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ECONOMIC RELATIONS WITH EUROPE

KOREA'S ECONOMIC RELATIONS WITH THE EU AND THE KOREA-EU FTA

By Kang Yoo-duk

Abstract

Since the late 1990s, Korea has sought a FTA with its trade partners, while the EU has been pivoting to Asia since the mid-2000s in search of a FTA partner. The Korea-EU FTA was important for both sides: Korea had been recording the most important trade surplus with the EU; and from the EU's point of view, the trade deal with Korea was its first FTA attempt with an Asian partner. Despite optimistic expectations, Korea's exports to the EU decreased since the Korea-EU FTA was implemented. Reasons for this unusual change in trade include the economic recession in Europe, Korea's concentrated export structure, relocation of Korean firms' production base abroad, and an increase in imports of certain products such as crude oil. Classic statistics on exports and imports will lose their role in assessing the outcomes of FTAs, and the strategy of governments and firms in the post-FTA era must change.

Introduction

The European Union (EU) is an important economic partner for Korea both in trade and investment. If the EU is considered a single economic area, it is fourteen times larger than the Korean domestic market and it has always been an important export destination of Korean companies. Trade with the EU accounts for 10.4 percent of Korea's total trade in 2014 and it is the third most important partner after China (21.4 percent) and the U.S. (10.5 percent). European companies have been very active in investing in Korea. According to European statistics, they represent more than 40 percent of the cumulative total FDI (Foreign Direct Investment) since 1962.[1] For the period 2008-12, European companies were the largest contributors to inward FDI into Korea with investment totaling $22 billion. Korean companies are also increasingly active in investing in Europe. Half of Korean cars sold in European markets are produced in the assembly lines in Slovakia and the Czech Republic, and Korean electronics companies made a number of important investments from R&D centers to production facilities in Europe. In financial sectors, Korea's economy is more closely related to European financial markets. According to statistics from the Bank for International Settlement (BIS), European banks have very important exposures to the Korean economy. Almost half of Korea's external liabilities are with European banks, which means that both economies are increasingly interdependent. In this context, creating a more stable economic framework is beneficial to both Korea and the EU and this was the basic background that Korea and the EU agreed to launch a FTA negotiation in 2007. As of early 2015, the Korea-EU FTA is the only FTA that the EU has implemented with an Asian country.

This article reviews Korea's economic relations with the EU, focusing on the Korea-EU FTA implemented in July 2011. The FTA should be understood from mutual economic interests as well as its overall trade policy. The Korea-EU FTA was the first FTA that Korea implemented with a large trading partner, and from the EU's perspective, it is the first completed agreement in a new generation of FTAs.

The first section of this article reviews the background of the Korea-EU FTA from both the Korean and EU perspective. We describe the economic and political background of the FTA in the context of the overall trade policy of Korea and the EU. The second section sheds light on the negotiation process of the FTA, focusing on arguments emphasized during the negotiation. The third section examines the trade statistics for three years of the FTA. In order to compare changes in trade before and after the FTA, we discuss important factors which affect trade between both sides during the implementation of the FTA. Finally, we discuss future prospects of Korea's economic relations with the EU in the post-FTA era.

Background of the Korea-EU FTA

Korea's Perspective

Negotiating a FTA with the EU was scheduled in the FTA roadmap announced in September 2003. This medium-term FTA plan reflected and expanded upon Korea's first FTA, the Korea-Chile FTA. Even though trade with Chile accounted for a very small part of Korea's total, the first FTA provoked significant controversy and its ratification took more than one year. In order to obtain public support, the Korean government set up the FTA roadmap which states four principles of the Korean government's FTA policy: 1) multiple-track FTAs; 2) advanced and comprehensive FTAs; 3) transparent procedures in FTA preparation; and 4) diplomatic consideration in FTA policy.[2] The roadmap also announced trade partners to be considered for FTAs on the basis of concrete economic criteria, such as economic feasibility and large and advanced economies. It organizes FTA partners into two groups: partners in the near future (negotiation in two years) and those for medium-term perspective (negotiation in more than three years). The EU was included in the list of medium-term perspective FTAs with the United States and China. One reason for this differentiated schedule is that they are large trade partners, and the impact of the FTAs will be much more significant than FTAs with small countries. Another reason is that the EU exercised a de facto moratorium on new FTA negotiations from 1999 to 2006.[3]

