

Is the ASEAN-Korea Free Trade Area (AKFTA) an Optimal Free Trade Area?

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Abstract

Since the Asian currency crisis of 1997-1998, there has been an unmistakable loss of momentum and self-confidence among the once high-flying economies of East Asia. Korea, Thailand, Indonesia, Malaysia and the Philippines were hit the hardest by the crisis, but the region as a whole realized its economic vulnerability to external forces. This realization fostered a greater sense of economic regionalism, which, in turn, provided a strong impetus to regional economic integration. The Chiang Mai Initiative (CMI) of the ASEAN+3, which represents the ten Southeast Asian countries of ASEAN plus the big Northeast Asian economies of China, Japan and Korea, is an important and concrete example of this newly found economic regionalism.

In particular, the governments of the region increasingly view the promotion of intra-regional trade, along with strengthening domestic demand, as an important means of reducing heavy dependence on extra-regional trade as an engine of economic growth. For example, the ASEAN-China Free Trade Area (ACFTA) initiative seeks to eventually create the world's biggest free trade area in terms of population. Another significant initiative in this context is the ASEAN-Korea Free Trade Area (AKFTA), for which the two sides began negotiations in February 2005. Our central objective is to examine the economic feasibility and desirability of AKFTA. To do so, we use the conventional theory of economic integration based on the theory of customs union.

Viner pioneered the theory of customs union, the forerunner of the theory of economic integration. Regional economic integration is a process whereby various economies of a region undergo a progressive removal of the barriers to free movement of goods, services, capital and labor. Reduction or removal of tariffs and non-tariff barriers among the economies of a region will obviously promote economic integration within the region by facilitating the flow of goods.

Whether a customs union is beneficial depends on whether the magnitude of trade creation is greater or less than trade diversion. The following factors are relevant in answering this critical question. All of them are static in the sense that they are considerations which help us to compare the one-shot change in welfare due to a customs union – before and after its formation. Those factors do not emerge or change with the passage of time. More specifically, a custom union is more likely to raise rather than reduce welfare

- the larger the size of the common market
- the higher the pre-union level of tariffs among members, and the lower and the less disparate the pre-union level of tariffs against non-members
- the greater the pre-union level of intra-regional trade
- the more similar the levels of per capita income and economic development
- the closer the members are geographically and the better the transportation infrastructure
- the greater the substitutability between products of member states and products of non-member states
- the smaller the pre-customs union share of extra-regional trade in total trade
- the more complementary the economic structures of the member states.

The following is the central question we address in our paper – “Do the theoretical considerations we have discussed above bode well for the success of AKFTA?” Broadly speaking, economic integration between ASEAN and Korea at this stage means more trade between the two sides. At this stage, ASEAN-Korea trade is largely between the richer ASEAN inner core – Indonesia, Malaysia, Philippines, Singapore,

Thailand and Brunei – and Korea. However, we can expect the poorer ASEAN periphery of Cambodia, Laos, Myanmar and Vietnam to also benefit substantially from AKFTA as their economies and trade grows in the future. In particular, the Vietnamese economy has been growing very rapidly in recent years. A single market for goods, services, capital and labor like the EU remains a distant vision for ASEAN and Korea. The next realistic stage in economic integration is to move steadily toward a free trade area. Therefore, we look at the various static factors that impinge upon AKFTA's ability to become an effective mechanism for promoting mutually beneficial trade between ASEAN and Korea. We have already looked at the criteria which theoretically favor the creation of a customs union in the preceding section and we examine the extent to which AKFTA would satisfy those criteria.

All in all, in terms of static considerations from economic theory, there are grounds for both optimism and pessimism about the success of AKFTA. In particular, the large and growing level of pre-AKFTA trade between ASEAN and Korea suggests that AKFTA will yield substantial economic benefits for both ASEAN and Korea. Other positive factors include the large size of the AKFTA market and relative geographical proximity between ASEAN and Korea. On the other hand, the two sides' dissimilar income levels, limited substitutability between AKFTA imports and non-AKFTA imports, and inadequate transportation infrastructure are causes for pessimism about AKFTA's prospects. Finally, it is unclear whether the economic structures of ASEAN and Korea will become complementary after AKFTA. Nor is it clear whether the current structure of tariffs in ASEAN and Korea will lead to more trade creation or diversion. On balance, our examination of the extent to which AKFTA satisfies the theoretical criteria for integration provides some, but not overwhelming, support for AKFTA's prospects as an effective means of promoting trade between ASEAN and Korea.

