# THE FUTURE OF KOREAN TRADE POLICY

## KOREA'S TRADE STRUCTURE AND ITS POLICY CHALLENGES

*By Lee Junkyu*


### Abstract

In 2011, Korea achieved one trillion dollars in international trade amidst the global crisis, which marked a new page in Korea's history. Korean trade will no doubt continue to strengthen its economy. Only eight countries are ahead of Korea in terms of achieving one trillion dollars in trade, and Korea should no longer be a follower, but instead a country which sets the course of trade policy within the global economy. It cannot be emphasized enough that Korea should be recognized as a model for its past economic accomplishments and to illustrate the beneficial cycle between trade and growth for the future. The following sections will first investigate changes of Korea's trade structure over a longer period, and its recent export structure by product and destination as well as of the import structure. The next section will look further ahead with trajectories of Korea's trade policies and a dramatic policy shift jumping onto the active FTA policy stance as well as with the FTA roadmap. Furthermore, it will review the comprehensive and high-quality FTAs pursued by Korea since the implementation of the FTA roadmap. Finally, it concludes with challenges facing Korea's future trade policy, including an enhancement of the competitiveness of the service sector, and discusses how to support inclusive and sustainable economic growth with an indispensable pillar, which is free trade policy in the Korean economy.

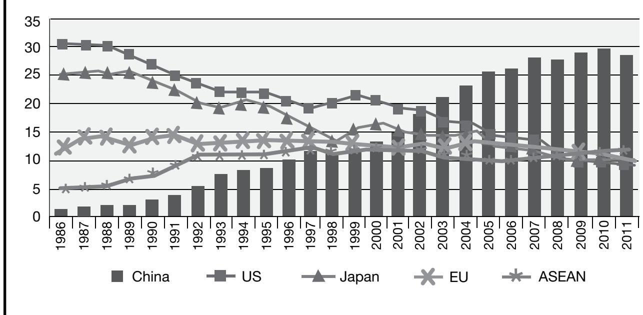
## Trade Structure Change

Over the past decades, Korea's trade structure by country has changed greatly. Specifically, as seen in Figure 1, in 1986, the United States took the largest share of 30.8 percent in Korea's total trade, and was followed by Japan with 24.6 percent. The share of China in 1986 was 1.1 percent. But, in 2011, the situation became very different. The largest trade share in Korea's total trade became China with 20.4 percent, followed by ASEAN (11.6 percent), by Japan (10 percent), the EU (9.6 percent) and the United States (9.3 percent). In a nutshell, trade partners became more diverse by country and the rapid rise of the Chinese share is catching attention. Notably, Korea's trade depends much more on China in 2011 than in 1986, but it is not as high as Korea dependence on the United States in 1986. It points out that Korea's efforts to diversify its international trade by country have worked to a certain extent, but that it should not stop its efforts to further reduce excessive concentration of by-country trade.

Moreover, there has been a great deal of change to Korea's regional trade structure with emerging economies receiving bigger shares.

Compared to the trade structure in 1971, in 2011 Korea traded much less with advanced economies and much more with emerging and developing countries. During the past four decades, Korea's trade share with emerging economies rose from 17.5 percent to 67 percent. Since the 2008 global financial crisis, advanced economies continue to face major brakes on growth while emerging economies appear to maintain solid growth momentum. Accordingly, although Korea was not immune to weak recovery with the major advanced economies, Korea's recent high trade share with emerging economies has definitely played an important role in lowering the risks of negative spillovers from the crisis.

**Figure 1** Share Changes by Country in Korea's Trade



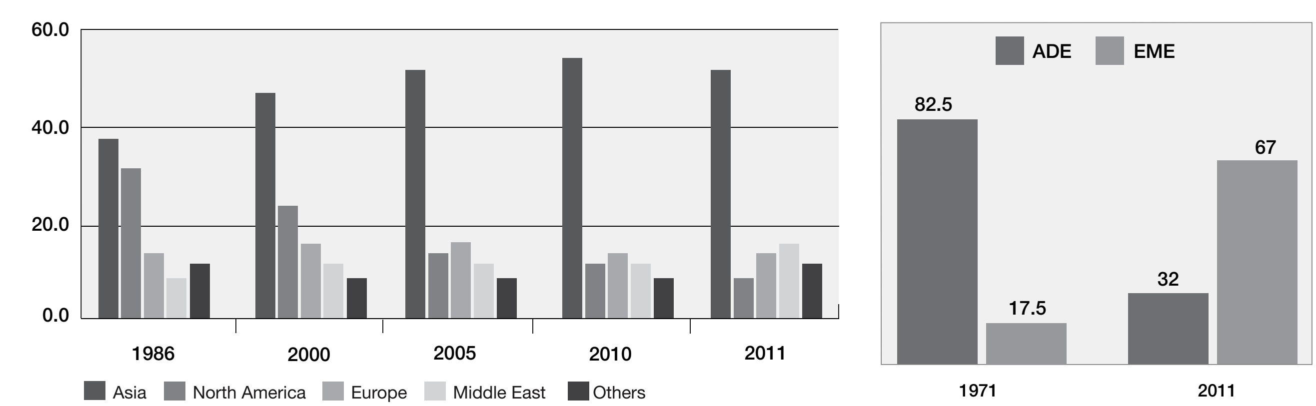

Source: KITA (2012)

Similarly, by region, from 1986 to 2011, Korea traded much more with Asia (37.0 percent→50.8 percent) and the Middle East (7.2 percent→14.1 percent), and much less with North America (33.8 percent→10.4 percent). According to the IMF (WEO, April 2012), in 2011 the United States grew 1.6 percent and developing Asia registered an economic growth rate of 7.8 percent, which is higher than that of any other region in the world. Asian exports have also recovered strongly since the global financial crisis, contrasted with those of developed economies. Notwithstanding continued anemic growth in advanced economies, Korea's high trade share with Asia helped counter the negative impact of the recent Great Recession on its trade performance in 2011, although the latest Korean exports data (April 2012) show moderation in export momentum. Korea is expected to continue its rising trend of intra-regional trade over the next decades.

## Product Composition Change of Trade

There has also been a great deal of trend change in Korea's exports by industry over the past decades. In the 1960s, more than 72 percent of Korea's exports were primary industry goods.

**Figure 2** Share Changes by Region and Economy




Source: KITA (April 2012)

**Table 1** Trend in Product Composition of Korea's Exports

| Share (%) | 1962 | 1972 | 1980 | 1995 | 2000 | 2011 |
|---|---|---|---|---|---|---|
| Primary industry goods | 72.3 | 11.1 | 7.7 | 4.9 | 2.8 | 2.8 |
| Industrial products | 27.7 | 88.9 | 92.3 | 95.1 | 97.2 | 97.2 |
| Light | NA | 67.4 | 48.4 | 19.9 | 16.2 | 6.2 |
| Heavy | NA | 21.5 | 43.9 | 75.2 | 81 | 91 |

Source: KITA (April 2012)
Note: NA means not available

As seen in Table 1, since the 1970s, Korea's major exports have been composed of industrial products. For example, in 2011 the share of industrial products was 97.2 percent.

Among them, heavy and chemical products increased greatly from 21.5 percent in 1972 to 91 percent in 2011. In the 1960s, Korea exported labor intensive products like clothes and textiles. In the 1970s, the Korean government strongly pushed the development of heavy and chemical industries, such as steel, shipbuilding, and automobiles. From the 1980s until now, the Korean economy has been exporting a great deal of capital and technology intensive goods. This trend change explains why Korea's top exports include ships, automobiles, semiconductors, displays and mobile communication devices.

## Recent Exports Structure

Korea's exports have been a useful indicator and a barometer to gauge Korea's economic vitality and the soundness of global economic growth. The following sections highlight Korea's recent export structure by product and destination.

## By Product

Korea's exports in 2011 registered 19.3 percent growth from a year earlier and reached the historic figure of $556.5 billion. While the global economy remained in a heightened state of uncertainty due to the euro zone sovereign debt crisis beginning in the second half of 2011, the Korean economy exported its largest value thanks to the competitiveness of Korea's major exports products and its FTA policies. According to MTI3 digit classification, vessels, articles of petroleum, automobile, and parts of automobiles reached their highest level, while semiconductors, flat display, and wireless communication apparatus declined respectively by 1.1 percent, 4.9 percent, and 1.1 percent year-on-year.

It is worth noting the significant rise in exports such as vessels, automobiles and their parts, and petroleum products. Despite the euro zone debt crisis in the second half of 2011, vessels and ocean structure exports rose significantly in 2011 to $54.5 billion year-on-year. Growth rates of vessel exports were 3.7 percent in 2009, 10 percent in 2010, and the rate rose by 15.2 percent in 2011. The share of vessels was the highest, with 10.2 percent of total exports. In terms of growth rates, petroleum was the highest with 63.7 percent year-on-year and reached $52 billion in 2011 due to high oil prices. Although Korea is not an oil-producer, it exported a large amount of refined oil products—even to OPEC countries, such as Indonesia. In 2011, Korea's petroleum exports equaled $11 billion to China, $8.6 billion to Japan, and $6.5 billion to Indonesia. This momentum is expected to continue due to high oil prices

**Table 2** 2011 Top Five Major Exports (in U.S. millions)

| Export items | 2010 | | 2011 | |
|---|---|---|---|---|
| | Value | Growth (%) | Value | Growth (%) |
| Total | 466,384 | 28.3 | 555,214 | 19 |
| Vessel, ocean structure and part of vessel, ocean | 49,112 | 8.8 | 56,588 | 15.2 |
| Articles of petroleum | 31,531 | 37.3 | 51,600 | 63.7 |
| Semiconductor | 50,707 | 63.4 | 50,146 | -1.1 |
| Automobile | 35,411 | 39.4 | 45,312 | 28 |

Source: Korea International Trade Association (2012) and strong demand for refined products from emerging economies. Automobile exports in 2011 rose by 28 percent year-on-year to the amount of $45.3 billion, which was an 8.2 percent share in total exports. Of Korea's total automobile exports, the United States received the highest (19.7 percent), followed by Russia (7.1 percent), and China (5.2 percent). Exports of automobile parts continued to rise every month and reached $23.1 billion with a growth rate of 21.8 percent in 2011 compared to the previous year. Due to its competitiveness and active FTA policies, an increase in auto parts exports is expected in the following years.