In the meantime, trade and investment with European countries had been rapidly increasing. In 2007, the EU became the second largest trade partner for Korea after China. After its first FTA with Chile, Korea initiated new FTA negotiation with the European Free Trade Association (EFTA). The FTA with EFTA was generally considered as a preparatory step to one with the EU, because its member countries have maintained free trade status with the EU, adopting most of EU's trade regulations. The Korea-EFTA FTA was concluded after only 10 months of negotiation.

EU's Perspective

In the mid-2000s, EU business circles and external trade surroundings put increasing pressure on the EU to pursue bilateral FTAs. There were increasing concerns that industries of emerging countries like India, Brazil and China would become more competitive than European ones, as their rapid economic growth overwhelmed that of European economies. In this context, the arrival of the new trade commissioner, Peter Mendelssohn, brought a new point of view on bilateral FTAs. He argued that wisely constructed and ambitious bilateral agreements with carefully chosen partners could create new trade and improve the competitiveness of EU companies in key enlarging markets.

Incorporating new objectives in external trade policy, the European Commission announced a new trade policy in October 2006, later known as 'Global Europe.'[4] The latter emphasizes the role of the EU's external trade policy which contributes to EU's competitiveness in foreign markets. Considering that it is hard to deal with investment, public procurement, competition and intellectual property rights in the WTO, negotiating comprehensive FTAs with like-minded countries was regarded as the second best option in realistic terms. In order to select FTA partners, the European Commission proposed the key economic criteria: 1) market potential (economic size and growth); 2) level of protection against EU exports (tariffs and non-tariff barriers); and 3) potential partners' FTA negotiations with EU competitors (potential discriminatory impact on European firms). On the basis of these principles, the European Commission identified ASEAN, Korea and MERCOSUR as priorities.

In addition to using fully economic criteria for selecting FTA partners, Global Europe is notable in several aspects. First, it aims for ambitious and high-level FTAs. New competition-driven FTAs aim to be comprehensive and ambitious in coverage, aiming at the highest possible degree of trade liberalization including far-reaching liberalization of services and investment. Second, ongoing or scheduled FTA negotiations with EU's competitors (implicitly the United States) were also taken into account. Third, the new FTAs explicitly focus on tackling non-tariff barriers through regulatory convergence and contain strong trade facilitation provisions, intellectual property rights and competition. This means that the FTA model that the Commission wanted to construct was deep integration, which seeks to harmonize trade-affecting rules. The objectives of the EU's FTA policy corresponded to what Korea had been seeking for its FTA roadmap.

Negotiating Korea-EU FTA

Negotiation Process

Official Korea-EU FTA negotiations were launched in May 2007 after a series of preparatory meetings held the previous year. It took over two years with eight rounds of negotiation and many technical meetings on the side to finalize the deal on 15 October 2009. By this time, Korea had already finished FTA negotiations with the U.S. and signed the KORUS FTA in June 2007. This allowed Korean trade negotiators to use technical know-how obtained in KORUS FTA negotiations as an example of an advanced FTA. In that sense, the KORUS FTA provided a partial template for the Korea-EU FTA. The EU sought a comprehensive and advanced FTA with Korea, which was its most economically-developed bilateral FTA partner to date. Accordingly, the Korea-EU FTA is the most comprehensive FTA ever negotiated by the EU. Import duties are eliminated on nearly all products (97.3 percent of Korean products for the EU market by number of items) and the service market is liberalized further than the KORUS FTA (KORUS Plus). Composed of 15 chapters, the FTA includes provisions on investments (termed as establishment due to the Commission's mandate in trade negotiation) both in services and industrial sectors, provisions on intellectual property and competition rules. The Korea-EU FTA is also a pioneering case in that it aims at reducing non-tariff barriers and promoting a future dialogue in industrial regulation. During the preparatory and implementation period, Korea changed many parts of its domestic laws in accordance with implementing Korea-U.S. and Korea-EU FTAs. Most of the revisions concern service sectors and intellectual property.[5]