There are also dynamic economic considerations and non-economic considerations that bode well for AKFTA's prospects. In particular, AKFTA can help to bring about significant dynamic improvements in the productivity and efficiency of both Korea and the ASEAN economies by subjecting them more fully to competitive pressures from each other. Re-allocation of resources toward more productive activities will enable both Korea and the ASEAN economies to compete more effectively in the global economy in the long run. Furthermore, there are no serious political obstacles to closer economic cooperation between the two sides. To the contrary, their shared sense of vulnerability to the Chinese and Japanese giants may draw them closer.

1 Introduction

Korea and the ASEAN countries of Southeast Asia have been integral parts of the East Asian Miracle that has transformed the region from a group of typical poor Third World countries into the world's most dynamic group of economies. More precisely, Korea and the ASEAN-4 of Indonesia, Malaysia, Singapore and Thailand have achieved sustained rapid growth in the postwar era along with Japan, Taiwan and Hong Kong to put East Asia on the world map as an economic powerhouse. Korea and Singapore are newly industrialized economies along with Taiwan and Hong Kong. Malaysia, Thailand and Indonesia have also transformed themselves from stagnant agricultural economies to dynamic manufacturing economies. The eight East Asian Miracle countries, including Korea and the ASEAN-4, shared a number of common elements, such as sound macroeconomic policies, high savings and investment rates, and heavy investments in education. Above all, the remarkable success of those countries was based on export-oriented industrialization and is thus a powerful tribute to the potential benefits of globalization.

The same globalization that served those countries so well turned against them with ruthless force in the Asian financial crisis of 1997-1998. The massive capital inflows that helped to fuel the rapid economic growth of the region wreaked financial havoc as they suddenly flowed out of the region as foreign investors suddenly lost confidence in the region beginning with Thailand's forced devaluation in May 1997. The turmoil in the financial markets soon spread to the real economy and brought about a sharp contraction of output. Only huge financial assistance packages coordinated by the International Monetary Fund (IMF) for Indonesia, Korea and Thailand restored financial order and stability. While there is a lot of passionate debate about the causes of the crisis, it is likely that a combination of external and

internal factors played a role. What is beyond doubt is that the Asian financial crisis served as a painfully clear reminder that globalization entails not only opportunities but risks as well. Furthermore, there has been an unmistakable loss of momentum and self-confidence among the region's once high-flying economies.

There is a widespread perception throughout the region that external forces such as investors from the US and Europe were largely responsible for the Asian crisis. In addition, many East Asians criticized the IMF, which they view primarily as a Western institution guided by Western interests, for the way it handled the crisis. Regardless of their accuracy, such perceptions gave rise to a region-wide sense of vulnerability to and suspicion of external forces, which, in turn, fostered a resurgence of economic regionalism and gave a strong impetus to regional economic integration. Park (2006), Harvie, Kimura and Lee (2005), Asian Development Bank (2005), Ahn, Baldwin and Cheong (2005), Moon and Andreosso-O'Callaghan (2005), and Lincoln (2004) provide overviews of East Asian economic regionalism in the post-crisis period. In the immediate aftermath of the Asian crisis, the focus of economic regionalism lay in promoting regional financial cooperation, best exemplified by the Chiang Mai Initiative (CMI) among the ten ASEAN countries, China, Japan and Korea. The focus of regionalism is more recently shifting toward the expansion of intra-regional trade. The governments of the region increasingly view the promotion of intra-regional trade, along with strengthening domestic demand, as an important means of reducing heavy dependence on extra-regional trade as an engine of economic growth.

A concrete example of the region's active promotion of intra-regional trade is the ASEAN-China Free Trade Area (ACFTA) initiative, which seeks to eventually create the world's biggest free trade area in terms of population by 2010. A number of

bilateral free trade agreements, such as those Singapore has concluded with Korea and Japan, are also aimed at increasing trade among the region's countries. Another significant initiative in this context is the ASEAN-Korea Free Trade Area (AKFTA), which is the subject of our paper. ASEAN and Korea began negotiations for the AKFTA in February 2005, and in May 2006 the two sides signed a free trade agreement leading to a free trade area by 2016, although Thailand did not sign due to the exclusion of rice from the agreement. Korea is the world's eleventh largest economy and the ASEAN collectively is also a large economy so greater economic cooperation can yield significant benefits for both sides. Furthermore, both Korea and ASEAN are facing many common challenges in the post-crisis period, such as growing competition from China for manufactured exports and foreign direct investment, which further strengthens the case for economic integration between the two sides.

