

DIRECTORATE GENERAL FOR EXTERNAL POLICIES
POLICY DEPARTMENT

THE EU-KOREA FREE TRADE AGREEMENT

POLICY BRIEFING

Abstract

The negotiations with the Republic of Korea on a new generation FTA have almost come to an end. The text of the agreement has been recently circulated by the European Commission and the treaty is expected to be initialled before the end of the year.

The Korea FTA is one of the most ambitious and complete commercial deals ever negotiated by the EU. It will provide duty free access to the Korean market for European goods and services and introduces important clauses on the respect of intellectual property rights, regulatory issues as well as on sensitive social and environmental matters. Both economies will likely register an increase in real income, output and GDP but the effects of trade liberalisation will be bigger, both in relative and absolute terms, for the Korean Economy.

The Korea agreement has been largely welcomed by the EU business community. However sectors like the automotive and the textile industries, which will be the most negatively hit by the new agreement, warned about the possible repercussions in Europe (notable in terms of job losses) and asked the Commission to take their interests into consideration.

Finally the Korea FTA is likely to serve as a benchmark for future commercial treaties negotiated by the EU. The Korea FTA is certainly innovative but it contains provisions which may have a very negative impact on several EU industry and service sectors should they be extended to other trade partners like India, ASEAN countries or China.

The Parliament will receive the draft agreement under the "consent" procedure if the Lisbon Treaty enters into force.

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TABLE OF CONTENTS

INTRODUCTION	4
THE CONTENT OF THE EU-KOREA FTA	5
AN ECONOMIC EVALUATION OF THE EU-KOREA FTA	5
THE POSITION OF THE EUROPEAN STAKEHOLDERS	6
THE POSITION OF THE AUTOMOTIVE SECTOR	7
THE KOREAN DOMESTIC REACTION TO THE FTA	8
THE SYSTEMIC IMPACT OF THE EU-KOREA FTA	9

INTRODUCTION

South Korea is one of the most important trading partners of the European Union. South Korea is the EU's eighth largest trade partner and the EU has become South Korea's second largest export destination after China. EU trade with South Korea reached € 65 billion in 2008 and grew at an average rate of 7.5% between 2004 and 2008. The EU has been the single largest foreign investor in South Korea since 1962, and accounted for almost 45% of all FDI inflows into Korea in 2006¹.

Between 2000 and 2008 EU trade in goods with South Korea grew by around 50%, with EU exports to South Korea rising to 26 billion euro in 2008 compared with 17 billion in 2000, and imports rising to 39 billion from 27 billion. As a result, the EU trade deficit with South Korea increased from 10 billion in 2000 to 14 billion in 2008. The trade deficit with the EU is mainly due to exports of cars and electronics.

Among the EU Member States, Germany (8.6 billion euro or 34% of EU exports) was by far the largest exporter to South Korea in 2008, followed by France and the United Kingdom (both 3.0 billion or 12%), Italy (2.6 billion or 10%) and the Netherlands (2.5 billion or 10%). Germany (7.9 billion or 20% of EU imports) was also the largest importer, followed by the United Kingdom (4.1 billion or 10%) and Italy (3.0 billion or 8%). The largest deficits in trade with South Korea were observed in Poland (-2.6 billion euro), Slovakia (-2.5 billion), Spain (-2.0 billion) and Greece (-1.4 billion), while the largest surplus was recorded in Germany (+0.8 billion).

Almost half of EU exports to South Korea in 2008 were machinery and vehicles and around one fifth each were chemicals and other manufactured articles. Machinery and vehicles were three quarters of EU imports from South Korea and a further fifth were other manufactured articles. EU exports to South Korea also included machines for making integrated circuits, medicines, crude oil, uranium, motor cars and parts, while the main imports included mobile phones, electronic components, ships and motor cars.

