

# Static and Dynamic Consequences of a **KORUS FTA**



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## Comment: Scope for Dynamic Effects in Korea's Economy

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A U.S.-Korea Free Trade Agreement (KORUS FTA) would bring economic benefits to both the United States and Korea through various channels. First, it would substantially reduce trade and investment barriers and lead to the promotion of bilateral trade and investment. Second, it would serve as a mechanism for improving Korea's institutional infrastructure, resulting in strengthened national competitiveness. Third, it would stabilize the regional trading environment by addressing bilateral trade conflicts and potentially helping to reduce trade disputes. Finally, it would reinforce the critical political and security alliance between Korea and the United States, thereby stabilizing the geopolitical climate surrounding the Korean peninsula.

The three preceding articles deal with dynamic economic factors, including investments, a China-Japan-Korea FTA, and trade regionalism. As discussed in the conference that led to this volume, dynamic effects are extremely pertinent for the Korean economy.

### *Investments*

To capture the dynamic effects of the KORUS FTA, we need to take into account the positive relationship among trade, investment, and growth, which is fairly well established in a number of empirical studies. As Arthur Alexander (2007) maintains, foreign direct investment (FDI) has a robust effect on growth when trade and FDI are allowed to vary. In addition, we can expect greater positive effects through the KORUS FTA as the liberalization of the service sectors, including telecommunications, business services, and financial services, is specifically addressed in the agreement. Liberalization of trade in services is increasingly being recognized as a boon to the economy. An efficient services industry plays a vital role in the process of economic development, as services act as basic inputs or intermediates in industrial production.

As Professor Alexander points out, Korea's future growth will depend more on productivity improvements than additions to the capital stock. The Korea Institute for International Economic Policy (KIEP 2007) has undertaken several policy experiments during 2007 in order to examine the potential impacts of the KORUS FTA. The analyses basically implement three scenarios. The first scenario is estimated using a

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static computable general equilibrium (CGE) model, the second is estimated with a capital accumulation CGE model, and the third scenario assumes that Korea's productivity will increase by about 1 percent 10 years after the KORUS FTA has gone into effect.<sup>1</sup> The results are as follows: Using the static CGE model, Korea's GDP is estimated to increase by 0.32 percent; under the dynamic CGE model, Korea's GDP would increase by 1.28 percent; under the productivity assumption, Korea's GDP would increase by 5.96 percent.

I agree with Professor Alexander's argument that the effects of FDI seem to depend on conditions in the host country and firms. Furthermore, the gains from trade and investment liberalization are not automatic, but rather require deliberate efforts such as concerted investments in research and development (R&D) and human capital and the simplification of administrative processes. Trade liberalization policies, however, do not provide benefits for countries that do not have the necessary absorption capacity. Realizing the potential gains from trade liberalization requires great a great amount of effort, which cannot be simply distributed. The potential gains from policy changes, such as the KORUS FTA, would therefore only hold if Korea began to invest sufficiently in R&D activities and human capital.

### ***Trade Regionalism***

When we look back at the past five decades, we can see that multilateral trade negotiations sponsored by the General Agreement on Tariffs and Trade–World Trade Organization (GATT-WTO) have achieved relative success in that they have eliminated or reduced the obstacles to international trade, thus contributing to the expansion of global trade and the growth of the world economy. As one of the main beneficiaries of the liberal multilateral trading system, Korea cannot but appreciate the importance of continuing trade and investment liberalization.