While economic integration refers to the removal of barriers to the cross-border flows of goods, services, capital and labor, economic integration between ASEAN and Korea realistically means more trade between the two sides before they can contemplate moving toward deeper levels of integration. The central objective of our paper is to examine the extent to which theoretical economic criteria favor AKFTA's prospects. That is, our central question is whether AKFTA is an optimal free trade area in the sense that it is likely to be mutually beneficial for ASEAN and Korea from a purely economic viewpoint? To address this question, we use the theory of economic integration based on theory of customs union pioneered by Viner (1950), according to which whether a free trade area is beneficial depends on a number of economic factors which are static in the sense that they help us to compare the one-shot change in welfare due to a free trade area – before and after its formation. In

addition, dynamic economic factors and non-economic factors are also relevant in assessing a FTA. In this paper, we look at static economic factors as well as those additional factors in considering AKFTA's potential benefits for ASEAN and Korea.

2 Theory of Economic Integration

In this section, we define economic integration and review the theoretical considerations behind economic integration. In particular, we look at the factors that make integration theoretically feasible and desirable.

2.1 Definition of Economic Integration

Viner (1950) pioneered the theory of customs union, the forerunner of the theory of economic integration. Regional economic integration is a process whereby various economies of a region undergo a progressive removal of the barriers to free movement of goods, services, capital and labor. Reduction or removal of tariffs and non-tariff barriers among the economies of a region will obviously promote economic integration within the region by facilitating the flow of goods. Likewise, reduction or removal of restrictions and controls on the international flows of services, capital and labor reinforces regional economic integration. In the EU, the Maastricht Treaty of 1992 established, in principle, free movement of goods, services, capital and labor in Western Europe. EU is at the most advanced stage of international integration. Baldwin and Wyplosz (2006), De Lombaerde (2006), El-Agraa (1999), Jovanovic (2006, 2005), and Robson (2006) provide overviews of economic integration theory.

2.2 Types of Economic Integration

There are different types or stages of economic integration. Countries usually start off at a lower level of integration and move on to higher levels of integration if and when conditions become more appropriate. Broadly speaking, there are six types of economic integration:

- Preferential Trade Agreement (PTA) is the most basic form of economic integration. It imposes lower tariffs on imports from member countries than third countries.
- Free Trade Area is an agreement among countries whereby tariffs and non-tariffs barriers (NTBs) such as quotas, licensing and product safety regulations are abolished among members. However, each member retains its external tariffs and other regulations for trade with non-member countries. AKFTA is essentially a free trade area in progress.
- In a customs union, member states abolish all tariffs and quantitative restrictions on trade among member states. At the same time, they impose a common set of tariffs for trade with non-member states.
- A common market involves a customs union as well as free movement of factors of production such as capital and labor. The European Union (EU) has been a common market since the Maastricht Treaty of 1992.
- In an economic union among countries, in addition to a common market, there is also harmonization of fiscal, monetary, industrial and other economic policies. An example is the monetary union, which came into existence on 1 January 1999 among eleven members of the EU.
- The highest degree of economic integration is a supranational union. Member governments hand over their sovereignty for economic and social policies to a supranational government. A supranational union is unlikely since nations are generally reluctant to surrender their sovereignty.

In the context of AKFTA, economic integration realistically means the expansion of trade between ASEAN and Korea. The ultimate aim of economic integration is to remove all barriers to the movement of goods and services, capital and labor between

Korea and the ten ASEAN states. At this stage, however, economic integration between ASEAN and Korea is in its infancy and the realistic next step forward is the removal of most impediments on trade. In other words, before ASEAN and Korea can even contemplate more advanced stages can be even contemplated, they should concentrate on facilitating the flow of goods and services between the two sides.

3.3 Theory of Customs Union

The salient features of a customs union are:

- Elimination of tariffs and quantitative restrictions on imports from member states.
- Imposition of common external tariffs on imports from third countries.

The difference between a customs union and a free trade area is that in the former there are common external tariffs against non-members as well as free trade whereas in the latter, each member retains its own tariffs against non-members. It is thus possible to view a free trade area as a variant of the customs union or vice versa. What is important for our purposes is that the theory of customs union provides the basic theoretical framework for analyzing free trade areas despite the two are not the same.

(a) Partial Equilibrium Model

The potential benefit of a customs union is increased specialization and trade. There are both positive and negative effects in terms of welfare implications. The positive effect, trade creation, means the replacement of higher cost domestic products by lower cost imports from member countries. The change from an expensive to a cheaper source of supply is beneficial since it is a move towards freer trade. A more efficient foreign producer replaces a less efficient domestic producer. For example, in the case of AKFTA, Malaysia may be better off by importing automobiles from Korea instead of producing them locally and Korea may be better off by importing some electronics components from Malaysia rather than producing them locally.

