

# Korea's Economy 2008

Korea's Economic Achievements and Prospects

The Graying of Korea: Addressing the Challenges of Aging

Financial Asia Rising: Asian Stock Markets in the New Millennium

Korea's Money Market

Ingredients for a Well-functioning Capital Market

The Capital Market Consolidation Act and the Korean Financial Market

Progress in Corporate Governance

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U.S.-Korea Economic Relations: View from Seoul

U.S.-Korea Economic Relations: A Washington Perspective

Peering into the Future: Korea's Response to the New Trading Landscape

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Realistic Expectations of the Future Role of the IFIs on the Peninsula

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# PEERING INTO THE FUTURE: KOREA'S RESPONSE TO THE NEW TRADING LANDSCAPE

By Troy Stangarone

As the first decade of the twenty-first century nears an end, distinct patterns are emerging in the global trading system. The Doha Development Round remains stalled and has begun to raise questions about countries' ability to reach meaningful trade liberalization under the current multilateral structure. At the same time there has been a quickening of the pace in the development of bilateral trade deals, especially in Asia.

While economists rightfully argue that the multilateral system yields the most gains for all countries, that position tends to underplay the political reality that for each country the greatest gains in trade liberalization come from realizable yields and through agreements that a country can realistically expect to conclude.

Before 2003, Korea had no free trade agreements (FTAs) and was committed to the multilateral system. Today it is negotiating or considering negotiating FTAs with the European Union, China, Japan, Australia, India, and the Gulf Cooperation Council (GCC), among a wide range of states and regional groupings. Although Korea is still committed to negotiating multilaterally, it has undergone a significant shift toward complementing that strategy on the bilateral level. This paper will explore the changes in Korea's FTA policy under President Roh Moo-hyun and its likely prospects under the administration of President Lee Myung-bak.

## Changing Landscape of Trade

Preferential trading agreements have long been part of the international trade agenda, but since the postwar trading system was developed they had primarily served as secondary pieces to a larger puzzle. When the United States pursued its first FTA with Israel, it did so with the intent of providing momentum to the ongoing

multilateral negotiations of the time. Multilateralism was the primary driving force of trade liberalization. That has changed.

Today, 55 percent of world trade takes place through FTAs.<sup>1</sup> In addition, all of Korea's major trading partners have begun engaging in more bilateral FTAs (*Table 1*) although the EU's move in this direction has come only since the end of 2006. In recent years, the United States has negotiated nine FTAs aside from the U.S.-Korea Free Trade Agreement (KORUS FTA), with negotiations still ongoing with Malaysia. Japan has either negotiated or proposed eleven FTAs, not including one with Korea, while the number for China is nine. Included in China's and Japan's lists of prospective FTA partners are regional trading blocs such as the Association of Southeast Asian Nations (ASEAN) and the GCC, key emerging markets such as India, and developed markets such as Australia. Between 2002 and 2006, the number of FTAs in the Asia Pacific alone tripled to more than 175.<sup>2</sup>

This is the new landscape that Korea's decision makers face. Economists refer to this proliferation of FTAs as a suboptimal "spaghetti bowl," where a series of overlapping agreements produce lower-level results than one overarching agreement could. However, the bilateral FTA route holds certain advantages for an individual country, specifically one like Korea. Multilateral negotiations entail a lengthy period of negotiations, but bilateral agreements can be concluded and implemented in a relatively short period of time. Within a bilateral framework, a broader range of issues can be addressed, and liberalization can be taken to a deeper level than occurs in multilateral negotiations where the needs and concerns of a broader range of nations are factored into any final agreement.

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1. Jeffrey Robertson, "The Price of Free Trade," *Asian Times*, 12 July 2005.

2. "We Can't Stand Still: The Race for International Competitiveness" (Washington, D.C.: Business Roundtable, March 2007), [www.businessroundtable.org/pdf/Intl\\_Trade\\_Investment/We\\_Cant\\_Stand\\_Still\\_2007.pdf](http://www.businessroundtable.org/pdf/Intl_Trade_Investment/We_Cant_Stand_Still_2007.pdf).