Diverging Concerns Between Korea and the EU

Two issues delayed the finalization of overall negotiation to the end: 1) the duty draw back system and 2) rules of origin. Korea and the EU showed a very clear divergence on the duty drawback system (DDS) from the beginning. From Korea's point of view, the DDS is a crucial support system, especially for small and medium enterprises (SMEs), that rely heavily on outsourcing to China and Southeast Asia for intermediate goods. Without DDS, any kind of FTA would not bring about tangible economic benefits to Korean firms. It seems that European negotiators sufficiently realized that the DDS is important for the Korean government not only for economic background, but also for political reasons. In order to gain ground from Korean exporting firms, it was necessary for the Korean government to maintain the DDS which dated back to 1964 in the Korean customs system. The problem is that the EU did not have precedent to include the DDS in the previous FTA with third countries (i.e. Chile, Mexico and South Africa). The reason for not including DDS in FTAs can be found in the trade structure of European countries which rely mainly on intra-European trade for supply of intermediate products. More developed Western European firms have taken advantage of the European enlargement toward Eastern Europe. As a result, they tend to rely less on outsourcing out of the EU, and the DDS is less important for them.

However, the relative indifference of the European Commission on the DDS turned to be its preoccupation, as major industrial associations—especially the automobile association—showed their concerns about Korea's DDS and its positive effect on price competitiveness of Korean products. The European Automobile Manufacturers' Association (ACEA) strongly opposed Korea's intention to include the DDS in the Korea-EU FTA.[6] The ACEA argued that approving the DDS in the framework of the Korea-EU FTA would offer a disproportionate competitive advantage to the Korean auto industry when exporting to the EU. It insisted that this would set a precedent for other scheduled EU FTAs. In finalizing the negotiations, Korea and the EU reached a compromise. In the final deal, the EU agreed to allow Korea to maintain the current DDS (on average 8 percent) on Korea's exports to the EU for five years from FTA enforcement. When Korea's imports of intermediate goods increase rapidly after the five-year grace period, EU can limit DDS to five percent.[7] Setting a threshold for local content in the rules of origin was also an issue for both parties. As for the DDS case, the EU had precedent which served as a principle; the EU used to set a percentage of the locally produced contents in a final product to 60 percent in the previous FTAs with Chile, Mexico and South Africa. This meant that in order to be qualified as "Made in Korea," Korean-produced content should exceed 60 percent of total value of the products concerned. Korea's initial proposal for local content share was 35 percent, which was applied in the KORUS FTA. In the final deal, EU agreed on reducing threshold for local content to 45 percent.

After more than two years of negotiations, Korea and the EU signed the deal on October 6, 2010 during Korea's presidential visit to Brussels for the 8th Asia-Europe Meeting (ASEM) summit. The agreement was approved on February 17, 2011 by the European Parliament. Korea's National Assembly ratified it on May 5, 2011. With this, all necessary legal procedures have been completed and the FTA entered into effect on July 1, 2011.