Trade diversion, on the other hand, refers to the replacement of low cost imports from non-member countries by higher cost imports from member nations. This diversion occurs because non-members face higher tariffs than members of the customs union. The differential tariff treatment diverts trade away from non-members toward members. Trade diversion has an adverse affect on welfare since it implies a shift toward a more costly source of supply. In this sense, it is a move toward protectionism and away from free trade. For example, in the case of an ASEAN-Korea customs union, Korea may be worse off by importing primary commodities from Indonesia rather than Australia.

Whether there will be any net gain from a customs union depends on which effect is larger. In other words, the formation of a customs union can be seen as simultaneously moving towards both freer trade and greater protectionism. The net effect on welfare will be positive, negative or neutral depending on the relative magnitudes of trade creation and trade diversion. If the trade creation effect outweighs the trade diversion, welfare will rise. Otherwise, the formation of a customs union will do more harm than good for its members.

(b) Static Factors

As we have just seen, whether a customs union is beneficial depends on whether the magnitude of trade creation is greater or less than trade diversion. The following factors are relevant in answering this critical question. All of them are static in the sense that they are considerations which help us to compare the one-shot change in welfare due to a customs union – before and after its formation. Those factors do not emerge or change with the passage of time. More specifically, a custom union is more likely to raise rather than reduce welfare

- the larger the size of the market

- the higher the pre-union level of tariffs among members, and the lower and the less disparate the pre-union level of tariffs against non-members
- the greater the pre-union level of intra-regional trade
- the more similar the levels of economic development
- the closer the members are geographically and the better the transportation infrastructure
- the greater the substitutability between products of member states and products of non-member states
- the smaller the pre-customs union share of extra-regional trade in total trade
- the more complementary the economic structures of the member states.

(c) Dynamic Factors

In addition to static factors, there are also possible dynamic benefits resulting from the removal of trade barriers and the restructuring of the economy associated with the creation of a customs union. These factors are different from static factors because they do not pertain to one-shot changes in welfare but gradually emerge over time instead. For example, we can expect the firms and industries of a country more exposed to competition from its neighbors after the formation of a customs union to become more efficient, but those efficiency gains will not be realized overnight.

Dynamic factors are difficult to measure and often overlooked. They include

- greater competition and hence an improvement in efficiency
- gains from greater specialization, economies of scale and learning-by-doing
- reduction of intra-regional transactions costs
- some protection from adverse developments in the world markets
- bargaining power vis-à-vis industrialized countries.

Against these potential dynamic benefits, we must also consider the dynamic cost of polarization. Integration among countries with different level of income and economic development could lead to an unequal distribution of gains. The more developed and advance nations tend to gain more than the less developed nations, and this may breed tension and resentment among the latter. More generally, setting aside differences in levels of income and development, any perception that the benefits or costs of integration are disproportionately falling upon a country or a subset of countries is likely to produce a backlash which will threaten the viability of the union over time.

2.4 Non-Economic Factors

Besides the largely economic criteria discussed in previous sections, there are a large number of non-economic factors which determines the success or failure of economic integration. The experience of EU highlights the central role of such non-economic variables in economic integration. Some examples are a common desire to put an end to violent conflicts, a shared feeling of vulnerability, a shared goal of achieving power equity between countries in the region, and political leaders who realize that there are common problems which require common solutions. By far the most important non-economic variable is political leadership seriously committed to integration and cooperation. That is, the success of integration requires a strong dose of political will in the member states. It is doubtful whether the present success of the EU and, to a lesser extent NAFTA, would have been possible without strong political will within the governments involved. By the same token, the political commitment of the governments of both ASEAN and Korea is a pre-condition for the success of AKFTA. The political commitment, in turn, depends to a large extent on whether it is in the geopolitical self-interest of both sides to strengthen their overall relationship. A key channel for strengthening the overall relationship between ASEAN and Korea is

to strengthen trade their bilateral trade through AKFTA.

3 Prospects of AKFTA

We now ask ourselves the following fundamental question – “Do the theoretical considerations discussed in the preceding section favor the success of AKFTA?” To repeat, economic integration between ASEAN and Korea at this stage essentially means more trade between the two sides. ASEAN-Korea trade is currently primarily between the richer ASEAN inner core – Indonesia, Malaysia, Philippines, Singapore, Thailand and Brunei – and Korea. However, Korea’s trade with the poorer ASEAN periphery of Cambodia, Laos, Myanmar and Vietnam is also growing rapidly, in particular with fast-growing Vietnam. A common market like the EU remains at best a long-term goal for ASEAN and Korea. The next realistic stage in their economic integration is to move steadily toward a free trade area.

