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Free Trade with Korea

Economic and Political Opportunities for Europe

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For the first time ever, the EU is concluding a free trade agreement with an Asian country. After 26 months of arduous negotiations, the Republic of Korea and the EU have agreed on the comprehensive liberalization of their trade and economic relations. The free trade zone between Europe and South Korea will in fact be the second-largest worldwide. Situated at opposite ends of the Eurasian land mass, Europe and the Korean peninsula will come closer through the agreement—both politically and economically. However, there is remarkable resistance to the Korea-EU Free Trade Agreement (KOREU FTA) in some sectors of the European economy, suggesting that ratification is by no means guaranteed. Europe's automotive industry, for example, considers KOREU to be unbalanced. Yet from a broader economic perspective, the agreement should be seen in a positive light. It bears great potential—especially for the German export industry, which has been badly scarred by the financial crisis. From a trade policy perspective, KOREU will send out a positive signal countering the worldwide trend toward protectionism.

Korea is an important trade partner for Europe and for Germany in particular. With an export value of 25.6 billion euros and an import value of 39.4 billion euros, in 2008 Korea was Europe's fourth-largest non-European export market and import source following the US, China, and Japan. Germany accounts for about one-third of all EU-27 exports and one-fifth of EU-27 imports. For Korea, the free trade agreement with the EU is even more important. The EU is Korea's second-largest trade partner, largest foreign investor, and a key technology partner. Korea's tariff and non-tariff trade barriers are also significantly higher than those of the EU, which means that opening up Korea's markets will have much more far-reaching effects. In view of the high foreign trade importance that the EU and Korea possess for each other, it is not surprising that KOREU is currently the largest free trade agreement that either side has ever entered into. It is an ambitious liberalization agenda that goes far beyond tariff cuts: In the opinion of the European Commission, KOREU can potentially act as a model for future free trade agreements between the EU and extra-European trade partners.

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Tariff reduction: transition periods and exceptions

The EU and Korea are entering the process of tariff liberalization from two very different starting points. While the EU's average WTO-bound tariff is 5.4%, Korea's is 17%. And at 5.9% Korea's trade-weighted average tariff for industrial imports from Europe is high as well. In the agriculture sector the Commission has even calculated an average tariff of 35%. In contrast, the EU protects its internal market from Korean competition with lower average tariffs. KOREU calls for drastic tariff reductions on the part of Korea first and foremost. It foresees the almost complete abolition of tariffs in industrial goods trade. Seventy percent of industrial tariffs will be suspended immediately when KOREU comes into force. Three years later 92% will be suspended, after another five years 97%, and after seven years, total exemption from duties will be achieved. Automotive tariffs were the subject of prolonged and intense struggle in this agreement. The compromise foresees removing all tariffs on mid-range and luxury passenger cars with a more than 1,500 cubic centimeter engine after just three years, but only after five years for smaller compact cars.

Compared to the tariff liberalization in industry, liberalization in agriculture is less comprehensive and the transition periods are longer. Because of the very high starting level of tariffs in Korea, drastic tariff reductions will be required in some cases. When the agreement comes into force, the following agricultural products will be exempted from duties: apples, peaches, grapes, fruit juices, wine, olives, tomato puree, cut flowers, chicken, as well as milk and dairy products—the latter in the framework of fixed import quotas. Other foodstuffs and luxury consumables like whisky, olive oil, chocolate, cheese, starch, and pork are subject to considerably longer transition periods of up to 15 years. Rice is completely exempted from liberalization. For a number of other products such as oranges, onions, garlic, pepper, and ginseng, customs duties remain unchanged.

All in all, the agreement will save EU industry and agricultural exporters 1.6 billion euros in duties and Korean exporters 1.1 billion euros. On the European side, the tariff reductions will benefit mechanical engineering (450 million euros), agriculture (380 million euros), and chemistry (180 million euros). It should also be mentioned that the agreement contains a general safeguard clause allowing tariffs to be reinstated for a limited time in case of a sudden surge in imports in order to prevent damage to the domestic economy.

Removal of non-tariff trade barriers

From the point of view of European manufacturers, Korea's high tariffs have always been a burden. But non-tariff trade barriers were seen as the larger and more decisive obstacles to market entry. The non-recognition of international standards; deficiencies in intellectual property right protection and competition law; bureaucratic arbitrariness in granting operating permits, in monitoring environmental rules, in following licensing procedures; and in other areas all add up to a very difficult-to-calculate cost item that has deterred numerous companies from entering the Korean market at all.