As far as services are concerned, in 2007, the EU exported 7.2 billion euro of services to South Korea, while imports from South Korea amounted to 4.0 billion, meaning that the EU had a surplus of 3.3 billion in trade in services with South Korea, compared with +2.4 billion in 2005 and +2.8 billion in 2006. The surplus in 2007 was mainly due to other business services (+1.1 billion), transport (+0.8 billion) and royalties and license fees (+0.6 billion). South Korea accounted for just over 1% of total extra- EU trade in services.

EU Foreign Direct Investment (FDI) into South Korea fell from 5.0 billion in 2005 to 1.7 billion in 2007, while South Korean direct investment into the EU decreased from 1.3 billion in 2005 to 0.3 billion in 2007².

¹ for more economic bilateral statistics see at http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113448.pdf

² From the Eurostat note entitled "South Korea Summit EU deficit in trade in goods with South Korea of 14 billion euro in 2008 Surplus of 3 billion in trade in services in 2007", May 2009.

THE CONTENT OF THE EU-KOREA FTA

EU-Korea negotiations began in May 2007. Korea was one of the priority targets included in the European Commission's "Global Europe" communication which intended to spell out the new guidelines of the EU trade policy in the era of globalisation.

The agreement is intended to remove up to € 1.6 billion of customs duties, of which € 850 million will be removed from day one. The biggest benefit for the EU economy will be in the services sector, where the European Commission has been able to obtain even further concessions than those previously granted by Seoul to the United States. The agreement contains many interesting elements which have not been included into any previous FTA negotiated by the EU. The agreement will, in principle, include strong provisions on geographical indications and on regulatory issues (such as protection of intellectual property rights, government procurement and regulatory transparency).

The agreement also provides a strong discipline on non-tariff barriers both horizontally as well as in key sectors (including cars and electronics) for which the Koreans accept to apply many European standards. These provisions are among the most ambitious ever negotiated in a single trade agreement.

The agreement contains rules on a bilateral dispute settlement system which would allow parties to solve their disputes (and in particular to tackle trade barriers) without having recourse to the WTO and within a reasonable period of time (up to 160 days).

The agreement also encompasses mechanisms for a general safeguard in case of an import surge from Korea would occur at a pace which causes, or threatens to cause, injury to the EU domestic industry. Understandably the same rules apply for the Korean counterpart. Another special mechanism enables the contracting parties to limit refunds on the duty drawback system in case of a notable increase in foreign sourcing by one of the signatories.

A chapter on "trade and sustainable development" which include comprehensive commitments on labour standards and environmental clauses is also included in the deal. Progress would be assessed by means of a monitoring mechanism, while the dialogue with the civil society will be enhanced.

AN ECONOMIC EVALUATION OF THE EU-KOREA FTA

The study prepared by Copenhagen Economics and Professor Joseph François¹ shows that either a full or partial FTA would be beneficial for both the EU and Korea. The Korean Institute for International and Economic Policy has reached similar conclusions. These studies show an increase in real income, output and GDP. Benefits will be greater for the Korean economy both in absolute and relative terms. This may be justified by the fact that the EU has a much greater economy and that Korea has more trade barriers in place than the EU. The biggest losses are, in fact, expected in those economic sectors which in the past were benefiting from strong domestic import protection.

¹ Economic Impact of a Potential Free Trade Agreement (FTA) Between the European Union and South Korea. Short study by Copenhagen Economics & Prof. J. F. Francois, March 2007 at http://trade.ec.europa.eu/doclib/docs/2007/march/tradoc_134017.pdf

The EU will profit from trade liberalisation in sectors such as "other business services" (mostly financial services), communications, transport and "other processed food" (like cheese and wine). It will instead lose significantly on sectors such as motor vehicles and electrical machinery. The Korean's expansion in the manufacturing sectors will also partly be dependent on the use of services as intermediate inputs in production, thus benefitting from the increase liberalisation of market of services in Korea after the entry into force of the agreement. In other words, the final result of the EU-Korea FTA is largely dependent on the effective increase in trade in services more than on the liberalisation of manufactured products. Agriculture in this scenario does not play a very important role since it accounts for less than 3 percent of the EU-Korean bilateral trade.