3.1 Static Economic Factors

Here we look at the various static factors that impinge upon AKFTA’s ability to become an effective mechanism for promoting mutually beneficial trade between ASEAN and Korea. We have already examined the criteria which theoretically support the creation of a customs union and we now apply those criteria to AKFTA to evaluate its prospects for success.

(a) Size of Free Trade Area (FTA)

The theory of customs union suggests that the larger the collective economic size of the free trade area, the larger the potential trade creation. While AKFTA is much smaller than the NAFTA or EU in terms of economic weight, it is by no means an economic lightweight. ASEAN comprises 10 countries with a combined 2003 population of around 537 million people and a combined 2003 gross national income (GNI) of US\$648.5 billion. Korea’s 2003 population was 48 million and its 2003 GNI

was US\$576 billion. Therefore, the 2003 population of AKFTA is 585 million and the 2003 real GNI of AKFTA is US\$1,224.5 billion. In purchasing power parity (PPP) terms, AKFTA is even bigger at US\$3,042.8 billion – Korea’s PPP GNI is US\$859 billion and ASEAN’s PPP GNI is US\$2,183.8 billion. Although there are no well-defined objective criteria concerning the size of the free trade area, AKFTA does appear to pass the test in this regard.

(b) Pre-FTA Tariff Structure

High initial tariffs between FTA members imply a large potential for trade creation. Due to tariff reductions under the ASEAN Free Trade Area (AFTA) framework, the tariff rates for intra-ASEAN trade are low and falling, with zero tariffs targeted for 2010. Despite a general trend toward trade liberalization in both Korea and ASEAN, especially the WTO members of the ASEAN inner core, under the multilateral WTO system, tariffs and non-tariff trade barriers between the two sides remain high enough to create significant opportunities for trade creation. For example, for political reasons, Korea has relatively high tariff rates against agricultural goods, which are a major export of ASEAN countries such as Thailand and Vietnam. Likewise, ASEAN countries that have sizable automobile industries, such as Thailand and Malaysia, have relatively high tariff rates against automobiles, a major Korean export.

Second, the higher the level and variance of tariffs against non-members, the larger the possibility of trade diversion. According to WTO (2005), for both agricultural and non-agricultural goods, the simple average of ad valorem tariff rates of Korea, Indonesia, Malaysia, the Philippines, Singapore and Thailand as of 2004 are 11.2%, 6.9%, 8.4%, 6.3%, 0.0% and 15.4%, respectively. For agricultural goods, the average rates of Korea, Indonesia, Malaysia, the Philippines, Singapore and Thailand as of 2004 are 41.6%, 8.2%, 3.3%, 9.5%, 0.0% and 29.6%, respectively. For non-

agricultural goods, the average rates of Korea, Indonesia, Malaysia, the Philippines, Singapore and Thailand as of 2004 are 9.5%, 6.7%, 9.1%, 5.8%, 0.0% and 6.7%, respectively. There is also a wide variance in the tariff rates of the ASEAN countries and Korea for different specific product categories. Therefore, the structure of AKFTA's tariffs against outsiders does not rule out significant trade diversion.

(c) Pre-FTA Intra-FTA Trade

The trade creation effect is stronger the greater the size of the pre-FTA trade. The underlying intuition is simple – countries that trade heavily with each other stand to gain the most from eliminating the impediments to trade. By the same token, removing trade impediments will be of limited value to those who trade little with each other. ASEAN and Korea are already important export and import markets for each other. In 2004, ASEAN's exports to Korea and imports from Korea reached US\$22.4 billion and US\$24 billion, respectively. ASEAN has become Korea's fifth largest trading partner and vice versa. ASEAN's exports to Korea accounted for around 4% of its total exports and imports from Korea accounted for around 5% of its total imports in 2004. Korea's exports to ASEAN accounted for around 9.5% of its total exports and imports from ASEAN accounted for around 10% of its total imports in 2004. Moreover, the ASEAN-Korea trade is not only substantial but also growing rapidly, rising from US\$46.4 billion in 2004 to US\$53.5 billion in 2005. The bilateral trade grew by a further 18% during the first three months of 2006. Both Malaysia and Singapore are among Korea's top ten trading partners. At the same time, Korea is a big and increasingly important trading partner for all the individual ASEAN economies. Our discussion suggests that the level of trade between ASEAN and Korea is large enough to generate significant benefits from the removal of trade barriers

(d) Substitutability of Products

Substitutability of products of member states for those of non-member states increases the chances of trade creation. Substitutability refers the production of similar but differentiated products. For example, Malaysia can theoretically substitute semi-conductors from Taiwan with similar but slightly different semi-conductors from Korea. In practice, although Korea and the ASEAN economies now export some broadly similar goods, most notably in the electronics industry, the range of substitutable products remains relatively small. While ASEAN's trade with Korea is large and growing, most of ASEAN's exports go to other markets and most of its imports come from other markets. ASEAN's biggest export markets are the US, EU, Japan and China while its biggest import markets are Japan, US, EU and China. Likewise, most of Korea's trade is with economies outside ASEAN, its most important trading partners being China, the US, Japan and the EU. Such trade pattern provides stylized evidence suggesting limited substitutability of products. The extent to which Korea and ASEAN can substitute imports from external markets with imports from each other is likely to be limited.