## By Destination

In 2011, Korean exports increased by more than two digits to most countries. However, exports to the EU appeared to grow at a weaker pace, by just 4.2 percent, due to the negative impact of the European sovereign debt crisis. While the debt crisis did negatively impact Korea's export performance, the Korean economy was able to withstand the adverse impact due to a larger share of its exports to developing economies. The share of emerging economies to Korea's total exports rose from 65.9 percent in 2007 to 72.5 percent in 2011, which contributed to safeguarding the economy against the debt crisis.

Regarding Korea's 2011 exports to China, they reached their largest value of $134.2 billion with a growth rate of 14.9 percent year-on-year. The share of Korea's exports to China compared to total world exports fell from 25.1 percent in 2010 to 24.2 percent in 2011, but the share has remained above 21 percent since 2005. During 2009, the share rose to 23.9 percent and, during 2010, it jumped to 25.1 percent. Accordingly, even a little hiccup in the Chinese economy would likely produce a major impact on the Korean economy. Except for in 2009, Korean exports to China have remained on an upward trend of two-digit growth rates. From 2002-2011, average annual growth rates of Korea's exports to China registered 21.2 percent.

Korea's exports to the United States reached a level of $56.2 billion in 2011 with a 12.8 percent growth rate year-on-year. In 1971, Korea's export share with the U.S. reached its maximum level of 49.8 percent. Subsequently, it is surprising to observe the rapidly declining share of Korea's exports to the United States in Korea's total exports. As of March 15, 2012, the Korea-U.S. FTA entered into effect, which will likely contribute to a rise of the U.S. share in Korea's exports, thereby reducing a risk of high dependency on trade with China. It is too early to confirm that Korea's exports point to a balance between China and the U.S. However, according to the Customs Office, from January to March 2012, the share of exports China received fell by one percentage point while the share of exports to the U.S. rose by 1.5 percentage points.

With the Korea-EU FTA coming into effect on July 1st, 2011—at the height of the euro zone debt crisis—it is important to gauge the impact of the FTA on Korea's exports in that context. From August-September 2011, Korea's exports to the EU rose, but turned negative in October 2011 due to the deepening concern of the euro zone debt crisis. In sum, Korea's exports to the EU reached $55.7 billion with a just 4.2 percent rise in 2011. However, the rise of only 4.2 percent does not necessarily reflect the full effect of the FTA on Korea's exports to the EU.

According to a report[1] by the Korea International Trade Association (KITA, March 2012), the group showing "an effect of tariff removals," in particular, had a great deal of export performance compared to exports of other countries to the EU over July-November in 2011. The report argued that, over the period, Korea's exports of the group to the EU presented a 14.8 percent rise compared to Chinese exports of a 0.5 percent rise, Japanese exports of a 2.6 percent rise, and the world's exports of a 7.9 percent rise to the EU. Evidently, while there is surely a positive effect of the FTA on the export items of tariff-reduction schedules, there remains an issue of how Korea and the EU can enhance the overall positive effects of the FTA on the economy as a whole regardless of tariff-reduction schedules. Regarding Korea's exports to Japan, Korea achieved $39.7 billion with a rapid rise of 40.9 percent year-on-year and Korea's trade deficit with Japan decreased from $36.1 billion in 2010 to $28.6 billion in 2011 due to the impact of the Japanese earthquake.

## Korea's Recent Import Structure

During 2011, Korea's imports reached $524.4 billion with a growth rate of 23.3 percent from a year earlier. The largest value of imports is mainly due to persistently high commodity prices such as crude oil. Recent import statistics point to high growth in raw materials (31.4 percent) and consumer goods (25.6 percent) and slower growth in capital goods year-on-year.

Imports of raw materials during 2011 grew 31.4 percent from the previous year, a share of 62.5 percent in Korea's total exports. The average annual growth rate of imports of raw materials is 14.9 percent, which is almost double the rate of imports of capital goods, 8.0 percent over 2005-2011. The main driver behind the high rate is due to increased volume and prices of crude oil. Compared to 2010, the volume grew 6.6 percent and the unit import price per barrel rose 37.8 percent.

The growth rate of imports of capital goods dropped substantially from 28.2 percent in 2010 to 7.8 percent in 2011. The share of capital goods in Korea's total imports has steadily fallen from 34.7 percent in 2005 to 27.4 percent in 2011. A steady rise of the import share of raw materials and a continuous fall of the share of capital goods are likely becoming a long-term issue to the Korean economy.

| Table 3 | Korea's Recent Imports by Use (in U.S. billion, as a %) |
|---|---|

| Export items | 2005 | | 2009 | | 2010 | | 2011 | |
|---|---|---|---|---|---|---|---|---|
| | Value | Share | Value | Share | Value | Share | Value | Share |
| Total | 261.2 | 100 (16) | 323.1 | 100 (-25.8) | 425.2 | 100 (32) | 524.4 | 100 (23) |
| Raw materials | 142.3 | 54.5 (20.9) | 186.1 | 57.6 (-31.5) | 249.5 | 58.7 (34.1) | 327.8 | 62.5 (31.4) |
| Capital goods | 90.7 | 34.7 (11.7) | 104.0 | 32.2 (-15.4) | 133.4 | 31.4 (28.2) | 143.8 | 27.4 (7.8) |
| Consumer goods | 26.4 | 10.1 (13.3) | 32.7 | 10.1 (-18.4) | 41.9 | 9.8 (27.8) | 52.4 | 10.0 (25.2) |

Source: KITA (2012)
Note: ( ) shows growth rates

The share of consumer goods has remained stable at around 10 percent while consumer goods grew 27.8 percent in 2010 and 25.2 percent in 2011 year-on-year. This increase in consumer goods is mainly driven by a rise in imported automobiles, clothes, beef and pork.

## Korea's Trade Policies to Date

During the 1950s, the key policies for the Korean economy were import substitution industrialization. The policies helped protect domestic import-substitution industries, but also impeded exports. A big shift from import substitution to export-oriented policy was introduced in the early 1960s by the Korean government. During the 1970s, the government provided much support to the heavy and chemical industries. In the 1980s, the government initiated the Comprehensive Liberalization Policy, including the Import Liberalization Five Year Plan, which was implemented from 1983-1988. The simple average tariff rates were 23.7 percent in 1983 which fell to 18.1 percent in 1988. The ratio of import liberalization in 1983 was 80.3 percent and it rose to 95.2 percent in 1988. In 1995, it rose to 99 percent. During the 1980s, the government transformed its trade and industrial policy from government led to liberalization and competition led policy. During the early 1990s and the beginning of the WTO, Korea further strengthened its policy direction of market openness, deregulation, and free trade. During the early 2000s, building on its continued policy stance of openness and competition promotion policy, Korea expedited its trade liberalization in pursuing Free Trade Agreements with developing and advanced economies around the world. From the early 2000s until now, Korea's trade policy, being in line with the GATT/WTO, has been centered on pursuing active FTA policies more than any other country in the world.

## A Policy Shift Towards FTA Policies

The proliferation of the regional trade agreements since the 1980s has been an important factor for encouraging free trade and liberalization in the world trade order. Before the 1997 Asian financial crisis, Korea had put more policy weight on the multilateral trade front. Since the 1997 crisis, Korea had no choice but to push forward complete structural reforms across the economy and to promote trade liberalization. Accordingly, the crisis made Korea well-poised to benefit from taking free trade agreements, which would impact the whole economy by revamping its economic health and structure.

With the proliferation of regional trade agreements, if Korea did not jump on the wagon of free trade agreements during the 2000s, it would be in a difficult situation. In the short-run, Korea would have a relative disadvantage in the global market and in the long-run, it would hamper the country's economic growth potential. The Korean government, mainly thanks to its determination to survive in the global market, turned FTA promotion into critical policy tools and measures to enhance its industrial and national competitiveness.

## The FTA Roadmap and its Step Forward

Korea concluded an FTA negotiation with Chile in October 2002. Following that effort, in September 2003, the Korean government announced "the FTA Roadmap" as its national economic development agenda. The FTA Roadmap marked a dramatic policy shift as it changed the country's passive FTA stance to an active one.

The Roadmap reflects two important policy principles. First, if Korea can conclude as many FTAs as possible in a short period of time, it can recover its competitiveness in the global market and reduce opportunity costs for Korean companies, which have observed rising disadvantages in the markets where Korea did not conclude FTAs. Second, the Roadmap pursues multi-track and simultaneous FTA negotiations with large economies. The main reason is to maximize whole economic benefits while minimizing negative costs from FTA negotiations. Building on those two principles, the Roadmap heavily pursues comprehensive and high-quality FTAs in terms of sectors and commitments.