One focal point of negotiations has therefore been the removal of technical and administrative market entry barriers through what are known as "sector chapters" for the automotive industry, electronics, chemicals, pharmaceuticals, cosmetics, and wines and spirits. In the electronics sector, it was agreed that Korea's expensive testing and certification processes will be eliminated and that in the future, EU certifications and product tests will suffice. For the pharmaceutical sector, Korea has promised improved transparency in its price-setting process for drugs. Negotiations over the automotive sector were long and contentious. Technical and administrative trade barriers, together with targeted discrimination against foreign suppliers, had caused Korea's automobile import market to remain closed for many years. Even in 2000 the foreign market share in the Korean automobile market was just 0.4%. According to reports by KAIDA, the Korean Automobile Importers and Distributors Association, this share has risen since then to 6% (2008). The European negotiators made it clear that EU tariff protection would only be dismantled if Korea lifted its non-tariff market barriers. The EU Commission succeeded in persuading Korea to recognize international standards for approximately 50 relevant norms and to harmonize another 30 norms with international standards over a period of five years, thereby fulfilling the key demands of the European automotive industry. As a result, European manufacturers will soon no longer have to carry out the expensive tests associated with these norms. Compromise was also reached on the specific, highly symbolic issue of standards for exhaust emissions control for automobile motors (On-Board Diagnostic Systems). Korea will recognize the coming generation of European emissions standards (Euro 6) as soon as they come into force (slated for 2014 at the latest). In the transition period (2010–2013) Korea will accept import quotas on vehicles that were tested with the existing European measurement procedures (Euro 5) despite the fact that these do not meet the stringent Korean exhaust emissions regulations. To prevent Korean authorities from using future regulations to exclude foreign producers from the domestic market, a joint working group will monitor the introduction and implementation of all norms and standards. In a fallback provision Korea has also promised to renounce all market access restrictions in the automobile sector. With a view to the critically important motor vehicle sector in particular, a dispute settlement mechanism has been agreed upon that will work much more quickly and efficiently than the established WTO procedure. The mechanism includes shorter deadlines for conclusion of the arbitration panel ruling (75 instead of 120 days) and for compliance (90 instead of 150 days), as well as more effective use of temporary remedies and retaliatory measures.

Controversial duty drawbacks

KOREU allows both sides to continue the system of duty rebates, which are refunds of import duties paid on products that are subsequently exported or used in the manufacture of exported goods—for example, duties on Chinese components built into Korean exports. The fact that free trade agreements permit duty drawbacks at all is essentially a systematic defect, since it means that imported goods are exempted from tariffs on intermediate products, while domestic suppliers continue to pay duties on the same intermediate products.

After Korea threatened to derail the entire negotiation process over this issue, the Commission made a significant concession by allowing duty drawbacks, thereby departing from its previous position of prohibiting drawbacks in preferential agreements. Two important regulations counteract the incentive such duties provide for using intermediate products from third countries in exports: first, rules of origin set the maximum percentage of foreign content, that is, non-originating input from third countries that can be used without affecting origin. In the automotive and consumer electronics sectors—both of which are sensitive for the EU—the percentage is set at 45%, for motor vehicle parts at 50%. To obtain values for originating materials, either the added-value–content method or the change-in-tariff-subheading method can be used. Second, the agreement contains a safeguard clause mechanism designed to reduce the disadvantages that can arise through duty drawbacks. If there is reason to suspect that the percentage of imported materials in export goods has increased significantly, consultations can be initiated in which the burden of proof lies with the defendant. If grounds for suspicion exist, then the safeguard mechanism comes into force, minimizing the potential negative consequences of duty drawbacks.

Opening up the market for services

One of the EU's main objectives in the negotiations was to open up access to the Korean service market. European-Korean trade in services makes up barely one-fourth of all bilateral goods trade, but has grown much more dynamically in the last few years and is an area in which European companies possess competitive advantages. Furthermore, the EU countries have a surplus in bilateral trade in services with Korea—in contrast to goods trade. The Commission has, in fact, been able to push through market opening and liberalization across the entire spectrum of services. Investments and shareholding will soon be possible, for example, in the area of telecommunications, including fixed networks and satellite services. And in the future, banks and insurance companies will have the right to transfer domestic data and conduct central data administration abroad, thereby significantly increasing cost efficiency. Wastewater removal services will obtain nondiscriminatory access to tendering for public procurement contracts. A most-favored-nation clause ensures that any further concessions by Korea to third countries will automatically apply to the EU.