(e) Disparity in Pre-FTA Level of Development

If the pre-FTA levels of income are similar among members, integration will be more beneficial. Similar income levels mean that consumers buy similar baskets of goods and services, increasing the opportunity for intra-industry trade – e.g. Germany and France selling cars to each other. A major reason for the success of the European Union is that all the countries are developed market economies with relatively small disparities in income levels and other structural characteristics. Broadly speaking, if we view the ten ASEAN countries as a single economy, then Korea is significantly ahead of ASEAN in terms of per capita income. Korea's 2003 per capita gross

national income (GNI) was US\$12,020 while ASEAN's 2003 per capita GNI was US\$1,208. In purchasing power parity terms, China's 2003 per capita GNI was US\$17,930 while ASEAN's 2003 per capita GNI was US\$4,067. Therefore, even in purchasing power parity terms, Korea is about four times richer than ASEAN. Only the city-state of Singapore and the small oil-based economy of Brunei have higher per capita incomes than Korea. Among the bigger ASEAN economies, even relatively rich Malaysia and Thailand have PPP per capita incomes that are roughly only 50% of Korea's. The income gap between Korea and the poorer ASEAN periphery is wider still. The income levels of ASEAN and Korea do not seem to be similar enough to provide potential for extensive intra-industry trade.

(f) Geographical Proximity and Transportation Infrastructure

Economic integration usually occurs among countries geographically close countries with lower transportation costs. Geographical proximity is not sufficient for lower transportation costs, which further require a good transportation infrastructure of land, sea and air links. Geographical proximity combined with a high-quality transportation infrastructure has been an important contributor to the extensive trade among EU economies. ASEAN and Korea are not geographical neighbors but separated by the large land mass of China. The flight time between Seoul, the Korean capital, and Singapore, ASEAN's commercial hub, is around six hours. Nevertheless, ASEAN and Korea are much closer to each other than some of their other major trading partners, especially US and the EU. There are no land transport links between ASEAN and Korea in the form of highways or railways. Even if there were such links, their usefulness for ASEAN-Korea trade is likely to be limited in view of the vast distance between the two sides. Of more relevance to ASEAN-Korea trade is the air and sea links, and these are well-developed. There are a large and growing number of

commercial airline flights linking ASEAN and Korea. At the same time, there is extensive commercial shipping activity between ASEAN, in particular Singapore, and main Korean ports such as Pusan. All in all, although there is some geographical distance and absence of land transport links between ASEAN and Korea, relatively good and improving air and sea connectivity place the two sides in a strong position to realize the potential increase in their bilateral trade due to AKFTA.

(g) Complementary or Competitive Economic Structures?

Whether the members' economic structures are complementary or competitive influences the success or failure of a free trade area. The insights of Meade (1955) suggest that the trade creation effect will be stronger if the pre-FTA economic structures are competitive but post-FTA economic structures are complementary. High tariffs and non-tariff barriers may induce FTA members to produce similar goods before the FTA. After FTA, the more efficient producers replace the less efficient ones and the number of similar goods produced falls, resulting in welfare gains associated with specialization and economies of scale. That is, the removal of trade barriers within a FTA allows member countries to take better advantage of their comparative advantage. Korea and the ASEAN economies are competitive to some extent now – trade barriers are high enough to protect inefficient domestic producers from effective competition in selected high-priority sectors such as Korea's agriculture and certain manufacturing sectors in ASEAN. The more significant question is whether ASEAN and Korea will become complementary after AKFTA so that they produce less similar goods than before the FTA, but the answer to this is unclear. Although the rapid growth of ASEAN-Korea trade in recent years does provide some indirect evidence of potential complementarities, such evidence is far from conclusive.