**Table 1: FTAs Concluded, Currently under Negotiation, or Proposed since 2000 by the European Union, China, and Japan**

Countries	FTA partners
EU	ASEAN GCC India Korea MERCOSUR Russia
China	ASEAN Australia GCC Iceland India Japan Korea New Zealand Pakistan SACU
Japan	ASEAN Australia Brunei Canada Chile GCC India Indonesia Korea Switzerland Thailand Vietnam

Note: ASEAN = Association of Southeast Asian Nations, EFTA = European Free Trade Association, EU = European Union, GCC = Gulf Cooperation Council, MERCOSUR = Mercado Comun del Cono Sur (Southern Common Market), SACU = Southern African Customs Union.

Perhaps more important, in bilateral negotiations the partner nations have significantly greater say in the ultimate designs of the agreement. Although the World Trade Organization (WTO) currently has 151 members, the heavy lifting of the negotiations is conducted by the United States, the EU, Brazil, and India, with these parties representing larger groupings of parties within the WTO. Under a bilateral framework, Korea can tailor an agreement to its needs in terms of offensive and defensive interests with its trading partners.

### Korea's Hub-Based Goals

Korea has aspirations to become a financial and logistics hub of Northeast Asia. Less discussed is its goal to become the FTA hub of the region as well. While these might seem like separate goals, they actually complement each other. For Korea to become a hub

in Northeast Asia, it will need to develop the transparency, consistency, and the ease of access that will allow goods and services to flow freely and seamlessly in and out of the Korean market; to achieve this, Korea needs to resolve lingering concerns about disputes such as that arising from Lone Star's sale of Korea Exchange Bank.

Korea's FTAs can help to expedite its ambitions to become a hub in Northeast Asia. One of Korea's stated goals in negotiating the KORUS FTA was to aid in liberalizing its financial services sector in an effort to increase competitiveness and import global standards. Korea's FTA with the EU undoubtedly will help to further this goal as well. As Korea opens its market and adopts international standards, it will become an attractive market from which to do business in the region on account of its strategic location between China and Japan.

### FTA Strategies

Each country has its own strategy, reasons, and goals when it pursues a free trade agreement. When developing an FTA policy, individual nations or regional trading blocs often pursue goals beyond trade liberalization. These can include foreign policy and security considerations, competitive considerations, preferential access to markets and resources, strategic export considerations, and internal domestic economic reforms among a range of others. This wide range of goals and considerations can be seen in the policies pursued by Korea's main trading partners: the United States, the EU, China, and Japan.

When Robert Zoellick was the U.S. Trade Representative, the United States began pursuing a policy of competitive liberalization. The intellectual framework behind competitive liberalization was that, if the United States pursued liberalization on the multilateral, regional, and bilateral levels, it could advance the overall cause of global trade liberalization by spurring other nations or trading blocks to do the same, with the eventual outcome being the knitting together of various trade pacts to create a broader, more open global trading system.

During Zoellick's tenure as the U.S. Trade Representative, the United States also began to ground its trade policy in broader economic, security, and foreign

policy aims. The outgrowth of this logic was a policy that focused on concluding FTAs with strategic partners, including allies such as Australia and countries in strategic regions such as the Middle East. Historically, the United States has also used its FTAs to create new precedents for liberalization and templates for other nations to follow.<sup>3</sup> The United States has continued to innovate on issues addressed in FTAs, such as in the 10 May 2007 bipartisan agreement to include definable and enforceable labor and environmental standards.

In late 2006, the EU announced a new trade policy that shifted its focus from a sole reliance on multilateral negotiations to include bilateral and regional FTAs. The new policy of the EU Commission set up economic criteria for EU negotiations that include (1) the market potential of a prospective partner, (2) the level of protection against EU exports, and (3) prospective partners' negotiations with EU competitors.<sup>4</sup> Under this new policy, the EU began considering the FTA policies of its competitors in addition to economic criteria when choosing potential trading partners. The movement to bilateral FTAs also allowed the EU to address areas such as services to a degree that would not have been possible at the multilateral level.

In contrast, Japan's FTA policy focuses more on maximizing the strengths of Japan's economy. When considering FTA partners, Japan focuses on negotiating with partners that complement its economy and that advance the interests of its companies. Because Japan's FTAs focus on its economic strengths, they tend to exclude agriculture to a significant extent. In Japan, as in many nations, agriculture is a politically sensitive issue. It was Japan's reluctance to include agriculture in a substantively meaningful way that led Korea to suspend its FTA discussions with Japan.

