with ASEAN in 2002. Following the conclusion of bilateral talks on trade in goods, the China-ASEAN Free Trade Area (CAFTA) came into effect in July 2005. Trade will be liberalized between China and the original six ASEAN members by 2010, and between China and the new members of ASEAN by 2015. Outside the Asian region,

China also concluded an FTA with Chile in November 2005.

Korea has signed FTAs with Chile (2003), Singapore (2005), and EFTA (2005), as well as a Trade in Goods Agreement with ASEAN (excluding Thailand; 2005). Korea is negotiating or studying numerous other FTAs, and is involved in negotiations towards an FTA with the US. This FTA will offer significant economic and political benefits to Korea, given the size of the partner and the trade structures of the two countries.

The pursuit of agreements with ASEAN by China, Japan and Korea may result in three “ASEAN plus one” FTAs preceding one “ASEAN plus three” FTA or a CJKFTA. At this stage, joint research on a possible CJKFTA should take into consideration the other FTAs that will coexist with a CJKFTA in the future. This awareness influenced the selection of research topics for 2006. The study of ROOs is of particular relevance in a situation in which numerous FTAs coexist. In addition, the study of the existing FTAs of the three countries, either signed or agreed upon, enables the sensitive sectors (goods and services) in each country to be determined. These studies will contribute to future consideration of a CJKFTA.

II. Major Findings of the Joint Study in 2006

In 2006, the joint research has focused on service sectors, rules of origin (ROOs) and sensitive sectors. Studies by each of the institutes have adopted a common approach to examining the clauses in the existing FTAs of the three countries in order to identify sensitive goods and services, to understand the ways in which sensitive sectors have been dealt with, and to study the effects of ROOs.

II-1 Study of Service Sectors

This study has considered the competitiveness of the service sectors of China, Japan and Korea, the service industries that have been liberalized in the existing FTAs of the three countries and the implications of this liberalization, and selected service industries, including logistics and wholesale and retail industry.

Competitiveness of the Service Sectors in China, Japan and Korea

China, Japan and Korea share comparative advantage in trade in goods, but they also share relative disadvantage in the service sector¹. However, not all service industries in the three countries display comparative disadvantage, and the competitiveness of service industries in each country differs from product to product². China displays trade competitiveness in travel services for all survey periods from 1980 to 2003, and in computer, communications, and other services from the late 1990s. Japan displays trade competitiveness in transport services for all survey periods from 1980 to 2003 and in computer, communications, and other services from the late 1980s, and Korea in transport services for all survey periods from 1980 to 2003 and in insurance and financial services following the currency crisis.

Liberalized Service Industries in the Existing FTAs

As inclusive agreements, regional FTAs tend to include liberalization of the service sector in their scope. Liberalization of the service sector has also been important in the existing FTAs of China, Japan and Korea. China is strengthening its service sector through Closer Economic Partnership Arrangements (CEPAs) with regions that are more developed in this sector, such as Hong Kong and Macao, ahead of the liberalization of the service market agreed to by the country upon its accession to the World Trade Organization.

The service sector agreements in the existing FTAs of Japan and Korea are characterized by their use of the negative list method, in which only the fields which will not be liberalized are listed. Japan has sought legal stability and transparency concerning laws and regulations by introducing standstill/rollback disciplines, which contribute to making the situation more predictable for service suppliers. Japan has also emphasized

¹ The volume of service trade in China, Japan and Korea is less significant in world trade than the nations' trade in goods. The ratio of the sum of the service export and import share in China, Japan and Korea to the world total was lower than the sum of the goods export and import share in the three countries in 2003. In addition, China, Japan and Korea record service trade deficits whereas other countries that rank highly in terms of service trade, the USA, the UK, and France, record surpluses. This implies that China, Japan and Korea have a comparative disadvantage in the service sector.

² These findings are from the Relative Revealed Comparative Trade Advantage (RTA) indices 1980-2003.

sectors of particular interest, such as manufacturing-related services and distribution. The transfer of manpower has been another issue. In the Japan-Philippines EPA, Japan made a commitment to opening its labor market to nurses and caregivers with certain qualifications. Korea gained momentum in enhancing the competitiveness of its service sector through liberalization of service sector trade with Singapore, which is well known for its developed finance, transport, communications, and business services.

