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# 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 multilateralized, 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<sup>1</sup> 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.<sup>2</sup>

More recently Korea has been an aggressive participant in trade liberalization mostly in the form of signing free trade agreements (FTAs).<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup> 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,<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup> 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<sup>10</sup> 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.<sup>11</sup> 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,<sup>12</sup> 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 multilateralized, 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<sup>13</sup> 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.<sup>14</sup> 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.<sup>15</sup> 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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<sup>1</sup> This paper refers to the Republic of Korea, or South Korea, simply as Korea, distinguishing it from North Korea.

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

- <sup>3</sup> 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.
- <sup>4</sup> 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.
- <sup>5</sup> 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/>.
- <sup>6</sup> 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>.
- <sup>7</sup> 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.
- <sup>8</sup> See Armstrong, S., "The Politics of Japan-China Trade and the Role of the World Trade System," in *The World Economy*, forthcoming 2012.
- <sup>9</sup> 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.
- <sup>10</sup> Again, see Menon (2009) for discussion of South Asia.
- <sup>11</sup> 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.
- <sup>12</sup> 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/>.
- <sup>13</sup> See Francois, J. and B. Hoekman, "Services Trade and Policy," *Journal of Economic Literature*, 2010, Volume 48, pp. 642-92
- <sup>14</sup> 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.
- <sup>15</sup> 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.