(h) Summary of Static Theoretical Considerations

Our examination of static theoretical considerations suggests that there are grounds for both optimism and pessimism about AKFTA's prospects. Among the positive factors, the large and growing level of pre-FTA trade between ASEAN and Korea in particular suggests that AKFTA will yield substantial economic benefits for both ASEAN and Korea. Additional positive factors include the large size of the AKFTA market, and the good air and sea transportation links between ASEAN and Korea. Among the negative factors, the large income gap between Korea and ASEAN as a whole suggests only a limited potential for intra-industry trade. Additional negative factors include limited substitutability between AKFTA imports and non-AKFTA imports as well as the geographical distance between ASEAN and Korea. Finally, the current structure of tariffs in ASEAN and Korea is conducive for both trade creation and trade diversion, and it is also unclear whether AKFTA will make the economic structures of ASEAN and Korea more complementary. Overall, our application of static theoretical criteria to AKFTA indicates that its prospects are neither decidedly favorable nor unfavorable but mixed and ambiguous.

3.2 Dynamic Economic Factors

Although static benefits are an important motivation for economic integration, potentially large dynamic benefits provide an additional impetus. FTAs realize dynamic benefits from integration gradually realized over a long span of time. Dynamic welfare gains are inherently harder to quantify relative to static welfare gains and are often overlooked as a result. This does not, however, render them any less significant. In fact, if they are large enough, they could conceivably justify economic integration even if the static welfare gains are uncertain or negligible. In particular, we have to take into account the greater competition and improved

efficiency that will create positive welfare gains for both Korea and the ASEAN economies as a result of ACFTA. The Asian financial crisis which engulfed both ASEAN and Korea in 1997-1998 was a blessing in disguise to the extent that it shattered a growing sense of self-complacency and invincibility. As a result, the crisis highlighted the need for both economies to make improve their competitiveness and efficiency. A common challenge facing both ASEAN and Korea as a consequence of globalization is the emergence of and competition from China and India. Fostering greater competition through deeper and broader integration with each other can be highly useful in promoting productivity and efficiency, which is a pre-condition for success in an increasingly competitive global economy.

In fact, dynamic economic considerations seem to be a powerful underlying motivation behind the AKFTA initiative. While both ASEAN and Korea have suffered an unmistakable loss of self-confidence and momentum in the post-crisis period, ASEAN faces a much more urgent need to sharpen its international competitiveness. The reason is that Korea is still substantially ahead of China and India in terms of its position in the manufacturing value chain and therefore less vulnerable to competition from the two emerging giants. By contrast, the technology and skill gap between China and India on one hand and ASEAN on the other is much smaller, leaving ASEAN more vulnerable. Although exports and economic growth are not a zero-sum game, and indeed ASEAN is benefiting from large and growing exports to China and India, there is little doubt that the emergence of China and India poses some challenges to ASEAN in the long run.

ASEAN economies can compete effectively in the global marketplace only by significantly improving their productivity and efficiency. Specific strategies for doing so include investment in human capital, physical capital and technological up-grading.

Such efforts will enable the ASEAN economies to increase their exports of skill-, capital- and technology-intensive exports to the world. Even though Korea is less exposed to competition from China and India than ASEAN, it will also benefit from greater competition with ASEAN in those industries in which both economies are significant producers. Korea's active post-crisis pursuit of bilateral free trade agreements, including AKFTA, reflects to some extent a realization among policymakers and the general public of the need to improve the economy's adaptability and flexibility in light of intensifying global competition. For example, we can expect AKFTA and other free trade agreements to have at least some impact on Korea's traditionally rigid labor markets. The formation of ACFTA may also increase the inflow of FDI into the ASEAN economies and Korea by creating a larger common market from the perspective of outside investors. Foreign multinational companies (MNCs) locating in ASEAN will find it easier to export to Korea and MNCs locating in Korea will find it easier to export to ASEAN.

3.3 Non-Economic Factors

While economic factors are clearly a powerful rationale for economic integration, we cannot ignore the importance of non-economic factors. The political commitment, will and leadership of governments are critical pre-conditions for a successful FTA because it facilitates close cooperation among governments. While ASEAN has often been criticized by many outside observers for being excessively consensual and hence largely ineffective, it has in fact been remarkably successful in promoting effective political cooperation among its member governments. Therefore, to a large extent, ASEAN countries have been able to speak with a single voice in their negotiations with Korea over the formation of AKFTA. As noted earlier, Thailand is a significant exception in this regard due to its objections over the exclusion of rice. In addition,

there seems to be an ASEAN-wide consensus about the desirability and feasibility of AKFTA.