Although economic concerns are often the basis for FTAs, political considerations sometimes dominate.

China's policy on FTAs is a prime example. When China began to pursue FTAs in Southeast Asia, it did so for political reasons, not economic ones. As China has grown in economic strength, it has at times experienced friction in its relationship with its neighbors. Although these concerns are often rooted in anxieties related to China's past as well as to legitimate concerns over the implications of China's growing economic might and development, they do represent a significant foreign policy concern for China. As a means of minimizing these concerns, China has adopted a policy of using FTAs to build political relationships that help to ease these regional tensions. Another goal of China's trade policy is to diversify its trade and reduce its dependence on the West,<sup>5</sup> while it also seeks greater access to the immense amount of resources it needs to power its continued economic growth.

As the FTA policies of Korea's key trading partners demonstrate, many potential considerations go into formulating an FTA policy, on both the political and economic levels. Before considering the overall response and implications of Korea's policy, we should consider Korea's official FTA policy:

First, Korea aims to pursue FTAs with large advanced economies or economic blocs and promising emerging nations.

Second, Korea aims to pursue FTAs that are high-level in terms of the degree of liberalization and comprehensive in terms of coverage and scope.

Third, Korea adopts a multi-track approach when negotiating FTAs, meaning that the negotiations can be carried out simultaneously with more than one country when necessary.

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3. Robert Zoellick, "Unleashing the Trade Winds: A Building Block Approach." *U.S. Foreign Policy Agenda* 8, no. 1 (August 2003), <http://usinfo.state.gov/journals/itps/0803/ijpe/pj81zoellick.htm>.

4. "Global Europe: Competing in the World" (Brussels: European Commission, n.d.), [http://trade.ec.europa.eu/doclib/docs/2006/october/tradoc\\_130376.pdf](http://trade.ec.europa.eu/doclib/docs/2006/october/tradoc_130376.pdf).

5. Chu Shulong, "China's Approach to the Free Trade Area" (presentation at "Free Trade and East Asia," meeting held by Foreign Policy Research Institute and World Trade Center of Greater Philadelphia, Philadelphia, Pa., 2006), [www.fpri.org/pubs/20061102.chu.chinafreetradearea.pdf](http://www.fpri.org/pubs/20061102.chu.chinafreetradearea.pdf).

Additionally, in order to achieve national consensus as part of the negotiation process, Korea aims to pursue a wide range of outreach efforts with the public and private sectors.<sup>6</sup>

However, if one digs deeper and considers Korea's choices and constraints, one can see a series of patterns begin to develop, some of which reflect aspects of its partners' FTA policies as well. Korea is generally acknowledged to have one of the higher FTA standards in terms of economic liberalization, which substantively covers all areas of trade, with rice being the one significant exception.

## A Doha unto Itself

In sports, depth is often a key to any championship run, while in business, politics, or any other endeavor having a backup plan is a key part of long-term success. The Doha round was conceived as a development round that would focus on liberalization in agriculture. The nearly universal political sensitivity of agriculture has been one of the constraints holding back the round's progress.

Although Korea stands to gain from liberalization in agriculture because it has some of the highest food prices in the world, being a net importer of food means that Korea has limited potential offensive interests in the round. This is where Korea's FTA policy comes into play. Should the Doha round ultimately fail to produce an agreement or produces a minimalist agreement that addresses little in terms of manufacturing or services liberalization, Korea's FTA policy will have provided it a means by which to address these deficiencies at the multilateral level.

Korea is a resource-poor county. Not only is it a net importer of food, but, because of its limited endowment of natural resources, it imports many of the raw materials it needs to produce the finished goods it exports and the energy it needs to run its economy. To meet these needs, Korea requires an FTA policy that will not only spur greater economic competitiveness

within its economy and provide it access to markets for its industrial goods, but it should also open markets that can supply needed resources and energy for Korea's economy.

Although Korea could undertake unilateral liberalization in regard to its natural resources requirements, which would likely entail minimal political costs in Korea, Korea would also be missing an opportunity. Unilaterally reducing or eliminating tariffs on natural resources would be of clear benefit to Korea's economy, but doing so would not provide reciprocal access for Korea's finished goods in those markets. By undertaking this process through a series of FTAs, Korea maintains the political leverage it needs to open up additional markets for its producers.