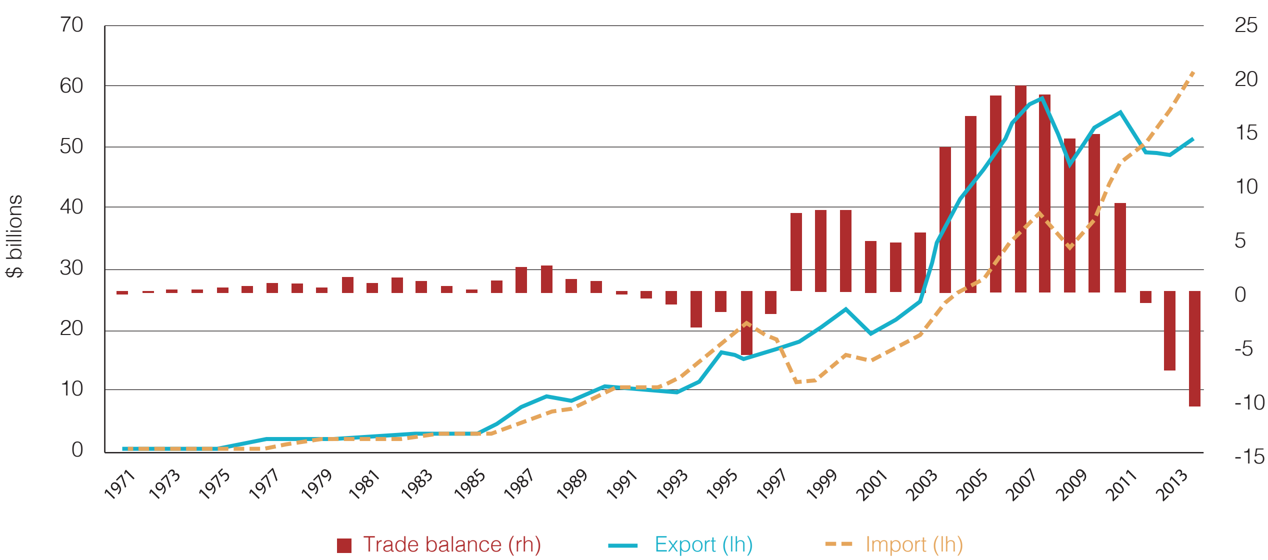
Three Years of the Korea-EU FTA

Trade Flow Between Korea and the EU After the Global Financial Crisis

In the 2000s, trade between Korea and the EU increased considerably. Korea's exports to the EU soared from $39.2 billion in 2000 to $98.4 billion in 2008. Imports from the EU showed a similar increase from $23.4 billion to $58.4 billion. In this context, the possibility of FTA implementation raised the prospects for more exports to the EU. Various studies suggest that the Korea-EU FTA will contribute to increasing Korea's exports to the EU as well as Korea's GDP. According to KIEP (2010), the FTA is expected to increase Korea's exports to the EU by $2.5 billion per year and, as a result, Korea's GDP will increase by 0.1 percent in the short term and by 5.6 percent in the long term.[8] Decreux, Milner and Péridy (2010) provides a similar estimation, stating that Korea's export to the EU will increase by up to 5.5 percent following the implementation of this FTA.[9]

While Korea's trade surplus vis-à-vis the EU reached a record level of over $19 billion in 2007, it has been gradually decreasing. Korea's imports from the EU increased by 21.3 percent per year from 2009-2011, while its exports to the EU increased only at an annual rate of 9.3 percent in the same period. The reason for the difference between export and import growth rates is the slowdown of EU's economic growth, which decelerated import demand, and the increase

Figure 1 Korea's Exports and Imports with the EU (in $ billions)



Source: Korea International Trade Association (KITA).

Table 1 Korea's Exports to its Trade Partner Before and After Korea-EU FTA

	Exports ($1 billion)				Change (%)			
	1 year before	1st year	2nd year	3rd year	1st year	2nd year	3rd year	3 years
EU	57.9	50.8	48.4	47.3	-12.3	-4.7	7.9	-10.4
China	125.6	133.2	140.5	134.5	6.1	5.5	4.2	17.6
USA	54.2	59.1	59.2	58.4	9.1	0.2	21.4	32.8
ASEAN	62.2	75.5	82.9	78.0	21.3	9.9	2.7	38.3
Japan	34.3	40.1	36.6	31.2	16.8	-8.8	-7.5	0.8
Total	**518.7**	**556.6**	**549.4**	**518.9**	**7.3**	**-1.3**	**3.2**	**10.0**

Note: 1) 1 year before: July 2010 to June 2011, 2) 1st year: July 2011 to June 2012, 3) 2nd year: July 2012 to June 2013, 4) 3rd year: July 2013 to June 2014, 5) 3 years: change in exports from 1 year before (July 2010 to June 2011) and the 3rd year (July 2013 to June 2014).