WTO-plus agreement

In addition to the usual trade chapters, KOREU also contains numerous provisions on the so-called WTO-plus issues. Thus, in different chapters, the agreement goes far beyond the multilateral obligations for both sides stipulated by the WTO. In it, (1) industrial subsidies are forbidden. This is true of both unlimited loan guarantees and loan restructuring programs that do not contain any plausible plan for rehabilitation. (2) Rules on competition are included to prevent companies with a dominant market position, as well as state-owned companies, from keeping foreign competitors away through unfair competition or market entry barriers. (3) In the framework of the TRIPS-plus provisions to protect and enforce intellectual property rights, copyright protection now subsists in Korea for 70 rather than 50 years. Product piracy will become subject to criminal prosecution. Geographical indications for 165 European and 64 Korean specifically named agricultural and food products will be protected in both markets. The two sides also agreed on (4) social and environmental standards, (5) mutual transparency in industrial regulation, and (6) improved access to public procurement markets on the federal and national level. (7) On French request, an agreement on cultural cooperation was reached. (8) For the time being, the North Korean special economic zone Gaesong is not covered by the free trade agreement. The trade law status of the goods produced there will be determined by a bilateral commission as stipulated by an enabling clause to the agreement.

Positive economic effects

There is no doubt that the planned liberalization will expand and deepen trade relations between Korea and Europe significantly. But beyond this blanket observation, can we obtain meaningful forecasts of the quantitative impact on foreign trade and income? Studies provide tentative answers. The Danish research institute Copenhagen Economics studied the macroeconomic effects of a European-Korean free trade agreement even before negotiations were initiated by the EU Commission. Using a general equilibrium model, they found that European exports to Korea could rise by 19.1 billion euros and European imports from Korea by 12.8 billion euros. The study assumed that industrial tariffs would be removed completely without transition periods, but that agricultural duties would be reduced by just 40% and service tariff equivalents by 25%. In reality, trade increases would likely exceed those calculated for two reasons. First, the static calculation of income gains does not take into account that investments will be higher because of liberalization, productivity will increase more rapidly, and new technologies will be introduced at an earlier stage. Second, the removal of non-tariff trade barriers is not taken into account in the simulation.

Copenhagen Economics and the Korean Institute for International Economic Policy (KIEP) simulated the overall economic effects of KOREU on production and income as well. In their findings, the two institutes agree on only modest income gains for Europe in the tenth of a percent range as a result of better resource allocation and increased production, but considerable gains for Korea (+0.6% of GDP). Korea profits significantly more: for one, because of the EU's relatively heavy weight in Korean foreign trade, but also because of its much higher level of protection at the outset. Nevertheless, KOREU will benefit the European economy. In view of the weak demand due to recession, trade liberalization will have the effect of a multi-billion euro economic stimulus package. The net exports (= export growth minus import growth) generated by KOREU provide additional domestic income that also creates new consumer demand through multiplier effects. Since market opening produces a sustained rather than one-time effect, the multiplier will probably be larger than 1 and thus produce considerable positive income effects. One can therefore reasonably hope that KOREU will provide an important source of economic support especially to the German export industry, which has been severely battered by the financial crisis.

The question of how liberalization will affect specific economic sectors has been examined by the Swiss Prognos AG on behalf of the German Federal Ministry of Economics and Technology. In their study, they estimate Germany's potential exports as well as threatening displacement effects, calculating in the dampening effects of the global financial crisis, and find that the German mechanical engineering industry will be the major winner with increased annual exports to Korea after the removal of high tariff barriers amounting to well over 7 billion euros. Surprisingly, the German electronics industry could also profit from KOREU at a quite high level. Positive, although lower net effects (but still in the three-digit million euro range) can be expected for the chemical and pharmaceutical sectors, insurance industry, and the automotive supply industry. And since customs barriers and non-tariff trade barriers will have been eliminated, German motor vehicle manufacturers can count on increased exports to Korea as well. European imports of Korean automobiles, however, will increase even more noticeably. The Korean Samsung Research Institute estimates that approximately half of Korean export growth—around 6 billion euros per year—will be concentrated in the automobile sector.