There are also domestic political gains for Korea in undertaking a piecemeal approach rather than waiting for multilateral liberalization or engaging in unilateral liberalization. When Korea began negotiating the KORUS FTA, one of its stated goals was to use the KORUS FTA to aid in liberalizing its service industry. As several academics have pointed out, Korea could achieve the same goal at a lower cost by unilaterally liberalizing its service industry. However, this approach does not take into consideration the domestic political costs of unilateral liberalization.

By tying the liberalization to its negotiations with the United States, Korea was able to achieve two important objectives. First, it was able to introduce competition into its service industry in a controlled manner, which will allow domestic providers a better chance to adopt international standards and techniques while adjusting; and, second, it lowered the domestic political cost of any reforms in the service industry by tying them to wider benefits in other parts of the economy.

As part of this process, Korea has completed, begun negotiations, or proposed negotiations with 19 other countries or regional groups (*Table 2*). In terms of Korea's stated aims, its agreements with the United States, the EU, India, and others clearly meet its criteria of seeking out partners with advanced or

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6. "Korea's FTA Policy," Document no. 3 (Seoul: Ministry of Foreign Affairs and Trade, 15 June 2007), [www.mofat.go.kr/english/econtrade/fta/issues/index.jsp](http://www.mofat.go.kr/english/econtrade/fta/issues/index.jsp).

**Table 2: Korea's Free Trade Agreements, January 2008**

Status of FTAs	Countries
Implemented or concluded	ASEAN Chile EFTA Singapore United States
Under negotiation	Canada EU GCC India Japan Mexico
Potential or agreed to negotiate	Australia China Israel MERCOSUR New Zealand Peru Russia SACU

Note: ASEAN = Association of Southeast Asian Nations, EFTA = European Free Trade Association, EU = European Union, GCC = Gulf Cooperation Council, MERCOSUR = Mercado Comun del Cono Sur (Southern Common Market), SACU = Southern African Customs Union.

promising economies. Korea is considered to have a high standard for FTAs, and it is meeting its other goal by conducting multiple negotiations. Korea has also conducted a major educational outreach program to build domestic support for the KORUS FTA.

Korea's FTA policy, however, clearly shows aspects that move beyond its overarching structure. These include political and security considerations, gaining access to the natural resources its economy requires, ensuring it has market access for key producers, and encouraging domestic economic reforms that are needed to keep Korea competitive in an increasingly dynamic world.

### ***Strategic Foreign Policy Considerations***

Foreign policy and international politics have always played a role in trade policy, with nations using trade pacts as parts of their alliances to strengthen their allies. Some modern-day agreements may be used to encourage reforms in allied nations, as the U.S. agreements in the Middle East are used, but the hard political reality is that it is politically easier to conclude agreements with allies. In the case of Korea, this aspect

played a prominent role in the KORUS FTA. One of the stated objectives on both sides was to broaden and deepen an alliance that, although it has been a long and beneficial one, has been generally acknowledged in recent years to be showing signs of strain. Shoring up this important alliance in a key part of the world was a prominent concern for both sides.

### ***Market Access***

The Korean economic miracle of the last half of the twentieth century occurred under an export-driven economic strategy, and, although Korea's economy has undergone significant liberalization, exports continue to play a significant role in Korea's economy. For export-driven industries to continue to flourish, Korea needs to ensure that its producers have market access at the best possible terms in key economies. As China continues to move up the production chain and Korean firms increasingly find themselves in competition with China, this has become a more prominent concern. During the KORUS FTA negotiations, Korean officials and U.S. business interests continually stressed the loss of market share by both sides to China in their respective domestic markets, and they emphasized that the KORUS FTA was an opportunity to regain that market share. Only time and other market trends will determine whether this is the case, but it does underline the political need to ensure the best possible access in the world's most attractive markets.

The United States remains the world's largest consumer market, and the EU is Korea's second-largest trading partner. In a strategic sense, Korea has not experienced the same success in selling automobiles in the EU that it has in the United States, adding to the potential of a Korea-EU FTA. By concluding FTAs with China, India, MERCOSUR, ASEAN, Canada, and Mexico, Korea would have agreements with most of the world's most significant markets.