Where competition has been promoted by liberalization and the appropriate abolition of regulations in the service sector, the service sectors of China, Japan and Korea are operating smoothly, and labor and capital are effectively distributed. Companies in the three countries are therefore likely to gain comparative advantages in related fields by lowering materials costs and positively adapting to rapidly changing competitive circumstances. Furthermore, this will have a positive effect on their GDP growth by improving economic efficiency.

Logistics Sector

The share of the logistics sector in economic value and employment is smaller in China than in Japan or Korea; however, China has the greatest potential for growth. In terms of transport infrastructure (air and sea transport), China and Korea display higher cost competitiveness than Japan. In terms of cost structure, Korea is twice as efficient as Japan and China, and Korea is subject to less government intervention in the logistics sector than Japan.

China has relatively higher intermediate logistics costs than Japan and Korea in spite of its lower infrastructure costs, indicating the country's lower logistic productivity. One strategy for increasing productivity in this sector is the introduction of new logistics techniques such as supply chain management. High infrastructure costs and the various domestic regulations may limit the improvement of competitiveness in the logistics sector in Japan, despite the country's competitiveness and level of economic development. Korea's logistics sector is the most competitive among the three countries, and this may be due to the fact that it is subject to less government regulations. For all the three countries, the improvement of infrastructure in the services sector and the deregulation and liberalization of service industries would contribute to increasing the

competitiveness of the service sector. Given this, the inclusion of logistics services in a CJKFTA should be considered.

Wholesale and Retail Industry

The wholesale and retail trades are important services for producers, and their liberalization can be helpful in improving the degree of specialization and modernization of industry in China, Japan and Korea. To increase their productivity, it will be necessary to enhance cooperation and communication in such areas as standardization, training, information and e-business at the governmental level in the three countries.

In China, Japan and Korea, efforts should be made to realize national treatment of these fields apart from the commitments to relaxing the market access conditions in them. Currently, most of the barriers to trade by foreign investors in the three countries reside in substance in domestic policies and regulations. It will therefore be necessary to eliminate the differential treatment between foreign and local service providers in priority fields and increase the transparency of policies and regulations. The liberalization of the trading of sensitive goods is not only an issue in terms of the liberalization of trade in services, but is also closely connected with industrial development strategies and trade in goods policies. For example, in industries subject to import quota control, designated operation or government pricing, although there are not many restrictions on market access, it is difficult for foreign wholesalers or retailers to enter the field.

II-2 Study of the Economic Effects of Rules of Origin

Rules of Origin and their Implication in an FTA

Preferential trade agreements, including FTAs, require rules of origin (ROOs) to enable a given trade good to be identified as originating in the area covered by the agreement, and thus subject to exemption from customs duties. ROOs exist to prevent imports from countries outside the scope of the agreement from taking advantage of the

concessions of FTAs³. It has been pointed out that ROOs may function as trade protection measures when a country establishes numerous overlapping FTAs. Moreover, ROOs require traders to prepare official documents to prove the origins of imported goods. If the cost of this is highly burdensome, a great deal of trade will be conducted on the basis of simply paying the MNF tariffs, without using the exemption provisions.

ROOs in the FTAs Concluded by China, Japan and Korea

The texts of all the FTAs concluded by China, Japan and Korea include a separate chapter or annex regarding rules of origin. When a good is wholly obtained or produced in one country, determining the country of origin is simple and straightforward. When there are more than two countries involved in production, the preferential ROOs of Japan and Korea apply two main criteria: the change in tariff classification and the percentage of value added. Either of these criteria is applied in isolation to certain goods, and they are sometimes also used in various combinations or in combination with supplementary criteria. By contrast, China uses value added as the main criterion in some of its FTAs and uses change in tariff classification and specific manufacturing process in others.

The required value added (local content) varies among the three countries' FTAs. Around 40 to 60 percent is the commonly admitted range. Higher value added tends to be required to prevent trade deflection. On the other hand, looser criteria regarding the required local content may facilitate the establishment of production chains and networks. This may be the case in East Asia.