In 2010, the share of Korea's trade with its FTA partners versus Korea's total trade was just 14.6 percent, which is much lower than that of the world average, 49.2 percent according to KITA's estimates (April 2011). The U.S. had a 34.1 percent share with FTA partners, and the EU had more than a 70 percent share. However, during 2011, Korea's trade share with its FTA partners rose to 27.4 percent due to the Korea-EU and Korea-Peru FTA. Over this period, Korea's exports to its FTA partners increased 18.4 percent ($166.8 billion) and the imports from them increased 20.6 percent ($129.4 billion).

The KORUS FTA entered into effect on March 15, 2012. Although it is too early to present an accurate analysis from the KORUS FTA, according to the Korea Customs Service (May 2012), in its initial two months Korea's exports to the United States rose by 11.3 percent and the imports from the United States rose by 2.0 percent. This increase occurred despite weakening Chinese economic growth and the deepening euro zone crisis. Korea's trade with the United State appears to have grown more stable due to the FTA.

In analyzing the FTAs Korea has concluded to date, it is reasonable to say that Korea established a global FTA network and became a hub country in the region. It made itself well-poised to benefit from the FTAs by liberalizing the market and enhancing the investment environment.

## Comprehensive and High Quality FTAs Pursued

As argued, Korea has pursued comprehensive and high-quality commitments, that is to say, the NAFTA style, complemented with the South-South style. From the eight FTAs in force, Korea's average concession rate is 97.5 percent with due consideration of sensitive sectors, such as the agricultural sector in the KORUS FTA.

By sector coverage, the KORUS FTA comprehensively includes all sectors, for example, from goods to services and investment, MRA, competition, IPR, Investor-State Dispute Settlement, e-commerce, labor and environment.

## Trade Policy Challenges Facing Korea

In 1966, Korea's total trade was about $1 billion and within a half century it topped $1 trillion. Membership in the $1 trillion dollar club is all the more important because the Korean economy achieved such a surprising performance amidst the heightened global economic crisis. Korea's effective economic policy demonstrated that an economy could grow through trade. Despite its eye-popping trade performance, there are challenges and opportunities facing Korea's trade policy for the future. Specifically, Korea faces the challenge of evaluating its trade performance not only by quantity, but also

**Table 4** Korea's FTA Progress

| Status | FTA partner | Dates in force |
|---|---|---|
| FTAs in force (8 FTAs, 45 countries) | Chile | Apr 2004 |
| | Singapore | Mar 2006 |
| | EFTA | Sept 2006 |
| | ASEAN | Jun 2006 (goods) |
| | | May 2009 (service) |
| | | Sept 2009 (investment) |
| | India | Jan 2010 |
| | EU | Jul 2011 |
| | Peru | Aug 2011 |
| | US | Mar 2012 |
| FTAs, signed recently | Turkey | Mar 2012 |
| FTAs, under negotiation | Canada, Mexico, GCC, Australia, New Zealand, Colombia, China | |
| FTAs, under examination | Japan, Korea-China-Japan, Mercosur, Israel, Vietnam, Central America, Indonesia, Malaysia | |

Source: Ministry of Foreign Affairs and Trade (as of April 2012)

**Table 5** Korea's Concession Rates in the FTAs

| FTA | Korea's concession rates (%) |
|---|---|
| Korea-Chile | 99.8 |
| Korea-Singapore | 91.6 |
| Korea-EFTA | 99.1 |
| Korea-ASEAN | 99.2 |
| Korea-India | 93.2 |
| Korea-US | 99.8 |
| Korea-EU | 99.6 |

Source: MOFAT, KIEP, and author calculation

by quality. Accordingly, Korea should look at what should be done to sustain economic growth and to continue its high performance in international trade.

First, the Korean economy should continue to diversify its trading partners and products to reduce the risks of external shocks. If the crisis does not subside, it will impact the Korean economy through trade channels as well as financial channels. As seen in Figure 1 and Figure 2, the Korean economy has been making a great deal of effort to minimize its risk of too much dependence on a small number of trading partners. The effort to lower its excessive exposure has worked, but the economy should not become complacent.

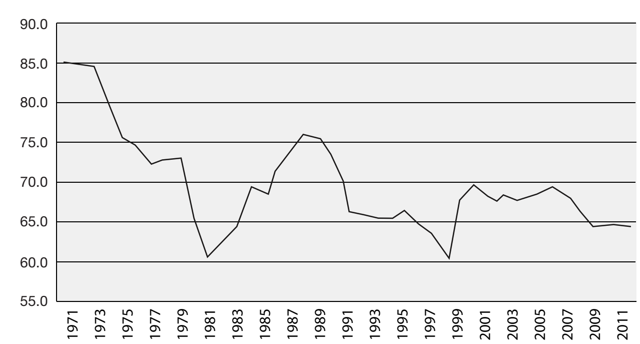
Furthermore, while the export share of China-US-Japan-EU-ASEAN in Korea's total exports has been in a falling trend as indicated in Figure 3, the 2007-2011 share appears to stay at around 65 percent. This means that Korea has yet to run away from its high-trade dependency on its big five trading partners.

In 2011, according to the MTI 3 digit, Korea's top ten export products had a share of 60.3 percent, which shows much greater product concentration compared to the numbers of other economies. According to a KITA report,[2] in average, from 2008 to 2010, the share of top ten export products was 27.1 percent for the U.S., 28.8 percent for China, 24.2 percent for Germany, and 34.7 percent for the UK. The shares of these countries were much lower than that of Korea, which was 51.1 percent in the report. Accordingly, it is desirable for SMEs to enhance their competitiveness and reduce concentration by exporting a variety of goods and services. This is easier said than done, requiring a longer term effort and continued commitment by the government and SMEs.

Second, the Korean economy needs to enhance the competitiveness of its services sector and increase the share of its service exports in the world.

As seen in Table 6, the share of Korea's service exports in the world rose from 2.1 percent in 2007 to 2.3 percent in 2011, while China rose from 3.6 percent to 4.4 percent over the same period. Specifically, during the last decade (2001-2011), according to the WTO (2012), the share of Korea's merchandise exports rose from 2.4 percent to 3.0 percent while the share of Korea's service exports rose from only 2.0 percent to 2.3 percent. Moreover, the annual average growth rate of

**Figure 3** Exports Share of China-US-Japan-EU-ASEAN (as a %)



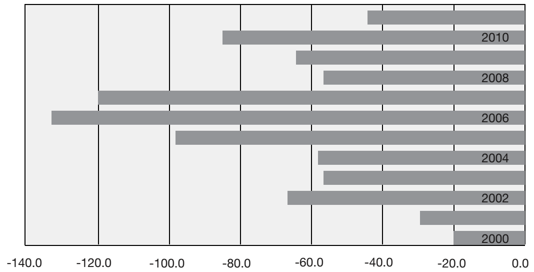

Source: KITA (2012)

**Table 6** Export Shares in Commercial Services by Country

| Share (%) | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| United States | 13.7 | 13.4 | 14.1 | 13.9 | 13.9 |
| UK | 8.4 | 7.3 | 7.1 | 6.6 | 6.6 |
| Germany | 6.3 | 6.5 | 6.7 | 6.2 | 6.1 |
| China | 3.6 | 3.8 | 3.8 | 4.5 | 4.4 |
| Japan | 3.7 | 3.8 | 3.7 | 3.7 | 3.4 |
| Korea | 2.1 | 2.3 | 2.1 | 2.3 | 2.3 |

Source: WTO (2012)

**Figure 4** Korea's Service Trade Balance (in U.S. 100 million)




| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Service balance | -20.4 | -29.7 | -64.4 | -57.9 | -59.6 | -99.5 | -133.3 | -119.7 | -57.3 | -66.4 | -86.3 | -43.8 |

Source: Bank of Korea (2012)

Korea's merchandise exports is 13.9 percent, which is higher than that of its service exports, 12.3 percent.[3]

However, while Korea's ranking in merchandise exports rose from 13th to 7th from 2001-2011, Korea's ranking in the services exports fell from 13th to 15th. According to the Bank of Korea, in regards to Korea's services' balance between 2000- 2006, it has continued to widen the trade deficit. As seen in figure 4, while reaching its peak deficit in 2006, Korea still maintained a substantial amount of the service trade deficit. Economic evidence builds that the service sector helps promote job-creation and economic growth. Yet, Korea's trade policy thus far has been centered on strengthening the manufacturing sector, leading up to an inevitable rising gap between goods and services in terms of trade balance.

Imperatively, the Korean economy will not be able to sustain itself or promote more balanced growth in the mid-to-long term without enhancing the competitiveness of the service sector.

Third, Korea must implement policy measures to further enhance the effectiveness of its FTAs. There should be domestic reform measures commensurate with free trade agreements. For example, domestic reform measures in distribution services should be implemented to make consumers feel price cuts through tariff reductions. Should consumers not reap the benefits of price reductions, static welfare effect will not be materialized, and thereby the non-competitive market structure will eventually erode the support of consumers for further trade liberalization. Domestically, it is imperative to make the market more competitive to benefit from the FTAs and to raise the utilization rates in those FTAs in force. According to a recent KIEP[4] report, except for the Korea-Chile FTA which has around 95 percent utilization, most of the existing FTAs have low utilization rates. For example, the Korea-India FTA maintained just a 25 percent rate for exports.