Sectors gaining and losing most from a full FTA agreement (Copenhagen study)

	European Union			Republic of Korea	
<i>Gainers</i>	Other business services	0.7%		Motor vehicles	28.8%
	Communications	0.3%		Electrical machinery	27.1%
	Transport	0.2%		Iron and steel	18.1%
	Financial and banking services	0.2%		Non-ferrous metals	10.7%
	Other services	0.1%		Other machinery	10.6%
	Trade	0.1%			
<i>Losers</i>	Motor vehicles	-1.7%		Other business services	-23.1%
	Electrical machinery	-1.7%		Communications	-6.7%
	Non-ferrous metals	-1.0%		Beef	-2.25%
	Iron and steel	-0.9%		Other services	-2.4%
	Textiles	-0.6%		Other primary agriculture	-2.3%

Source: CEPS - "A Qualitative Analysis of a Potential Free Trade Agreement between the European Union and South Korea", 2007.

THE POSITION OF THE EUROPEAN STAKEHOLDERS

The new EU-Korea FTA has been welcomed by a large part of the EU business community. *Business Europe* supported the new agreement in condition that the duty

drawback issue was properly solved¹. Importers' and services providers' associations urged the Commission to finalise this agreement without delay². Overall there is an understanding that the EU-Korea FTA would provide benefits to both contracting parties and that under the current economic situation there is little chance to finalise any other pending free trade agreement or other economic agreements with third countries in the foreseeable future. The WTO Doha negotiations are also far from being concluded, despite a recent attempt to continue the negotiation after the Delhi Ministerial.

The European car producers' association (ACEA), and the European Textile Federation (Euratex), did not approve of the agreement and asked the Commission to revise certain clauses which they found particularly detrimental to their respective sectors. In particular, Euratex asked for a performing system of import surveillance and called for a simplified and immediate use of the safeguard instruments (both general as well as duty drawback safeguards, see below) included in the agreement³.

The agreement was also criticised by European Trade Unions and in particular by the European Metalwork Federation, fearing that the new FTA would further worsen the already difficult situation of the European car sector and result in significant losses of jobs⁴.

As far as Member States are concerned, it seems that the Commission was able to convince many of them, even those who in the past had opposed the agreement, in particular Germany, and that there is now a comfortable majority of Member States supporting it. This may result in a relatively quick conclusion of the agreement which would then be submitted to the Council (and the Parliament, if the Lisbon is finally adopted) for ratification. A few Member States with a strong industrial sector are still opposing the EU-Korea FTA and have asked for more clarifications and guarantees from the Commission before taking their final decision.

THE POSITION OF THE AUTOMOTIVE SECTOR

Automobiles are the single most important export product of South Korea. The South Korean car industry is mainly focused on exports, with a production of 3.5 million cars per year, of which 2.5 million (73%) are exported. By contrast, 80% of cars produced in the EU are also registered in the EU. The EU is a key target market for Korean manufacturers, with 700.000 cars in 2007, or 20% of all EU car imports, and an average 10% annual growth between 2000 and 2007. During the same period, the EU exported only 30.000 cars to Korea, mainly upmarket luxury ones.

ACEA has openly criticised the agreement and requested the Commission to reopen negotiations and modify some aspects of the agreement, notably regarding the rules of origin and the duty draw back system.

According to ACEA the increase of permissible levels of foreign content from 40% to 45% will severely hit the EU industry notably in the low-price cars category (A, B, C) where the Korean competition is tougher. The Commission replied to these allegations

¹ see letter of Business Europe, Mr Philippe de Buick to Commissioner Ashton of 6 July 2009, at <http://212.3.246.117/docs/1/CNKHJLEDCOLMOFBGKMINOHGEPDBG9DW1GN9LTE4Q/UNICE/docs/DLS/2009-01546-E.pdf>

² see e.g. the Foreign Trade Association statement of 7 July 2009 at <http://www.fta-eu.org/ftapress215.pdf>

³ At the moment, the use of safeguard instruments on DDB would be allowed only after five years from the date of entry into force of the agreement.