ROOs and Cumulation Provisions

All of the FTAs concluded by China, Japan and Korea adopt partial bilateral cumulation provisions, which means that materials originating in one of the FTA partners are considered as originating in the other partner (the exporting country), if sufficient work is conducted on the material in that country. Cumulation provisions have a huge economic impact on participating countries. Bilateral cumulation has the

³ When this takes place, it is termed "trade deflection."

advantage of boosting intraregional trade of parts and materials in addition to finished goods. Given the spreading horizontal production networks of industries in East Asia, bilateral/regional cumulation is significant and is in accord with the basic purpose of a CJKFTA. The short-term effects of a cumulation provision would be to encourage producers to change their source of supply in order to satisfy the requirements for preferential tariff rates. However, in the long run, a cumulation provision may affect investment decisions, including those relating to inward FDI. Therefore, China, Japan and Korea must give careful consideration to cumulation provisions in future FTA negotiations.

Avoiding Complexity in ROOs

Overall, Japan and Korea use similar criteria in determining the country of origin, while the China-ASEAN FTA adopts a similar approach to that of AFTA. It has been pointed out, however, that ROOs tend to be used to protect sensitive items. The different application of ROOs to specific goods among the three countries will create extra complexity and generate additional production costs, and this problem may be exacerbated as they conclude an increasing number of FTAs.

It will therefore be necessary to study the economic impact of specific provisions of ROOs in the existing FTAs of the three countries, and to determine the type of originating rules that would be most appropriate. As the first step, there should be exchange of information among the three countries regarding the ROOs in FTAs that have been concluded or are under negotiation. Moreover, each government should endeavor to minimize incompatibilities between the ROOs in the FTAs of the three countries when they are involved in FTA negotiations.

II-3 Study of the Sensitive Sectors in the Existing FTAs of the Three Countries

The most commonly cited obstacles to a CJKFTA are usually non-economic factors. Furthermore, while a CJKFTA would bring macroeconomic benefits, its economic impact on individual industries would vary, and it would therefore be resisted by individuals and groups with vested interests in industries that would be adversely

affected. The existence of sensitive sectors constitutes a hindrance to even a bilateral FTA in Northeast Asia, and therefore represents an even greater hindrance to a CJKFTA.

Because the three countries recently concluded several bilateral FTAs, this year's joint research reexamined the issue of sensitive sectors by analyzing the tariff elimination schedules of those FTAs. The study sought to identify the sensitive sectors as reflected in the FTAs, and also examined the modality of tariff reduction and elimination employed in the FTAs.

Sensitive Sectors in Existing FTAs

All the countries in question have sensitive products with relatively high costs of production and stronger protection by tariff and other trade barriers. Sensitive sectors are generally excluded from tariff elimination schedules, have longer transition periods or are the subject of other protective measures under FTAs. The FTAs concluded by China, Japan and Korea all indicate the existence of sensitive sectors.

The majority of Japan's sensitive items are agricultural products or products of agriculture-related industries. Grains and grain products, dairy products, meat of bovine animals, nuts, vegetables such as konnyaku tubers, sugar and sugar products, fruit and fruit products, some fish and plywood are common sensitive items in the three EPAs concluded by Japan. Most of these products are excluded from tariff elimination or granted a transition period of more than ten years. Processed leather, footwear and shoes are the major sensitive items that are products of the mining and manufacturing sectors. Petrochemical products are also excluded from tariff elimination in the Japan-Singapore EPA⁴, as are animal and vegetable oils and materials such as essential oils, albumin and casein in the Japan-Mexico and Japan-Malaysia EPAs.

The structure of Korea's sensitive sectors is similar to Japan's. Because the average import tariff rate on agricultural products is rather high, it is mainly agricultural, fisheries and forestry products that have been placed on Korea's Highly Sensitive List⁵

⁴ JSPEA is currently under review negotiation, in which the reduction of the exemption list is being discussed.