Last but not least, Korea has to continue gathering internal constituent support for FTA policies. It must also enhance policy communications with a variety of groups and sectors across the economy, including opponents to its FTA policies. As trade liberalization moves forward, it is natural to see some sectors win and other sectors lose, while achieving a net positive gain for the whole economy. Frequently, widening income gap between winners and losers would cause conflicts among the sectors or the groups in the economy, which can play a negative role by impeding economic growth and stalling consumer benefits.

Therefore, it is important to prepare a compensation mechanism as well as promote competitiveness in the specific sector which is adversely affected by free trade policy. Legitimate concerns of the sector should be properly addressed by the government and a mutual consensus should be pursued among the members of the society. Conclusively, free trade policy has been an indispensable pillar of support for economic growth in Korea. Building on free trade agreements already concluded, Korea should pursue an inclusive and sustainable growth trajectory with strong support of its citizens for future FTAs. It must also continue to figure out a new growth opportunity by implementing measures such as promoting R&D, expanding the FTA network in Asia and other regions, and advancing high valued-added technology.

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[1] *Trade Focus*, Vol.11, No.15, p.8-14. March, 2012, Korea International Trade Association (KITA-IIT)

[2] *Trade Focus*, Vol.10 No.55, November 2011, KITA: The data comes from the UN Comtrade by HS 4 digit.

[3] According to the calculation based on the WTO (2012), the annual average growth rate of world merchandise exports was 11.4 percent and that of the world services exports was 10.8 percent from 2001 to 2011.

[4] *Korea's FTA Networks and its Global Leadership*, Young gui Kim, May 8, 2012, KIEP.

# IMPACTS AND MAIN ISSUES OF THE KOREA-CHINA FTA

*By Choi Nakgyoon*

## Abstract

In May of this year, after Korea finalized all necessary domestic measures, Korea and China officially launched bilateral FTA negotiations. This paper looks at the FTA from the Korean perspective. The FTA talks will be conducted in two stages. In the first stage, they will finalize the modalities for trade in goods, services, investment and other areas. In the second stage, they will discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. For its part, Korea needs to protect sensitive sectors including agriculture and fishery, among others. The FTA will be beneficial for the sustainable growth of Korean economy and the service and investment liberalization will be no less important than the tariff reductions for the impact of the FTA. The FTA will also benefit Korea as China has shifted its policy directions in favor of domestic demand rather than exports. However, the agreement is expected to have negative effects on the Korean agricultural and fishery sectors. Beyond economic benefits, the Korea-China FTA is expected to contribute to stabilizing the diplomatic and geo-political relationship between Korea and China. It can also be seen as a first step in accomplishing Northeast Asian regional integration.

In January 2012, Korean President Lee Myung-bak had a summit meeting with Chinese counterpart Hu Jintao and announced that Korea would initiate steps domestically to officially launch Free Trade Agreement (FTA) negotiations between Korea and China. The two countries decided to officially launch bilateral FTA negotiations in May after Korea finalized all necessary domestic measures regarding a public hearing and the ministerial meeting for international economic affairs.

In retrospect, there was more than seven years since the two countries agreed to begin joint research on a Korea-China FTA by private institutions in 2004. The joint study investigated the macroeconomic benefits expected from the bilateral FTA. From 2007 to 2010, the joint research of industry, government and academia on Korea-China FTA focused on impacts to industrial sectors, such as agriculture and manufacturing industries, discussing how to deal with sensitive products.

Until recently, China strongly hoped to launch Korea-China FTA negotiations as soon as possible. For its part, Korea needs to protect sensitive sectors including agriculture and fishery, among others. In order to facilitate the negotiations, the two countries will take the following two-stage approach. In the first stage, they will finalize the modalities for trade in goods, services, investment and other areas. They are expected to focus on the share and composition of the tariff lines placed in the sensitive as well as highly sensitive list. In the second stage, they will discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. That means nothing is considered final until everything is actually agreed upon.

This paper deals with the Korea-China FTA from the Korean perspective. It reviews the current status of economic relations between Korea and China, dealing with the benefits and potential costs of a Korea-China FTA. It also touches upon the main issues of the bilateral FTA, comparing it to the proposed Korea-China-Japan FTA.

## Economic Relations between Korea and China

The interdependency between Korea and China has rapidly increased in recent years. According to research conducted by KIEP[1], Korean exports to China will increase by about 2 percent and real GDP will increase by about 0.22-0.38 percent, if the Chinese real GDP increases by 1 percent. China has become the biggest exporting and importing country for Korea since 2004 and 2007, respectively. Currently, Korea is China's number four trading partner after the U.S., Hong Kong and Japan.

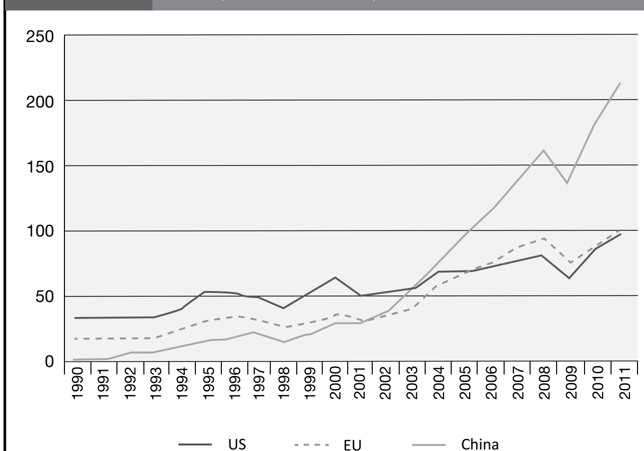
Korean exports to China amounted to $134.2 billion in 2011, occupying 24.1 percent of total Korean trade, followed by the U.S. (10.1 percent), Japan (7.1 percent), Hong Kong (5.6 percent), and Singapore (3.7 percent). Korea imported $86.4 billion from China, occupying 16.5 percent of total Korean imports, followed by Japan (13.0 percent), the U.S. (8.5 percent), Saudi Arabia (7.1 percent), and Australia (5.0 percent).

A breakdown of Korean exports to China by final usage shows that the majority are products for re-exports, such as parts and material. According to a Korea International Trade Association (KITA) report[2], Korean exports for domestic use to China in 2011 were 34.4 percent, which was very low compared to Japan (51.7 percent), Hong Kong = (59.5 percent), and the United States (66.7 percent). As we are all aware, the tariffs on exports for use in re-exporting are exempt or re-funded in most countries including China. Therefore, almost two-thirds of Korean exports are not disadvantaged by high levels of Chinese tariffs.

On the other hand, Korea's bilateral trade with China was $220.6 billion, which amounted to 20.4 percent of total trade in 2011, followed by Japan (10.0 percent) and the U.S. (9.3 percent). Korea recorded a bilateral trade surplus of $47.8 billion, which represents 155.2 percent of the total trade surplus in 2011. That means Korea would have recorded a trade deficit of $17 billion without its trade with China. According to the Bank of Korea, the average Korean GDP growth rate from 2008 to the first half of 2010 was 4.2 percent, while the contribution level of exports to China was 2.2 percent, indicating that the contribution of exports to China on the Korean GDP is approximately 52 percent.

China has been one of the most important partners for Korea in terms of inbound as well as outbound FDI. Outbound Korean FDI to China increased rapidly in recent years in order to make the most of China's expanding market[3] and low labor costs.

**Figure 1** Korea's Trade with China, the US and the EU (in U.S. billion)




Source: KITA

**Table 1** Chinese Contribution to Korean Inbound and Outbound FDI (in U.S. million)

| | Before 1990 | 1991-2000 | 2001-2011 | Total Chinese Contribution | Chinese Share (%) |
|---|---|---|---|---|---|
| Foreign Direct Investment | 2.8 | 149.1 | 3,584.8 | 3,736.7 | 2.0 |
| Overseas Investment | 22.5 | 5,369.1 | 28,718.8 | 34,110.4 | 17.7 |

Source: Ministry of Knowledge Economy and Korea Eximbank

As of 2012, China is second among Korea's overseas investment destinations, surpassed only by the United States (20.4 percent). Korean outbound investment to China amounted to $35.9 billion, or 18.9 percent of total Korean overseas investment, followed by Hong Kong (6.5 percent), the UK (4.6 percent), Vietnam (3.9 percent), Canada (3.4 percent), Netherlands (3.3 percent), Indonesia (3.0 percent), Singapore (2.2 percent), Australia (2.1 percent), and Brazil (2.0 percent).

On the other hand, inbound FDI from China from 1991 to 2000 amounted to $149.1 million, jumping to $3.58 billion from 2001 to 2011, which means that Chinese investment to Korea has been accelerating during the last decade. The total of China's FDI stock in Korea amounted to $3.74 billion from 1962 to 2011, and its share in the total inbound FDI in Korea turned out to be 2.0 percent. This number is relatively small compared to the U.S. (24.6 percent), Japan (15.1 percent), Netherlands (11.2 percent), the UK (6.2 percent), Germany (5.7 percent), Singapore (3.9 percent), Malaysia (3.9 percent), France (3.3 percent), Canada (2.8 percent), and Hong Kong (2.5 percent).