### ***Import Effect***

Among trade topics, imports have a negative connotation in the political discussion. From a political perspective, countries seek to enhance the ability of their industries to export products, while they strive to limit the ability of competitors to penetrate their markets. To successfully export heavy industrial products such as steel or high-tech products such as Samsung

phones, however, Korean firms must have access to the raw materials and energy needed to produce these products.

Korea has limited natural resources and is dependent on other countries to meet its energy, resource, and food needs. At a time when oil has quadrupled in price and other natural resources are at all-time highs, FTAs can serve as a means to both ensure access to available resources and reduce the costs to industry.

In light of Korea's resource needs, it is not surprising to see nations that can play a significant role in meeting those needs on Korea's list of prospective FTA partners. Korea's current FTA plans call for it to conclude FTAs with energy-rich nations such as Russia, the GCC, and Canada, while also concluding agreements with other resource-rich partners such as MERCOSUR, Australia, and the South African Customs Union. In addition, it would have FTAs with some of the world's prime agricultural producers in the United States, Australia, and New Zealand.

### ***Internal Domestic Economic Reforms***

From the start of negotiations with the United States, Korea has been open about its desire to pursue domestic economic reforms through its FTA with the United States. Of all of the Organization for Economic Cooperation and Development (OECD) countries, Korea has the least-developed service sector and a highly inefficient agricultural sector. One of the goals of the KORUS FTA has been to open Korea's service industry, specifically the financial services sector, to competition with U.S. firms in the hopes of further developing its service sector and encouraging foreign investment that would bring needed managerial knowledge to boost the sector's international competitiveness. An FTA with the EU, the world's other leading service economy, would also clearly aid in advancing this goal.

By taking the bilateral trade route in addition to the Doha round, Korea will enable itself to better construct a trading system that meets the needs of its economy, while ensuring that it secures market access that will likely go beyond the liberalization of the Doha round in manufacturing and services. As the Doha round continues to stall, Korea is essentially pursuing a parallel trading system that meets its needs and aids

Korea in reaching other domestic and political goals as it encompasses more than 90 percent of global GDP in its parallel system. This new Korean trading system has the added benefit of allowing Korea to protect its rice industry as it moves toward greater overall liberalization in agriculture, industrial goods, services, and investment provisions. This is a key component, for it would not be politically possible to push an aggressive FTA agenda in Korea if the rice sector were to be liberalized. In the long run, however, the key for Korea will be to create a system with a set of largely similar agreements.

### ***The Early Results on Korea's FTAs***

Because Korea did not conclude its first bilateral FTA until 2003, it does not have a track record of a nation such as the United States on the benefits of bilateral FTAs. However, the early figures on exports to Chile, Korea's first FTA partner, have been especially strong, with exports increasing by nearly 50 percent or exceeding it in the first three years. Since the establishment of the FTA with Singapore, Korea has seen export growth to Singapore of around 25 percent per year. Trade with countries of the European Free Trade Association, for which Korea has FTA data for only one year, has not seen growth in Korea's exports. While Korea's FTAs have been successful on the whole, they have also provided Korea with valuable negotiating experience to prepare it for future negotiations with the United States. This is especially the case with Chile and Singapore, both of which already had FTAs with the United States.

### **A Different Type of FTA**

One unique characteristic of many of Korea's FTAs is their inclusion of the South Korean industrial complex in the North Korean city of Kaesong. The Kaesong industrial complex is an outgrowth of Korea's policy of engagement toward the North. It is also a hard-headed recognition of the fact that, should the regime in North Korea collapse or peaceful reunification occur in the near future, North Korea's economy is significantly lagging in comparison with the South Korean economy. In light of the high level of disparity between the two nations' economies, Korea initiated the Kaesong project, along with others, to begin the process of introducing aspects of a market economy into North Korea and beginning the work of reform-

ing the North's economy. The high costs experienced in the reunification of East and West Germany have led South Korea to conclude that improving the North Korean economy may be the only means by which South Korea can bear the costs of reunification, absent significant sums of outside aid.

Although access for goods from the Kaesong industrial complex was included in Korea's initial FTAs, including this provision in additional agreements has led to political difficulties. The KORUS FTA does not directly include access for goods from Kaesong; instead it includes provisions for a committee that will determine under which conditions goods from Kaesong would be permissible under the agreement. Even then, should those criteria be met, Korea's National Assembly and the U.S. Congress would need to approve an amendment of the agreement to include goods from Kaesong. The EU has also expressed reservations about including goods from the complex in its deal with Korea.