Success for Korea's trade policy

As the global trading nation that adhered longest to the principle of nondiscriminatory multilateralism, Korea has moved to the front of the pack in the Asian race to bilateralism despite its late start. Korea has concluded free trade agreements with Chile (2004), the EFTA (2005), Singapore (2006), ASEAN (2006), the US (2007), and very recently India (2009). The ratification of the Korean-American Free Trade Agreement KORUS FTA remains highly uncertain due to opposition in the US congress. Korea is still in negotiations with Japan, Canada, Australia, New Zealand, Mexico, Peru, Colombia, and the Gulf Cooperation Council. Korea also plans to open talks with China.

Korea's assertive approach to trade policy promotes its foreign trade strategies in diverse ways. Since China has risen to become the "factory of the world," South Korea's foreign economic relations with the "old" industrial regions of Japan, North America, and Europe have diminished in importance over the past several years. In the South Korean political and economic discussion, there is distinct apprehension about ending up in a risky position of economic dependence on China. Here, free trade agreements offer a welcome corrective. Furthermore, they promote Korea's foreign trade policy objective of becoming a transnational business and logistics center for northeast Asia. Given Europe's importance as an export market and investor, KOREU will play a central role helping Korea achieve all these objectives. Furthermore, the tariff cuts will make Korean industry—which produces a very similar range of products to Japan, China, and Taiwan—more price-competitive in relation to its direct competitors on the European market. In addition, the liberalization of service markets will spur European direct investments in Korea's tertiary sector and will increase Korea's importance as a business location in the regional context. In terms of trade policy, Korea expects the agreement with the EU not only to improve sales opportunities in Europe but also to provide a kind of comprehensive insurance policy against protectionist measures by the EU and against increasing uncertainties about the future of the multilateral trade system. Indeed, over the course of the ongoing negotiations Korea has progressively strengthened its position. Now the pressure on the US to ratify the unpopular KORUS agreement has increased.

EU Commission satisfied – automotive industry disgruntled

The EU Commission also considers KOREU a success. Trade policy has been a matter of community competence since the inception of the EU as a customs union, and the Commission is indeed strongly positioned in this area. With its negotiating mandate, the EU Commission was able to bring together the offensive and defensive interests of the Member States and negotiate independently with Korea, while Members received continuous feedback on progress in the negotiations through the Article 133 Committee coordinating EU trade policy. EU Trade Commissioner Catherine Ashton pointed out that with the agreement on market opening in Korea, the EU has achieved even more than the US with its much greater political clout. Under KOREU, tariff barriers are being dismantled significantly faster than under KORUS, the removal of non-tariff trade barriers is being made a binding obligation across a broad front, and the market for services has been opened further. By comparison, Korea's specific concessions to the US seem less important in the highly sensitive areas of beef and media and in granting a snapshot clause that allows 2.5% import duties to be imposed again in the case of a surge in car imports.

KOREU is also Europe's first and until now only bilateral free trade agreement in the framework of the "Global Europe" foreign trade strategy launched in 2006. The latter's goal is to improve Europe's international competitiveness through trade liberalization and thus to promote growth and employment in Europe. KOREU is seen as a pilot project demonstrating how a bilateral free trade agreement can facilitate market entry for European companies on key markets outside Europe. With KOREU the EU has also succeeded in occupying an important trade policy position in East Asia—still the most economically dynamic region of the world. KOREU proves that free trade agreements with the EU are possible if they do actually succeed in opening up the respective markets, and it refutes the still-widespread prejudices in Asia against what is seen as the "fortress of Europe."