⁵ The Highly Sensitive List is subject to a well-defined maximum ceiling: 200 tariff lines at the HS 6-digit level or 3 percent of all tariff lines at the HS digit level of each party's own choice and 3 percent of the total value of imports from ASEAN member countries as a whole.

in the Korea-ASEAN FTA, while these products also represent more than half of the tariff lines placed in its Sensitive List⁶. The tariff items exempted from tariff concessions include agricultural products such as meat, vegetables, fruits, cereals, and fisheries products such as live fish and frozen fish. They represent 4.4 percent of Korea's total agricultural tariff lines and 12.1 percent of Korea's total fisheries tariff lines. Agricultural, fisheries and chemical products constitute the majority of the items that are excluded from tariff elimination in the Korea-Singapore FTA, while many textile, chemical, and agricultural items belong to those tariff lines that will be eliminated within 10 years.

The structure of China's sensitive sectors differs from those of Japan and Korea. The proportions of zero-tariff products in Japan and Korea are higher than in China. The tariff levels in China for most manufactured products, including petrochemicals, iron & steel and machinery, are higher than in Japan and Korea. This structure reflects China's sensitive sectors. The sensitive products listed in the China-ASEAN FTA are mainly, in terms of the tariff headings of sensitive products⁷, paper products and transportation equipment, while plastic and rubber products, paper products, animal & vegetable oils and fats are the main sensitive products in terms of import value. In the China-Chile FTA, products subject to a transition period and exceptional products include agricultural products and processed food, wood and furniture, chemicals, paper products and some textiles products.

Implications for a CJKFTA

The number of exceptional items exempted from tariff concessions should be minimized to the extent possible. This will be important to ensuring economic benefits from a CJKFTA concluded by China, Japan and Korea. It would be pragmatic, however,

⁶ The Sensitive Track is subject to a maximum ceiling: 10 percent of all tariff lines and 10 percent of the total value of imports from ASEAN member countries as a whole. Korea and ASEAN 6 will reduce the tariff rates to 20% not later than January 1, 2012, and these tariff rates will subsequently be reduced to 0-5% not later than January 2016.

⁷ According to the Agreement on Trade in Goods, the sensitive products that China and the six ASEAN member countries can retain may include up to 400 six-digit tariff headings, and the sum of their import value should not exceed 10% of the total import value. Among these, the tariff rates for generally sensitive products should be reduced to 0-20% by 2012, and further to 0-5% by 2018.

to allow limited transition periods before liberalization and to introduce compensation schemes, so as to mitigate short-term adverse impact and ensure broad-based domestic support. By adopting these measures when they establish a CJKFTA, the governments of the three countries can deliver clear signals to enterprises and producers, in order to promote the process of structural adjustment.

III. Conclusion and Joint Policy Recommendations

Conclusions

Our joint research from 2003-2005 identified major macroeconomic benefits from an FTA among China, Japan and Korea. The CJKFTA will be a win-win-win strategy for the three countries, bringing macroeconomic benefits to them all. Business surveys indicated that the majority of the business sector of the three countries generally supported early realization of a CJKFTA. Our industrial impact studies identified various policy implications, issues and challenges, but the general conclusion was that a CJKFTA would be desirable and any measures required to overcome the difficulties in achieving it should be considered.

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Recommendation 2: Recommendations from the Study in 2006

Based on the findings of joint research in 2006, the three representative institutes jointly offer the following policy recommendations:

a. A CJKFTA should include liberalization of the service industries

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b. The governments of China, Japan and Korea should endeavor to minimize incompatibilities between the ROOs in the FTAs concluded by the countries

China, Japan and Korea should be aware of the importance of minimizing the incompatibilities between their FTAs in terms of rules of origin (ROOs). Information

⁸ These recommendations do not necessarily imply official agreements between the governments of the three countries.

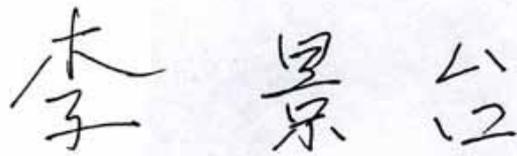
concerning the ROOs in FTAs that are under negotiation or have been agreed upon should be exchanged among the three countries.

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