### **Speed Bumps along the Road**

Korea's ability to conclude all of its proposed FTAs, should it ultimately pursue them, will largely rest on a wide range of factors. Negotiating an agreement is only half the process, as the KORUS FTA demonstrates. Political constraints, in terms of the concessions that Korea or its prospective partners can make, also impact the outcome of the deal and when it can be implemented.

With respect to the KORUS FTA, a series of interwoven political constraints hinder the agreement's approval in the legislatures of both countries. Even before the agreement's negotiation, disputes relating to U.S. beef and autos were the two most politically sensitive issues. Although it is unlikely that the concerns of the U.S. auto industry and United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) regarding the agreement's provisions on autos can be resolved, hope remains that an agreement can be reached on the resumption of both boneless and bone-in U.S. beef exports to Korea. Korea, however, faces vocal opposition from some domestic groups

regarding the safety of U.S. beef. All of this is made more complicated by elections in the United States and Korea, which potentially limit the possibilities for passage, should the beef issue be resolved, to the first half of 2008 in the United States and after Korea's National Assembly elections in April 2008.

The EU negotiations, while ongoing, are largely tied up in some of the same concerns that the United States has regarding the level of openness in Korea's automobile market. Negotiations with Canada have been drawn out, with autos also being one of the areas of contention. With a renewed push on both sides to finish the Korea-Japan FTA, its prospects will largely hinge on Japan's ability to go beyond its previous position on agricultural liberalization unless the incoming Lee administration decides that the agreement is too strategically important in helping to mend relations between the two countries to let agriculture stand in the way. An agreement with China makes significant strategic sense in regard to Korea's aspirations to be a hub in Northeast Asia and in political and economic terms, but domestic concerns could arise over giving one of Korea's primary competitors preferential access to Korea's market, especially because Korea's and China's economies are more competitive than complementary.

### **Long-Term Prospects**

President Lee ran as a pro-business candidate who would place greater emphasis on increasing the nation's economic growth rate. The centerpiece of his platform included the 747 pledge on the economy: 7 percent annual GDP growth,<sup>7</sup> \$40,000 per capita income, and the 7th largest economy in the world—an ambitious goal that will require a significant amount of economic reform to realize.

To achieve the 747 pledge, Korea will need to implement a series of economic reforms, of which additional FTAs can be one component. With that in mind, President Lee has expressed support for the quick passage of the KORUS FTA and for Korea's proceeding with agreements with China, Russia, and Japan. Although any new administration is bound to undertake a policy

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7. President Lee's team subsequently pared back the target for GDP growth during his first year in office: from 7 percent to 6 percent.

review, it seems unlikely that Korea would pull back from its FTA push during the Lee administration.

As Korea continues its FTA push, the high level of its FTAs will be one advantage it will have in moving toward becoming Northeast Asia's FTA hub. There is a certain geostrategic logic to Korea's becoming the region's FTA hub. Korea has often been described as a shrimp trapped between two whales, yet Korea as the nexus for trade in Northeast Asia could help to stem any long-term concerns and mitigate any potential rivalry for such a role between China and Japan. China and Japan, with their relative economic strengths, would be unlikely to see such a development as threatening their regional positions.

The question is not whether Korea has the economic weight to be the focal point of a regional economic system but whether, through its fast-paced FTA policy and economic liberalization, Korea can serve as a catalyst for a regional system of rules that both maintains the openness of the region and serves as a force for regional economic stability.

## **Conclusion**

Korea's FTA policy has the potential to create a free trade area that will address the needs of the Korean economy for rest of this century. If Korea is to remain competitive internationally, it must continue to move up the production ladder and, more specifically, move headlong into the services industry as other developed nations have. A review of Korea's prospective FTA partners and the goals it has given for some of those agreements shows that Korea is clearly using its FTAs to help address this issue as well as other strategic issues. If Korea successfully concludes FTAs with all of its prospective partners, it will have agreements with nations or regional trading blocs that represent more than 90 percent of the world's GDP. This will present an immense opportunity for Korean producers and for Korea's FTA partners as well.

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