Not everyone in Europe is as satisfied as EU Trade Commissioner Ashton. Europe's automotive industry, currently crippled by structural crisis, fears a glut of Korean cars after abolition of the 10% protective duty. Given that in 2008 450,000 Korean cars were sold in Europe but just 37,000 European cars sold in Korea, market equilibrium is not being maintained even today. On these grounds, criticism of the short transition periods on the agreement has been raised. The European Automobile Manufacturers Association ACEA also questions whether market entry in Korea is certain, fears new trade barriers due to the planned CO_2 reduction goals, and criticizes the payment of duty drawbacks. The ACEA has found an ally in the textile and clothing industry, whereas the remaining industrial and economic associations—even agriculture—are strongly in favor of the agreement on liberalization with Korea and support its swift entry into force. Doubts and objections about specific aspects of the agreement have been raised until recently on the political level as well. László Kovács, EU Commissioner for Taxation and Customs Union, rejected duty drawbacks as a matter of principle. Despite this critique, however, the Commission approved conclusion of the negotiations on October 7 and thus opened the way for the agreement to be initialed, which took place October 15. As early as July, France, Italy, and Portugal had lodged general scrutiny reservations in the Article 133 Committee. France's doubts as to whether the chapter on cultural cooperation would meet the country's own standards have since been put to rest, however, while Portugal and Italy have also signaled their acquiescence, despite persistent criticism of a number of specific issues.

The rest of the ratification process is likely to prove arduous nevertheless and last well into the year 2010. If the agreement is concluded under the existing regulations of the Treaty of Nice, a unanimous decision of the EU Council would be required. And since the agreement in question is what is known as a mixed agreement, containing elements that fall under the competencies of the Member states, ratification by all 27 Member States would be required. If the new rules of the Lisbon Treaty were to be applied, which is probable in light of recent developments, the Council could decide on most parts of the agreement with a qualified majority. However, under the Lisbon Treaty, the European Parliament (EP) also has to agree. In any case, the Commission has already signaled that it is seeking the agreement and involvement of the EP. Finally, of course, the Korean side has to ratify the agreement as well. Since Korean agriculture will suffer losses in production and income due to KOREU, heated debates will undoubtedly take place there. But given the majority situation in the Korean National Assembly, ratification of the agreement is not likely to be at risk.

For speedy ratification

KOREU makes economic sense: the agreement allows for substantial liberalization of European-Korean economic relations, providing European consumers with substantial welfare gains and giving reason to expect considerable export growth for industry and the agricultural sector. Within the EU, Germany—Korea's main trade partner in Europe—stands to profit the most. The earlier the agreement enters into force, the more favorable its economic impact will be. Competition on the European automotive market will be even tougher when the anachronistically high car import duties of 10% have been abolished. In the medium term, this will strengthen rather than weaken the European automotive industry. European car manufacturers will benefit from significantly improved sales opportunities on the Korean domestic market, since tariff and particularly non-tariff trade barriers will be eliminated. The idea that foreign manufacturers could gain market shares in Korea is proven by the events of recent years. At the same time, fears still remain that Korean authorities will use CO_2 reduction targets for motor vehicles as protectionist devices to keep foreign competition out. This could become an important test to determine how seriously Korea takes its responsibility to achieve market opening. If necessary, European foreign economic policy should remind Korea that not just the letter, but also the spirit of the agreement is to be observed.

KOREU is also an important trade policy signal at a time when—despite widespread proclamations that we must not resort to protectionism to escape the current financial crisis—industrial agricultural subsidies and national public procurement policies are increasing, WTO unbound tariff rates are being raised, and currencies are devaluing, in short: a time of increasing state interventionism. To counteract this creeping trend toward protectionism, the EU and Korea can implement a proactive liberalization strategy that does not limit but indeed expands the potential for growth in foreign trade. One may reasonably object to bilateral free trade agreements on the grounds that they disadvantage third countries, that they create additional bureaucratic costs through the obligation to provide certificates of origin for goods to be exported, and that they hinder the process of multilateral trade liberalization. These objections are valid. Nevertheless, currently the best possible option for those actors in favor of liberalization—for example, the EU and Korea—is to sign a free trade agreement. In so doing, both sides should also commit to boosting their ongoing efforts to achieve successful conclusion of the Doha World Trade Round in the year 2010.

Finally, KOREU would point the way forward in foreign policy as well. The EU and Korea already decided to expand their relationship into a strategic partnership under the Czech Council Presidency. The planned free trade agreement and the desired fundamental renewal of the existing framework agreement were to form the foundations of closer cooperation, both bilaterally and globally. Korea would be the fourth Asian country after Japan, China, and India with which the EU has entered into strategic partnership. Not only is the heightened political importance of this relationship fully in line with the growing differentiation of European Asia policy; Korea also deserves—based on its democratic development, its economic perspectives, and its foreign policy orientation—to be Germany's and Europe's major foreign policy partner.

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