## FTA Policies of Korea and China

Korea designated Chile as its first FTA partner because Chile was regarded as being in a strategic position for advancement into other Latin American countries. After completing the negotiations with Chile in 2002, Korea concluded FTA negotiations with Singapore, the European Free Trade Association (EFTA), the Association of Southeast Asian Nations (ASEAN), India, the European Union, Peru, and the United States.

Notably, Korea diversified its FTA partnership among the Americas, Europe, and Asia. As an export-oriented economy, Korea urgently needed to access the major markets and minimize the negative effects from the FTAs of competing countries. Interestingly, Korea finalized FTA negotiations without any hesitation with regional bases such as Chile in America, Singapore in Asia, and the EFTA in Europe.

Upon a review of Korea's FTA policy, we found that Korea uses the FTAs to liberalize its domestic markets, as seen in the FTAs with the United States and the European Union. It also has taken care of its sensitive sectors by providing restructuring programs for the agricultural sector and designing assistance related to trade adjustment.

On the other hand, China shifted its international economic policy in favor of FTAs after joining the WTO in 2001. Specifically, China pursued FTA negotiations with neighboring countries including ASEAN in 2005, Pakistan in 2006, Chile in 2006, and New Zealand in 2008. Currently, it has been negotiating with many countries including Iceland, Norway, the Gulf Cooperation Council (GCC), and the South African Customs Union (SACU).

A review of the Chinese FTA policy reveals that China uses FTAs with neighboring and strategic base countries to support its diplomatic policy, as demonstrated by its designation of ASEAN as its initial FTA partner. China has not shown an interest in FTAs with developed countries such as the United States and the EU because they have not granted China market economy status. Specifically, it concluded FTA negotiations with Pakistan which imports armaments from China. It has been negotiating with Australia and the GCC, in consideration of the importance of energy resources and geo-political interests.

## Benefits and Potential Costs

The Korea-China FTA is expected to provide economic and geo-political benefits. First of all, it will be beneficial for the sustainable growth of Korean economy. According to KIEP, the Korea-China FTA is expected to increase Korea's real GDP by about 0.95-1.25 percent in five years and 2.28-3.04 percent in ten years[4]. The KIEP study included only concessions of the tariff schedule in its Computable General Equilibrium (CGE) simulations. It did not consider service and investment liberalization in the model. According to KIEP, the service and investment liberalization will be no less important than the tariff reductions for a FTA feasibility study, which indicates that the potential dynamic effects will be possibly greater than the static effects of tariff reductions.

Specifically, Korea can use the Korea-China FTA to make further advances into the Chinese domestic market, which is being regarded as the market with the biggest potential after the global economic crisis in 2008. China has shifted its policy directions in favor of domestic demand rather than exports. It is currently putting more emphasis on domestic demand than exports, according to the five-year economic development plan released in 2010.

It is noticeable that tariffs on exports for domestic use are neither exempted nor refunded. Thus, the Korea-China FTA will be very conducive to exports for domestic use. This is because China's major trading partners have not negotiated bilateral FTAs with China, with the exception of Taiwan which has finalized the Economic Cooperation Framework Agreement (ECFA) in 2010. The ECFA is reputed to be a preliminary step for China-Taiwan FTA negotiations. Thus Taiwanese products that have been competing with Korean export commodities in the Chinese market were given advantages by the ECFA, specifically in the chemical and electronic sectors. If main negotiations in the various areas such as goods, services, investment, and economic cooperation are concluded, it will have great impact on Korean exports. The Korea-China FTA will be expected to address Korean concerns about the potential increase for Taiwan in Chinese market shares.

On the other hand, the effects from the service and investment liberalization are expected to be substantial because beyond-the-border barriers in China are reputed to be very high. More specifically, a Korea-China FTA will contribute to the market expansion of producer services embodied in the Korean manufacturing exports. It is also expected to provide an impetus for substantial increase in the outbound FDI to China as well as intra-firm exports of services, in light of the rapidly expanding Chinese domestic demand.

In contrast to the benefits for the manufacturing and service sectors, the Korea-China FTA is expected to have negative effects on the Korean agricultural and fishery sectors. China is different from previous Korean FTA partners in that it can export fresh vegetables and live fish for the Korean market because it is geographically closer to South Korea. Therefore, potential costs from the Korea-China FTA are expected to accrue to the agricultural and fishery sectors.

Specifically, the imports of sensitive products from China have been increasing very rapidly in recent years. Korean agricultural exports to China amounted to $556.1 million while its agricultural imports from China reached $3.23 billion. The trade deficit in the agricultural sector amounted to $2.67 billion. Marine products from China also represent a sensitive problem for the Koran economy, as Chinese products have account for more than 30% of Korean fishery imports.

Besides the above-mentioned economic effects, the Korea-China FTA is expected to have geo-political effects in Asia. Above all, it will contribute to stabilizing the diplomatic and geo-political relationship between Korea and China, thereby contributing to the reunification of the Korean peninsula. The Korea-China FTA is expected to result in the expansion of bilateral cooperation and greater interdependency. It will also help the Chinese leadership and private sector to realize the importance of political as well as military security in the Korean peninsula. For its part, Korea can use the Korea-China FTA to develop a strategic and cooperative relationship with China while maintaining the Korea-U.S. alliance.

## Main Issues

Korea and China concluded (at the joint research of industry, government and academia) that a Korea-China FTA will lead to positive effects for both economies. However, they did not launch official negotiations because they have reacted sensitively to various products imported from each other. This demonstrates the importance of dealing with sensitive products. The two countries should design concession lists to maximize the expected benefits and maintain the balance of economic interests for both countries. The two countries are planning to negotiate the modality of market access for goods in the first stage of the FTA negotiations.

Specifically, Korea has a keen interest in how to liberalize the agricultural sector in the Korea-China FTA negotiations because most of the negative impacts of the bilateral FTA will be felt in that sector. On the other hand, China recorded huge trade deficits in the manufacturing sector including automobiles, chemical, and electronics among others and has an interest in these areas. In addition, rival companies of the two countries are engaged in competition to increase their market shares in third-country markets. For its part, China is expected to place many manufacturing tariff lines in the sensitive as well as the highly sensitive list.

Regarding rules—including intellectual property rights, anti-dumping, environment and competition policies, and government procurement—Chinese legal institutions substantially improved during the process of WTO accession in 2001. However, there were many complaints from Korean companies about the effective enforcement of Chinese rules. It is highly probable that a compromise on rules will be very difficult to achieve. It would be tough to apply domestic rules differently to member and non-member countries of a FTA.

Notwithstanding the geographic proximity and economic interaction between the providers and consumers of each country, the trade in services between Korea and China has been trivial compared to trade in manufactured goods. Yet the potential for future expansion in services trade is substantial in light of cultural homogeneity and the bilateral trade volume between the two countries.

A review of China's FTAs with New Zealand, Hong Kong, Macao, and Taiwan revealed that China liberalized various services sectors including telecommunication, transportation, government-related services, and business services. However, New Zealand is not noted for being competitive in the above service sectors. On the other hand, Hong Kong, Macao, and Taiwan all belong to the greater China economic area. Thus, it is not surprising to see that China has been reluctant to liberalize the service sectors in the case of the other previous Chinese FTAs. Part of the reason is that the competitiveness of China's own service sectors are lagging and the Chinese government tends to regard domestic regulations as security issues.

In the second stage of Korea-China FTA negotiations, the two countries are scheduled to discuss all the main issues regarding goods, services, and trade-related rules following a single undertaking method. In previous FTA negotiations, China's position in services and investment liberalization was a decidedly negative one. Thus, enhanced access to Chinese service markets and improvement of the Chinese investment environment are expected to be top priority agendas in the Korea-China FTA negotiations. Specifically, a guarantee of future liberalization, transparency, rational domestic regulation, and mutual recognition will likely be the main issues in negotiations for services and investment.

## A Comparison with the Proposed Korea-China-Japan FTA

Discussions about regional economic integration in Asia have not been as enthusiastic as those in other regions. For example, European countries launched an ambitious program for regional integration in the 1950s, and the North American countries concluded North American Free Trade Agreement, or NAFTA, in the 1990s. The Korea-China FTA will have potential effects not only on the two countries, but also on neighboring Asian countries.

A review of recent economic statistics finds that greater interdependency has developed among Korea, China, and Japan in terms of trade, investment, and technology cooperation in recent years. Amidst head-to-head competition among the three countries, there are also many opportunities for them to cooperate with each other to expand mutual economic relations through FDI, strategic alliances, and technology transfers.

For example, as we can see in Table 2, shares of trilateral trade among Korea, China, and Japan increased very rapidly for Korea and Japan. In the case of China, it decreased to 15.78% in 2010 because China diversified its trade partners for its aggressive advance into the global market.

Recognizing the importance of trilateral economic cooperation, discussion of the FTA among Korea, China, and Japan started in 2002. Specifically, the three countries launched a joint study of private institutions to investigate the feasibility of the trilateral FTA from 2003 to 2008. The joint study dealt with a wide range of topics including macroeconomic effects, impacts on industries, and rules of origin, among others. Since 2009, the joint research of industry, government and academia indicates that the trilateral FTA will lead to substantial macroeconomic effects in all three economies, meaning that it will be a win-win strategy to be adopted for regional integration.