Source: Author's calculation based on data from KITA.

of imports into Korea from the EU due to Korea's rapid economic recovery. In 2011, Korea recorded several monthly trade deficits with the EU, and in 2012 Korea recorded a $1 billion trade deficit with the EU for the first time since 1998. The deficit expanded further to $7.37 billion in 2013 and $10.7 billion in 2014.

Three Years of the Korea-EU FTA

Korea's exports to the EU, which had been recovering after the global financial crisis, began to experience a decrease in the latter half of 2011. For the first year of the FTA with the EU, Korea's exports to the EU decreased 12.3 percent compared to the previous year. This result is an exception, given Korea's overall exports to the world increased by 7.3 percent in the same period, as shown in Table 1. From Korea's point of view, this outcome based on trade statistics is rather disappointing as most of the previous studies predicted a substantial increase in exports. Moreover, this figure contrasts with Korea's considerable increase in exports to the U.S. after the KORUS FTA. For the second year, Korea's exports to the EU once again fell by 4.7 percent, while it rebounded for the third year, largely due to the base effect.

In contrast, Korea's imports from the EU increased by 13.1 percent for the first year of the FTA. Given that Korea's overall imports from the world increased by 10.6 percent in the same period, the increase in imports from the EU is in accordance with the overall trend. However, imports from the EU also increased for a second year while Korea's overall imports reduced by 3.5 percent. During three years of the FTA implementation period, imports from the EU increased by almost 40 percent and the trade balance turned from a surplus of $14.5 billion to a deficit of $8.4 billion. It is clear that the FTA exerted a positive influence on Korea's import through tariff-cut effect, given that the growth rate of imports from the EU was four times larger than Korea's overall import growth. However, a question remains regarding the fall in exports to the EU under the 'FTA effect.' In order to understand this change in trade between Korea and EU, it is necessary to review the economic situation and trade flow in more detail.

First, we can observe a stark contrast between Korea's exports to the EU and other regions. Exports to the EU have been decreasing despite the FTA, while its exports to other trade partners have considerably increased. Over the three years since the FTA came into effect, Korea's exports to the EU fell by more than 10 percent. On the other hand, its exports to the U.S., China and the ASEAN countries increased by 21-36 percent during the same period. The answer to such a difference can be found from a comparative view on exports of other Asian countries to the EU. According to trade data from Eurostat, most East Asian exporting countries – China, Japan and Taiwan – have experienced a sharper decline in their exports to the EU than Korea. While China's exports to the EU decreased by 5.6 percent, Japan and Taiwan's exports to the EU dropped by 13 and 22 percent respectively. Given the continued depreciation of the Japanese yen from late 2012, it is intriguing to see that Japanese exports to the EU have seen the most visible decrease. It is noteworthy that all East Asian economies experienced a decrease in exports to the EU. They have common features in that they are specialized in exports in manufacturing sectors. The sharp fall in domestic demand in the EU has exerted undoubtedly a very negative influence on exports to the EU of East Asian countries with a high export share in manufacturing industries. In other words, the less-than-expected performance in Korea's exports to Europe should be attributed to weak demand in the EU from around

Table 2 Korea's Imports from its Trade Partner Before and After Korea-EU FTA

	Imports ($1 billion)				Change (%)			
	1 year before	1st year	2nd year	3rd year	1st year	2nd year	3rd year	3 years
EU	43.4	49.1	53.0	54.7	13.1	8.0	12.5	39.4
China	81.0	83.8	81.3	78.4	3.4	-2.9	4.7	6.6
USA	42.4	45.7	40.8	40.0	7.8	-10.7	6.5	3.9
ASEAN	48.8	53.5	51.7	49.5	9.7	-3.4	4.3	11.4
Japan	67.6	66.8	62.2	51.9	-1.2	-6.9	-9.7	-15.5
Total	**479.7**	**530.3**	**511.0**	**479.9**	**10.5**	**-3.5**	**1.8**	**10.4**