The multilateral trading regime is theoretically superior to trade regionalism, as Cho Sung-joon (2007) contends in his paper. However, member countries that are also developing countries continue to argue that trade liberalization initiatives taken by the GATT-WTO have not enhanced their economic welfare. This incongruity arises from the fact that the globalization of economic activities leads to different effects and repercussions in different countries. Moreover, in view of what has happened since the launch of the Doha Development Agenda (DDA) negotiations, the strong dissent

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1. Bank of Korea (2003) has determined that total productivity increases by 0.11 percent if imports increase by 1 percent, while KIET (2000) reports indicate that the total productivity of manufacturing sectors increases by 0.19 percent if imports increase by 1 percent. Based on these results, total productivity would increase by about 1 percent (0.68–1.2 percent) when the expected import increase (6.2 percent) is multiplied by the aforementioned productivity effects (0.11–0.19 percent).

among WTO member countries necessitates a cautious approach to further trade and investment liberalization agendas. This implies that it will take a great length of time to complete ongoing DDA negotiations.

Despite a delay in reaching a final agreement on the DDA, FTAs will continue to proliferate as insurance policies. Thus, the number of FTAs is expected to increase in the future in pursuit of economic efficiency, access to larger markets, and circumvention of regional protectionism. The current development of FTAs seems to be a reflection of the domino effect initiated by major economies such as the United States and the European Union.

The multilateral trade system of the WTO and regional trade agreements can be seen as compatible rather than paradoxical. I agree with Cho's opinion that trade regionalism cannot be a substitute for multilateral initiatives,<sup>2</sup> but I think that the current FTAs can function as complements rather than barriers to multilateral liberalization.

### *China-Japan-Korea FTA*

Using a trade gravity model, Kang (2007) shows that (1) regional trade agreements are statistically significant determinants of trade flows, and (2) the distance between two trading partners is a significant barrier to trade flows. Previous literature also confirms that macroeconomic effects are positive for all participating countries. Studies from the DRC, KIEP, and NIRA (2003) show that under a China-Japan-Korea FTA (CJK FTA) the GDP gains for each country would be 2.5–3.1 percent, 0.1–0.5 percent, and 1.1–2.9 percent, respectively; the welfare gains for the three countries would be 11.4–26.3 percent, 6.7–7.4 percent, and 4.7–6.4 percent, respectively. These results demonstrate that a CJK FTA would be a win-win situation for all three countries.

Choi, Park, and Lee (2003) explore various trade liberalization options in the East Asian context. Their results reveal that the expected benefits of a trilateral agreement would be greater than any bilateral option for the three countries. Using a static CGE model, they find that Korea's, Japan's, and China's welfare would increase by 2.25 percent, 0.93 percent, and 2.31 percent, respectively. Under a dynamic CGE model, the three countries' welfare would increase by 4.13 percent, 0.90 percent, and 2.99 percent. It is generally accepted that a regional trade agreement among China, Japan, and Korea would impact the three countries to a substantial extent.

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2. Cho (2007) argues that FTAs should be managed and contained, rather than promoted.

Kang (2007) argues that a China-Japan-Korea FTA seems to be inevitable and that Korea should demonstrate its resolve toward the successful realization of a trilateral FTA by embarking on formal negotiations immediately.

I propose the following two scenarios regarding the future prospects of the trilateral FTA.<sup>3</sup> First, Korea's unique position could possibly situate it as a hub in the trilateral FTA. Korea has plans to launch a Korea-China FTA next year after the two countries conclude a government-business-academia joint feasibility study. Negotiations on a Korea-Japan FTA are expected to resume when Japan proposes more ambitious concessions in the agricultural sector. With completion of the Korea-Japan and Korea-China FTAs, the trilateral FTA could be more easily pursued. Second, the three countries may possibly work together to achieve developments in the ongoing discussions on formal trilateral economic cooperation. Institutionalization of economic cooperation in Northeast Asia began in 1999 in Manila at the historic summit meeting of the leaders of the three countries. At the summit, the leaders agreed to launch a three-year joint research project on trilateral economic cooperation. Before initiating government-level FTA negotiations, they will likely seek to form a joint study group comprising representatives from the government, industry, and academia to examine the feasibility of establishing a trilateral FTA.

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3. Lee et al. (2005) proposed three scenarios for the trilateral China-Japan-Korea FTA.

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