The Korean government for its part views the AKFTA initiative as a means of forging a closer relationship with ASEAN countries. It is important to note that the ASEAN governments and the Korean government enjoy cordial working relationships with each other. There are no serious political or historical obstacles to closer economic cooperation between the two sides. To the contrary, their shared sense of geopolitical vulnerability to the Chinese and Japanese giants may draw them closer to each other. Both ASEAN and Korea have been victims of Japanese military aggression in the 20th century, and both view the rise of Chinese power with at least some concern. In short, ASEAN and Korea share a desire for a multipolar East Asia which is not dominated by China and Japan, and this shared geopolitical objective provides a solid foundation for economic cooperation. AKFTA is thus a central component of ASEAN and Korea's broader efforts to strengthen their mutual relationship, which is consistent with each side's geopolitical self-interest of preventing the regional dominance of China, Japan or both.

The political commitment of both ASEAN and Korean governments to AKFTA is further reinforced by some fundamental economic considerations. From ASEAN's viewpoint, AKFTA represents a mechanism for benefiting from closer economic interaction with a significantly richer and technologically more advanced country that is the world's eleventh biggest economy. Such interaction includes not only the opportunity to expand exports into a big market but also to attract capital and technology from Korean companies. From the Korean viewpoint, AKFTA represents a means of expanding trade with an economically significant region which is already a major trading partner. As such, AKFTA is a means of further diversifying both

export and import markets, and thus reducing the country's reliance on trade with China and the US. We saw earlier that the ASEAN-Korea trade is more or less balanced with each side's exports roughly equaling its imports. This fact makes it politically less difficult for both sides' governments to sell AKFTA to their respective general publics, which tend to view trade surpluses as inherently beneficial and trade deficits as inherently harmful.

AKFTA is clearly an example of a broader regional trend toward closer economic cooperation among East Asian economies in the wake of the Asian crisis of 1997-1998. Whether accurately or not, there was widespread perception in East Asia that the crisis was largely brought about by external, non-Asian speculators. This region-wide sense of victimhood was further reinforced by what many in the region perceived to be the inadequate and untimely response to the crisis by the IMF. As a consequence, the crisis has galvanized regional policymakers into seeking closer intra-regional financial cooperation through the Chiang Mai Initiative. At the same time, the worldwide proliferation of regional trade agreements (RTAs) is encouraging regional governments to pursue RTAs of their own such as AKFTA. East Asia is following the global trend toward the coexistence of the multilateral WTO trade system and RTAs, of countries seeking to expand trade with the rest of the world as well as within their own region. Although the idea of East Asian economic regionalism is hardly new, the twin forces of the Asian crisis and global proliferation of regional trade agreements have given it a greater momentum than ever before.

4 Concluding Remarks

Korea and ASEAN have been part of the East Asian Miracle that has transformed a group of typical poor developing countries into the world's economically most dynamic region through sustained rapid growth. The East Asian Miracle is based on

export-oriented industrialization and thus serves as compelling evidence of the enormous potential benefits of globalization. However, the Asian financial crisis which devastated the economies of ASEAN and Korea in 1997-1998 served as equally compelling evidence of the potential risks of globalization. The crisis led to an unmistakable loss of momentum and self-confidence in the region, and gave rise to a new-found sense of vulnerability to external forces which, in turn, gave rise to economic regionalism. Although the initial focus of post-crisis East Asian economic regionalism lay in promoting financial cooperation through the Chiang Mai Initiative, the focus has gradually shifted to expanding intra-regional trade.

The subject of our paper is the ASEAN-Korea Free Trade Area (AKFTA) initiative, which is a concrete example of East Asia's active efforts to boost intra-regional trade in the post-crisis period. The two sides recently signed a free trade agreement in May 2006 to create a free trade area by 2016. Our central objective is to use the theory of economic integration based on customs union theory to critically examine whether purely economic static considerations are conducive for AKFTA. Our analysis of those considerations suggests that there are grounds for both optimism and pessimism about AKFTA's prospects. For example, the large and growing level of pre-FTA trade between ASEAN and Korea suggests that AKFTA will yield substantial economic benefits for both ASEAN and Korea. On the other hand, the large income gap between Korea and ASEAN as a whole suggests only a limited potential for intra-industry trade.

Although applying static theoretical criteria to AKFTA fails to give us definitive answers about its prospects, taking into account dynamic economic factors and non-economic factors provides some further grounds for optimism. ASEAN and Korea share the common challenge of growing competition from China and India, and more

generally, competing effectively in an increasingly competitive global economy. As such, improving the efficiency of their economies by exposing their firms and industries to greater competition from foreign competitors can bring about significant benefits. AKFTA will thus improve the international competitiveness of ASEAN and Korea by promoting competition and efficiency. In addition, ASEAN and Korea share a common desire for a multipolar East Asia not dominated by Japan and China, and this shared geopolitical objective provides a solid cornerstone for economic cooperation between the two sides, in particular AKFTA.

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