Note: 1) 1 year before: July 2010 to June 2011, 2) 1st year: July 2011 to June 2012, 3) 2nd year: July 2012 to June 2013, 4) 3rd year: July 2013 to June 2014, 5) 3 years: change in imports from 1 year before (July 2010 to June 2011) and the 3rd year (July 2013 to June 2014).

Source: Author's calculation based on data from KITA.

2008. Indeed, the decline in exports to the EU was common among the exporting countries in Asia.

Second, the fall in exports is salient in ships and electronics, which are Korea's most important export items. For example, ship exports accounted for 28 percent of Korea's total exports to the EU in 2011. However, its export amount fell by more than 60 percent since the implementation of the FTA. Exports of cellular phones, LCDs and semi-conductors were reduced by 15-52 percent. These products are marked either by general European import market contraction, due to the economic recession, or by relocation of Korean firms to Southeast Asia in order to cut production cost. Because Korean exports to the EU are highly concentrated in these few sectors, their fall creates a more statistically important impact on change in overall exports to the EU. On the other hand, Korea's exports increased for manufacturing items—such as refined oil, automobiles, and chemical products —for which tariff cut was quite important.

Third, Korea's imports from the EU increased considerably, which had a more important impact on change in trade balance than the decrease in exports. Imports from the EU increased by almost 40 percent over three years. This figure is outstanding, given that Korea's total imports only increased by 10 percent during the same period. At the sectorial level, an increase in imports from the EU is identified over a wide range of manufacturing products, from intermediates such as crude oil and refined petrol to machinery, automobiles and luxury items. For instance Korea's import of both crude and refined oil from the EU (Brent oil) was negligible before the FTA, but its import soared and accounted for 17.2 percent of Korea's total import from the EU. Instead, imports from OPEC countries fell, which means the FTA created a trade diversion effect from Korea's main oil resource to the EU – largely the UK. Some imports from Japan in machinery and industrial equipment were replaced by European products.

Fourth, the weakening value of the euro (since mid-2011) exerted a positive influence on EU's exports in that European products are becoming cheaper outside of Europe. The reasons for the weak euro can be explained by the decline of confidence and economic recession in the Eurozone and the lowest key interest rate since the introduction of the euro in 1999. As a consequence, the trade balance of crisis-affected European countries has considerably improved and Germany recorded its largest ever trade surplus. It is expected that the euro will remain weak while the European Central Bank considers an expansionary monetary policy. This will create a favorable trade environment for European exporters.

Korea's exports to the EU turned to positive growth in the third year of the FTA, mainly due to the base effect. As European economies start getting out of the recession, it is likely that Korea's exports to the EU will increase. However, as the EU is negotiating FTAs with Japan and members of ASEAN, Korea's unique status as EU's FTA partner in East Asia will become obsolete. All the more, Korean firms' relocation will be more salient, as they try to create supply chains in developing countries. In this context, the role of the FTA in promoting export in statistic terms will meet its limit and a more comprehensive approach will be required to make full use of the FTA.

Conclusion

Conventionally, FTAs focus on reducing tariff barriers. However, the role of tariff barriers in trade has become less important, as developed countries have already lowered their tariffs on industrial goods. As more FTAs will be implemented, issues of trade negotiation have been shifting from tariff liberalization to harmonization and mutual recognition of different regulations. During the negotiation of the Korea-EU FTA, different standards between Korea and the EU were highlighted, particularly regulations on the safety certificate procedures in electric/electronics and product standards for automobiles. The FTA states that both parties set regular committees on how to reduce trade-impeding regulatory barriers. It is still hard to expect that Korea and the EU can complete a free trade framework equivalent to that of the European Economic Area where most of the trade-related regulations are highly harmonized and mutually recognized. However, as trade and investment relations between the two parties are strengthened by the FTA, there will be more pressure toward tackling non-tariff barrier issues. What we will see in the next few years will be policy efforts to coordinate business practice as well as "regulatory convergence" between Korea and the EU. This will certainly require more time and involve more stakeholders, not only government officials, but also businesses.