Reportedly, China recognizes the importance of Korea's bridging role because of its intermediary position between China and Japan in terms of development level. Currently, both China and Japan are courting Korea to launch FTA talks. For its part, Korea may possibly restart the FTA with Japan and has announced it will launch a trilateral FTA with China and Japan after officially starting FTA negotiations with China. Thus, a Korea-China FTA can be seen as a first step in accomplishing Northeast Asian regional integration. In addition, it will also provide momentum for an East Asian FTA including ASEAN+3 because the three countries all concluded their FTAs with ASEAN. Furthermore, a Korea-China FTA will have international political impact on the discussion of a greater Asian FTA among China, Japan, Korea, ASEAN, India, Australia, and New Zealand.

It is highly probable that politico-economic factors are more important than economic ones in the process of trilateral FTA negotiations. Thus, the three countries need to set up the modality,

**Table 2** Bilateral/Trilateral Trade Shares (as a %)

| Year | China | | | Japan | | | Korea | | |
|---|---|---|---|---|---|---|---|---|---|
| | Japan | Korea | C-J-K | China | Korea | C-J-K | China | Japan | C-J-K |
| **2000** | 16.14 | 5.63 | 21.77 | 8.91 | 5.79 | 14.70 | 8.02 | 14.95 | 22.96 |
| **2005** | 12.49 | 6.72 | 19.20 | 15.98 | 6.27 | 22.26 | 17.51 | 12.77 | 30.28 |
| **2010** | 9.63 | 6.14 | 15.78 | 19.58 | 6.14 | 25.72 | 20.46 | 10.06 | 30.52 |

Source: Comtrade Database, UN

scope, and framework for the trilateral FTA, considering the template of the Korea-China FTA and the dynamic economic as well as political relations between China and Japan.

## Conclusion

The Korea-China FTA is expected to have substantial benefits for the two countries, but they have conflicting views on the main issues. Thus it will take a certain period of time to reach a compromise in goods, rules, and services areas. The Korean government is known to have precluded the possibility of concluding a Korea-China FTA within a pre-specified period.

Specifically, it is very important to negotiate successfully on the modality in market access for goods. If the two countries reach a compromise for a low-level FTA to take gradual concession schedules, then it will not be consistent with Article 24 of GATT 1948. In addition, it will not be the optimum choice in terms of economic benefits for the two countries to liberalize only a limited range of tariff lines.

Thus, one of the acceptable options for the two countries is to consider an 'ASEAN FTA plus' in order to protect the sensitive products of each country. This is because the level of concessions in the goods area of the Korea-ASEAN FTA is higher than that of the Korea-India Comprehensive Economic Partnership Agreement (CEPA), but lower than the FTAs with developed countries including the U.S. and the EU.

To conclude, the Korea-China FTA will provide more benefits for the Korean economy than potential costs, considering that it will strengthen its market competitiveness and upgrade its industrial productivity. If it is successfully concluded, Korea can become a business hub that connects the United States and European countries to Asian economies. In addition, the Korea-China FTA is expected to be an effective catalyst in speeding up the discussion about Asian regional economic integration.

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[1] KIEP, "Recent Trends, Main Issues, and Prospects of Chinese Economy," 2010.

[2] KITA, "Effects of Korea-China FTA on Korean Trade," presented at the public hearing on Korea-China FTA, 2012.

[3] China has emerged as the number one global market in such goods and services as automobile sales (13,640 thousand units), mobile phone (747.38 million persons), and internet usage (380 million persons) in 2009.

[4] KIEP employed the CGE (Computable General Equilibrium) model to investigate the potential economic effects according to the two scenarios of concession. See KIEP, "Macroeconomic Effects of Korea-China FTA," presented at the public hearing on the Korea-China FTA, 2012.

# KOREA: BEYOND PREFERENTIAL TRADE DEALS

*By Shiro Armstrong*


## Abstract

Korea has managed to sign free trade agreements (FTAs) with nearly all its major trading partners and the major global economies except for Japan and China. Although it has made some progress in trade liberalization due to FTAs, there is little evidence they have had, or will have, anywhere near the transformative effects on the Korean economy as did the earlier unilateral trade liberalization in the 1980s. Now that it is running out of potential FTA partners, Korea can be a leader in moving forward with untangling the extensive network of its FTAs and supporting the multilateral trading system. That would benefit Korea, its trading partners, regional trade flows and contribute to buttressing the global trading system when that is greatly needed. Preferential tariffs can be mulitilateralized, MFN rates can be reduced to the lowest preferential rates, or reduced to zero. The liberalization in service sectors can be extended with relative ease so that the Korean domestic economy can go beyond giving FTA partner country firms national treatment to allowing entry (and exit) of all foreign and domestic firms. It is in Korea's interest to extend the opening of its market which has been achieved via FTAs to all countries.

## The State of Play

Korea[1] owes its rapid growth and economic modernization to its opening up to, and integration into, the global economy. Korea went from being one of the poorest countries in Asia in the 1960s to an economic success story boasting the world's twelfth largest economy with membership in the club of wealthy countries, the OECD.

The export-oriented, but heavily protected Korean economy, really took off as it opened up unilaterally in the 1980s. Unilateral liberalization was underpinned by commitment to the multilateral trading system and supported through concerted liberalization through APEC. Concerted unilateral liberalization within the framework of GATT negotiations helped Korea and many of the East Asian economies to open up their economies and led to increasing trade shares and rapid economic modernization.

Korea has developed into a significant middle economic power and an active contributor to the global economic system. President Lee showed strong leadership during the global financial crisis to ensure no backsliding into protectionism. Korea hosted the G20 summit in 2010 and is playing an active role in keeping the global trade and economic system open.[2]

More recently Korea has been an aggressive participant in trade liberalization mostly in the form of signing free trade agreements (FTAs).[3] Korea has been very successful in its strategy of signing FTAs with large and important trading partners and given this success (despite the political difficulties in ratifying KORUS with the United States), it is now time to think about the next stage of Korea's trade policy strategies and economic diplomacy.

## Taking Stock of Korea's FTAs

At the turn of the century, Korea was one of the few East Asian economies not to have any FTAs and was still flying the multilateral flag. That changed when the Chile-Korea FTA was signed in 2003 and came into force in 2004. In less than a decade following its first venture into preferential trade, Korea has managed to sign agreements with nearly all its principal trading partners and the major global economies except for Japan and China. Nor has it yet signed an FTA with Australia, one of its key resource and food suppliers.

The Korea-US FTA (KORUS) came into effect in March 2012 giving Korea eight concluded FTAs with a further seven under negotiation and nine under consideration. While those numbers are not particularly high compared to its neighbors (Japan with twelve and Singapore with eleven, for example) what is significant is the partners of those FTAs. Of the completed FTAs, the economically and politically significant ones in addition to KORUS are with the European Union (KOREU), India and ASEAN. Among the countries with which Korea currently has FTAs under negotiation are Australia, Canada, Mexico, the Gulf Cooperation Council, New Zealand, and in the consideration stage are agreements with Japan, China, Japan and China together (CJK), Indonesia, Vietnam and MERCOSUR. If those were all completed, Korea will have trade agreements with its largest trading partners and political allies.

The economic effects of FTAs are usually quite limited with sensitive sectors exempted and difficult protection measures avoided, but for Korea, KOREU and KORUS have played an important role in liberalizing Korea's heavily protected automobile and agriculture sectors. There has also been success in opening up some service sectors to U.S. and European firms. KORUS and KOREU have managed to include the phase-out of protection of sensitive sectors in Korea including pork, dairy and other agricultural goods (except for rice). Although the tariff phase-out varies and is quite lengthy for some sensitive sectors (up to fifteen or twenty years for some products), they will eventually move to duty free.[4]

Although Korea has made some progress in trade liberalization due to FTAs, there is little evidence they have had, or will have, anywhere near the transformative effects on the Korean economy as the earlier liberalization in the 1980s. Earlier unilateral liberalization was undertaken in concert with other APEC economies so that the economic benefits to opening up were multiplied. Unlike liberalization through FTAs, unilateral liberalization does not distort trade towards preferred partners and allows for a more efficient allocation of resources determined by market forces.

The other major trade agreement in the region that could involve Korea is the Trans-Pacific Partnership (TPP) which is a trade deal being negotiated by nine countries including the United States, Chile, Peru and Singapore—with whom Korea already has FTAs—and with Australia, New Zealand, Vietnam, and Malaysia—with whom Korea has FTAs under negotiation or consideration. Mexico and Canada are set to join the TPP negotiations and Japan has shown interest in joining. All three and are also currently undergoing talks with Korea for signing FTAs.

There is a chance that Korea will find it congenial to join the TPP given that it has, or will have, deals with all the members, and importantly the United States. But given it already has deals with those members, and the political difficulties it had in passing KORUS, it is unlikely that Korea can or will attempt to join TPP talks in the near future. Korea has less incentive than Japan to join TPP negotiations, for example, because Japan does not have an FTA with the United States.

The trade agreement talks with China and Japan (Korea's two largest import sources and largest and third largest export markets, respectively) have recently been given a boost from the progress of the TPP, given that it is highly unlikely China can join the TPP any time soon.[5] As the world's second largest economy and the largest trading partner for most of the East Asian economies, China is an important element in Korean, Japanese and East Asian trade. The TPP has also given impetus for other broader regional arrangements such as an ASEAN+3 FTA and the ASEAN+6 FTA, in both of which Korea would be involved.