Technology cooperation can be another issue in the post-FTA era. For example, Korea and the EU can create and activate international technology transfer mechanisms both by public and private initiatives. Small and medium enterprises (SMEs) experience a number of hardships in the course of doing business, starting from finding technology in need, as well as financing. In some cases, it is impossible for SMEs to independently introduce, apply, and spread new technology. As institutional cooperation frames have been consolidated by the FTA and its associated arrangements, it will be more possible to promote cooperation between private firms. Trade associations can find a more important role in this regard.

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[1] Delegation of the EU to the Republic of Korea, *European Union-South Korea: Trade and Investment Relations*. Fact File Edition (2013).

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[3] Lamy, Pascal, *Stepping Stones or Stumbling Blocks? The EU's Approach Towards the Problem of Multilateralism vs Regionalism in Trade Policy*. The World Economy, vol. 25, issue 10 (2002), pp. 1399-1413.

[4] *Global Europe: Competing in the World - A Contribution to the EU's Growth and Jobs Strategy*. European Commission, COM (2006) 567.

[5] Korea-EU FTA made a two-year transition period in order to accommodate market liberalization and to revise domestic laws. In line with KORUS FTA, Korea changed 57 acts, enforcement decree and rules (as of Sep. 2012). Most changes are also related to the implementation of Korea-EU FTA (11), because the latter is based on KORUS FTA, in particular the service chapter.

[6] *EU Governments Must Denounce Unfair Competition to European Industries in Trade Conditions for South Korea*. European Automobile Manufacturers Association, ACEA Position Paper (July 8, 2009).

[7] The Singapore-EU FTA initialed in late 2013 excludes all kinds of drawback of duties for bilateral trade between Singapore and the EU. Given that the FTA with Singapore will work as an undoubted template for more FTAs with ASEAN members, it means that the EU does not want to include the DDS in its FTAs in the future.

[8] *Economic impact of Korea-EU FTA* (jointly conducted with 9 research institutes). Korea Institute for International Economic Policy (KIEP) (October 2010), in Korean.

[9] Decreux, Yvan, Chris Milner and Nichola Péridy, *The Economic Impact of the Free Trade Agreement (FTA) Between the European Union and Korea*. Report for the European Commission (May 2010).

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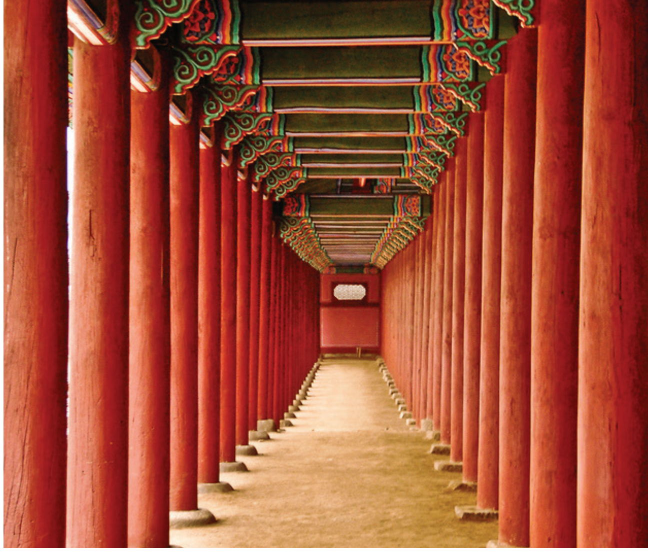

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