Historical baggage and differences in political systems could mean that any FTA signed with Japan, China or both together could be either full of exemptions and lack liberalization or take a long time to conclude. The three countries should work at making a clean (fewer exemptions), multilateral friendly (lack of discrimination) agreement even if that requires longer phase-in periods.

While Korea has made significant progress in signing FTAs, and that may be the end point for trade negotiators, trade liberalization should not stop with the conclusion of these trade agreements.

## Distortions and Inefficiencies

The problems with bilateral or regional preferential agreements are well known. Preferential trade agreements are a policy tool used to discriminate among trading partners and they divert trade away from third party countries regardless of whether they are members of the WTO and should have most favored nation (MFN) treatment in trade.

Korean trade is regulated by eight different preferential arrangements (in addition to the global rules and norms of the trading system) and potentially up to twenty-four if all those under negotiation and consideration come to fruition. Given the loss of political face for both sides of FTA negotiating countries, it is likely that the FTAs currently under negotiation will conclude at some stage, in some form, albeit with exclusions and potentially very little liberalization.

The proliferation of FTAs in the region has led to cumbersome rules of origin (RoOs) for trade across borders that involve different duties charged on different components or parts based on the country where value was added. Trade between two or more countries can come under different rules depending on which agreement or regulatory regime the trader chooses.

The gains in market share that Korea has achieved through FTAs will be eroded as its trading partners conclude more FTAs and divert trade from Korea. But that is not a main issue.

FTAs can inhibit competition, rather than encourage it. Preferential trade deals create interest groups around new preferences, or preferential access to investment or service delivery, that can make it harder to liberalize further. With European and U.S. beef enjoying preferential access to the Korean market, there now exists strong U.S. and European interest in protecting that preference from other suppliers, such as Australia and New Zealand.

FTAs have yet to demonstrate that they complement and promote multilateral liberalization, as their protagonists argue. For FTAs to be building blocks towards multilateral liberalization, and for this 'competitive liberalization' to work, the messy web of overlapping FTAs (noodles in the Asian noodle or spaghetti bowl) that have introduced distortions to business needs untangling. There also needs to be multilateralization or elimination of the preferences so that they add to the openness of the global trading system, not detract from it.

The problems that FTAs raise are compounded by the fragmentation of production and division of labor across countries in international production networks. Trade within production networks, and in other contexts, extends beyond bilateral trade but often, preferential trade deals are bilateral. Even when trade agreements involve more than two countries, they inevitably raise trade barriers relative to those outside the agreements. Each FTA that is brought into force in the region adds restrictions to trade, in the form of RoOs or a new set of discriminatory measures.

The proliferation of Korea's FTA can be argued as successful competitive regionalism, where countries sign FTAs to offset the discrimination they face in the Korean market. Some see KOREU as a response to KORUS,[6] although KOREU ultimately came into effect earlier than KORUS, and now there appears to be a big incentive for Japan to sign an FTA with Korea to offset the discrimination Japanese auto manufacturers face in Korean markets, for example.

What should Korea do once it has signed deals with Japan and China? It will have no important trade partners left to negotiate FTAs. The bicycle theory of trade suggests that a country should continue to liberalize otherwise they will backtrack into protectionism or liberalization will become stalled. Korea has been pedaling very fast but is it toward a dead end with too strong a focus on FTAs? Negotiating trade deals consumes a lot of resources and bureaucratic energy but is it worth it to sign more deals with smaller countries? Would pedaling in a different gear or different direction move Korea forward more effectively?

Liberalization through FTAs can be phased in but, unlike non-discriminatory framework agreements or agreements based on granting of MFN status, this liberalization has a tendency to stop there making them a somewhat static instrument for liberalizing trade. Interests privileged in participating partners have motivation to protect that privilege and frustrate more general liberalization. In addition, once a bilateral agreement is completed, for all practical purposes, that is the end for trade negotiators. Renegotiation or further liberalization in an FTA framework does not happen automatically even when review arrangements are built into the outcome, and is in fact very rare. Trade liberalization is an ongoing process of removing barriers to efficiently allocate resources towards their most productive use and to further the division of labor for a freer, flexible and more open economy.

Liberalization that occurs through negotiating FTAs, it is argued, may engage export interest groups that directly benefit from foreign market opening in overcoming resistance to trade reform. Yet by far the largest gains in trade liberalization accrue from what you give up, not what you extract from others in a negotiating framework, so it would appear that more productive catalyst might be found through mobilizing the interest of consumers and end-users on importable goods and services in trade reform and liberalization.

Korea has the opportunity to show leadership in untangling the FTA noodles given that it has signed FTAs with so many of its important trading partners; its record as a positive force in active middle power economic diplomacy; its location in the world between three economic giants; its secure trade agreement with the EU and its ally the United States; and its place in a dynamic, integrated region.

## Asian, Trans-Pacific or Global Trade Policy?

The choice of a bilateral, regional, trans-Pacific or global trade policy is a false choice in that if those options are seen as mutually exclusive, the global edifice into which they are built will be corroded. Bilateral and regional initiatives should be consistent with Korea's global outlook and be designed to foster open trade arrangements generally.

The failure of the Doha round in the WTO was used as an excuse to pursue FTAs but it has locked in preferences and meant that this second best (or even third best) FTA solution has become the enemy of the first best, non-discriminatory multilateral solution. Now that the Doha round has collapsed, it is a dangerous time to further weaken the multilateral system. Rather, there is need to show leadership in reversing some of the damage that bilateral deals have done to the non-discriminatory multilateral trading system.

The GATT was created to avoid a repeat of the retreat into preferentialism of the interwar period, where trade declined by seventy percent as preferential trade proliferated.[7] The interwar collapse in trade extended the Great Depression and exacerbated political tensions with the 'Dissatisfied Powers.' The global trading system has played a significant role in dampening political tensions. One prime example in Korea's neighborhood is the way in which it has underpinned growth of the economic relationship between Japan and China where that relationship has prospered despite the political tensions between the two countries. The unilateral liberalization that China undertook as part of its accession bid for entry to the WTO demonstrated commitment to the global trading system's rules and norms. This commitment to further reforms and marketization gave Japanese (and other international) investors and traders confidence in economic engagement with China even when political differences arose.[8]

Korea can be an active agent, or better, a leader in moving forward with untangling the extensive network of its FTAs and supporting the multilateral trading system. That would benefit Korea, its trading partners, regional trade flows and contribute to buttressing the global trading system when that is greatly needed. It would hurt narrow interests that currently have preferential access to Korean markets but those preferences are at the expense of Korean consumers and third party country trading partners. It is in Korea's interest to extend the opening up of its market which has been achieved via FTAs to all countries.

## Digesting the Noodles

Korea can be a leader in untangling the noodle bowl to make it more digestible. There are at least three ways forward in dealing with FTAs.[9] The first, which proponents of FTAs as stepping-stones towards regional trade agreements and then onto multilateralization might favor, is the consolidation approach. That would involve bilateral preferential deals being consolidated into regional deals. The second is to dilute the distortionary effects of FTAs by multilateralizing the preferences and other accords or by reducing the MFN rates. The third involves pushing deregulation and structural reform to level the playing field in the Korean domestic market and developing a regional and international agenda of regulatory reform and integration.

While the idea of consolidating, or joining up, FTAs may sound attractive, it is in practice unlikely to succeed in a way that will not be damaging to the global trading system. Where regional trade agreements have been brought into effect involving existing FTA partners, bilateral deals have not disappeared or become less important. The outcome is another layer or set of trade rules and restrictions within that region. If the consolidation approach did succeed, however, it is likely to further fragment global trade. Consolidation of intraregional FTAs is difficult enough[10] but consolidation of interregional FTAs is close to impossible. For example, if Korea succeeds in its FTA negotiations with Mexico and Canada, this will not qualify Korea to join NAFTA nor can those agreements join up in any easy way. And KOREU will not lead to Korea enjoying equal treatment among EU members.

Although Korea has FTAs with the United States and ASEAN, there is little chance that Korea could connect those two FTAs as the United States would have to extend KORUS preferences to ASEAN. But for Korea, there is powerful incentive to level the playing field between the U.S., Southeast Asia and other firms in the Korean economy.

The TPP was originally cast in terms of being the solution to overlapping FTAs and the related restrictions, such as RoOs, by consolidating FTAs in the region and providing a pathway towards a broader regional agreement encompassing all APEC members (a Free Trade Agreement of Asia and the Pacific). The goal of having a consolidated text with common market access schedules for all members and no exemptions is at risk. Instead of a truly clean regional FTA that liberalizes, albeit preferentially, a U.S.-led compromise made in Brunei in 2009 has led to market access offers on a bilateral basis or to the TPP as a whole.[11] There are signs that the TPP will end up as a series of bilateral deals which adds to the problems of overlapping FTAs instead of solving them,[12] in which case Korea should not join.

## Diluting Tariff Preferences

In order to reduce and eventually eliminate the distortions in Korea's FTAs, different aspects of the FTAs have to be dealt with in different ways. Preferential tariffs, for example, can be mulitilateralized, and MFN rates can be reduced to the lowest preferential rates, or reduced to zero. ASEAN has managed to multilateralize most of the preferences in the ASEAN Free Trade Area.

Korea has achieved opening up some sensitive sectors, such as agriculture and automobiles, in KORUS and KOREU (albeit with varying phase-in periods and safeguard measures in the event of import surges to protect domestic producers) that are arguably more difficult to achieve multilaterally. Some negotiations may be easier with only two parties but once those protected sectors are opened up to foreign competition, liberalizations can more readily be extended on an MFN basis.

Korea will completely remove its tariff on U.S. automobiles by 2016, from the pre-KORUS level of eight percent (they dropped to four percent as soon as KORUS came into force). Under KOREU, tariffs towards European automobiles will be eliminated roughly around the same time as with KORUS, with tariffs on light trucks eliminated a year or two earlier. Korean consumers will be paying more for Japanese automobiles which will incur eight percent tariffs and hence be at a disadvantage in competing in the Korean market. But given that Korea will have opened up to U.S. and European automobile companies, it should be relatively easy to eliminate tariffs towards Japanese automobiles, and all other auto-mobile suppliers, so that the Korean automobile market is more open, competitive and prepared to improve Korean consumer welfare. There is no justification for making any potential innovative or cheaper cars from Japan, China or elsewhere relatively more expensive in favor of U.S. or European cars.

The same applies for other sectors. Australia and Korea do not need an FTA for Korea to extend the tariff reductions to Australian beef and other agricultural goods that have already been extended to the United States and Europe. If Korean consumers can access cheap American and European agricultural goods, that access should be extended to Australian and Brazilian agricultural producers. Korean consumers can benefit from a more competitive market, including more product varieties, cheaper goods and more liberal trade with producers in the Southern Hemisphere with different climates.

Another way to dilute tariff preferences is to reduce MFN rates so that the margin of preference shrinks. Korea is already a relatively open economy with average tariffs at around nine percent, and now that it has succeeded in liberalizing some sensitive sectors for the first time, could work towards eliminating the remaining tariffs. Korea would then no longer be contributing to the RoO problem.

There is no justification for preferential treatment under other non-tariff barriers to trade that have been identified and liberalized through bilateral trade agreements.

## A Level Playing Field for Korean and Foreign Firms

But FTAs are not only about preferential treatment of goods at the border in terms of tariffs. They include services trade and often cover labor and environmental standards, intellectual property rights, competition policy, rules on investment, e-commerce, government procurement and other issues. Most of those are domestic economic policy issues to do with making the market more efficient and contestable.

There is little evidence[13] that preferential services commitments deliver much in terms of liberalization outside of Europe, but Korea has opened up its legal, financial, and telecommunications sectors in varying degrees for U.S. and European service delivery. Healthcare and education services are still protected sectors in Korea and have been excluded from all its FTAs. What gains in service trade liberalization Korea has achieved through its FTAs can be multilateralized relatively easily from the preferential accords that are in place.[14] Some of the services trade liberalization measures mean American and European law firms are now allowed to open offices in Korea. The forty-nine percent foreign voting share limit for telecom providers was removed for U.S. and European telecommunication service providers, European and American financial firms had data transfer restrictions lifted, and American and European accounting and taxation service providers are allowed to enter the Korean market.

Those hard fought trade "concessions" can be extended with relative ease so that the Korean domestic economy can go beyond giving U.S., European and other FTA partner country firms national treatment to allowing entry (and exit) of all foreign and domestic firms. As with many barriers to entry for firms, it is a domestic issue more than a trade issue and more about creating a level playing field for Korean and foreign firms in Korea. Barriers to entry that exist for domestic firms are just as important an issue as barriers to entry to foreign competition.

The aim for Korea is to have well-regulated and competitive markets, not markets with barriers to entry and national treatment for preferred country firms. As one of Asia's most developed economies, Korea should focus on adopting regulatory best practice and using its membership of the OECD, for example, to co-opt the most advanced benchmarks for new regulatory challenges.[15] Such regulatory leadership will not only help the Korean economy, but can contribute to the global and regional regulatory standards and the provision of this public good can be championed at APEC and the OECD.

With investment accords, instead of having different rules protecting foreign investors depending on their country of origin, Korean interests are much better served with a set of robust, transparent investment rules and regulations that afford all foreign investors protection in order to attract foreign capital and technology, as well balancing that with protecting Korean interests.

Other provisions or chapters labeled "WTO-plus" in FTAs such as labor and environment standards, as well as strengthened IPR, are measures usually included in FTAs to level the playing field between countries. They are usually measures introduced from more developed countries so that countries cannot gain competitive advantages when the cost of environmental degradation is not factored into the cost of production and wages are artificially low due to unregulated labor markets. The argument for IPR chapters is for protection of IPR in order to encourage innovation. Such measures can be seen as protectionist measures that do not recognize different stages of economic development and try to erode some of the comparative advantages in lower cost production, especially in developing countries.

Korea has a mature economy and does not have many of the problems that other developing countries might in meeting U.S. or EU standards for WTO-plus provisions. The one area where this is an issue in KORUS and KOREU, but not in most of Korea's other FTAs, is in relation to goods produced in the Kaesong Industrial Complex located in North Korea. Preferential treatment for products originating from Kaesong being traded between Korea and the United States or Europe will require further negotiation. Problems would arise if Korea demanded similar WTO-plus standards from its other trading partners, especially developing countries, before it engages in trade deals with them.

## A New Trade Paradigm: Beyond FTAs

Korea needs a new trade liberalization paradigm and strategy that takes it beyond FTAs.

Korea does not need negotiated trade agreements based on tit-for-tat trading of preferences and discrimination in order to liberalize trade. The domestic sell should move from opening up certain sensitive sectors like beef and automobiles to global powers bilaterally to opening up for a more efficient, open and contestable market and strengthening Korea's global role.

In APEC and the G20, Korea has the platform to show leadership in unilateral initiatives that dilute the effects of the discrimination in its trade agreements. Korea can make clear commitments to the multilateralization of preferences over time as well as commitments to multilateralizing special treatment in services trade or delivery. As the Korean economy moves towards a new economic model based on green growth, there is an opportunity to frame its commitments to trade globally in a manner consistent with its moves to free trade in green technologies.

The dilution or multilateralization of the adverse effects of FTAs will provide a regional and even a global public good, which can be supported and emulated at APEC, for example. Leading a concerted approach to untangling noodles will compound the benefits.

Korea sits between two economic giants in Japan and China, with both of whom it has large economic relations; is part of the production networks in a deeply integrated region; and has a major FTA with its important political ally in the United States. Korean interests are best served by eliminating the discriminatory and distortionary features in its trade arrangements and by being a leader in keeping the global trading system open and strong.

The debate must move to making Korea more competitive internationally and to continuing its economic development success story, and away from picking trading partners and leading the world in riding the FTA bicycle.

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[1] This paper refers to the Republic of Korea, or South Korea, simply as Korea, distinguishing it from North Korea.

[2] For instance, Korea is leading by example with free and open trade in green goods (those goods embodying environmentally friendly technologies).

[3] This paper uses FTAs to cover preferential trade agreements (PTAs), economic partnership agreements (EPAs) and any other bilateral or regional trade agreement that has preferential tariff and other features.

[4] For a detailed comparison of KORUS and KOREU, see Song, Y. "KORUS FTA vs. Korea-EU FTA: Why the Differences," Korea Economic Institute Academic Paper Series, Vol. 6 Issue 5, May 2011.

[5] Armstrong, S. "China's Participation in the Trans-Pacific Partnership," East Asia Forum, December 11, 2011. http://www.eastasiaforum.org/2011/12/11/china-participation-in-the-trans-pacific-partnership/.

[6] See Schott, J. "Free Trade Agreements and the Future of U.S.-Korea Trade Relations," *Navigating Turbulence in Northeast Asia: The Future of the US-ROK Alliance*, Korea Economic Institute, http://www.keia.org/publication/free-trade-agreements-and-future-us-korean-trade-relations.

[7] Cho, S. "Is a Free Trade Agreement a Royal Road to Prosperity? Demystifying Trade Regionalism," in Static and Dynamic Consequences of a KORUS FTA, The Korea Economic Institute, 2007.

[8] See Armstrong, S, "The Politics of Japan-China Trade and the Role of the World Trade System," in *The World Economy*, forthcoming 2012.

[9] For detailed discussion of dealing with FTAs in the Asian region and beyond, see Menon, J. 2009, "Dealing with the Proliferation of Bilateral Free Trade Agreements," *The World Economy*, Vol. 32, Issue 10, pp. 1381-1407.

[10] Again, see Menon (2009) for discussion of South Asia.

[11] See Barfield, C. "The Trans-Pacific Partnership: A Model for Twenty-first-Century Trade Agreements," American Enterprise Institute, *International Economic Outlook*, No. 2, June 2011.

[12] See Armstrong, S. "The TPP, APEC and East Asian Trade Strategies," East Asia Forum November 14, 2011, http://www.eastasiaforum.org/2011/11/14/the-tpp-apec-and-east-asian-trade-strategies/.

[13] See Francois, J. and B. Hoekman, "Services Trade and Policy," *Journal of Economic Literature*, 2010, Volume 48, pp. 642-92

[14] Hoekman, B. and L. A. Winters. "Multilateralizing 'Deep Regional Integration': A Developing Country Perspective." Paper presented at the Conference on Multilateralizing Regionalism, WTO and CEPR, September, Geneva, 2007.

[15] Cho, S. "Is a free trade agreement a royal road to prosperity? Demystifying trade regionalism," in *Static and Dynamic Consequences of a KORUS FTA*, The Korean Economic Institute, 2007.