⁴ Trade Unions asked that Korea commits itself to fully respect all ILO core labour standards.

by affirming that under current trade conditions Korean products entering the EU market are not subject to any effective restrictions on foreign content. Moreover, the current level of foreign content used by the Korean car industry is below 10%.

The second main ACEA allegation concerned Duty Drawbacks (DDB). Under the Duty Drawback system, the duties paid on parts and components used for the production of a final product (in this case, a vehicle) are refunded when the final product is exported. Both the EU and Korea currently make use of duty drawbacks, and the Commission considers that their impact on the competitive situation of EU companies from duty drawback is likely to be quite small considering the low level of foreign content in Korean products, especially in the car industry. ACEA did not agree with this interpretation of the agreement¹ and accused the Commission of opening the EU markets to cars prevalently composed of Chinese components "without giving similar advantages to European industries".

The Commission has proposed a special safeguard clause on duty drawback to address potential future increases of foreign sourcing by Korean manufacturers. This mechanism foresees a cap on the refundable duties if the trade figures show that there was a notable increase in foreign sourcing by Korean manufacturers.

Finally, ACEA considers that the new FTA does not sufficiently improve access to the South Korean market, because it fails to secure existing international vehicle standards when entering the Korean market, notably as far as emissions and safety rules are concerned. The Commission, rather indirectly, conceded that there are some non-tariff barriers in place which restrict the access of EU cars to the Korean market but claimed that the new agreement also contains strong provisions guaranteeing an almost complete harmonisation of technical standards and rules between the two parties of the agreement.

THE KOREAN DOMESTIC REACTION TO THE FTA.

Korea has one of the most active trade agendas of the industrialised world. South Korea has FTAs with Chile, Singapore and the European Free Trade Association (EFTA). It also has a partial pact with the Association of Southeast Asian Nations (ASEAN). The FTA with the United States was signed on 30 June 2007 but its ratification process is still pending before the US Congress (mainly due to the strong opposition of the US automotive sector).

While negotiating the FTA with the EU, Korea also looked at other possible trade agreements with an impressive number of partners. The Korean government's objectives for 2009 were quite ambitious, and included concluding FTA negotiations with Australia, Peru and New Zealand and, at a later stage, with Canada, Turkey, Colombia and the Gulf Cooperation Council. In addition, the Korean government signed, in August 2009, a Comprehensive Economic Partnership Agreement (CEPA) with India.

The US-Korea FTA has been harshly criticised by many Korean stakeholders. Protests focussed on agriculture liberalisation and notably on imported US beef. The Korean service sector also opposed the agreement on the ground that it will lose the quasi-monopoly position it has enjoyed for a very long time. Many opponents to the KORUS agreement accused the US of using its military power and its role of as the protector of

¹ According to ACEA, this would provide an unfair advantage to Korean producers, since it offers them the chance of exporting to the EU at zero customs duties while having up to 8% of duties paid on parts of their cars or non-Korean origin being repaid when they are exported outside Korea. This advantage does not apply to EU carmakers whose production is mainly intended for the EU markets only.

South-Korea to secure substantial economic concessions from Seoul. This was not necessarily true but it shows how an anti-American sentiment is diffused in South-Korea. There is no doubt that the successful conclusion of the EU will put significant pressure on the US to ratify its own free trade agreement with Seoul.

Not surprisingly the Korean service sector also opposed the negotiations of the FTA with the EU. There have been also some protests from farmers, but they have been much milder than those which had almost paralysed Seoul at the time of the KORUS negotiations.

THE SYSTEMIC IMPACT OF THE EU-KOREA FTA.

The European Commission describes the new Korea FTA as the "*flagship*" of the new Global Europe strategy.

The European executive is certainly right when highlighting the importance of the new agreement. The Korea FTA goes much farther than any previous agreement negotiated by the EU. Provisions on geographical indications and on the application of social and environmental standards are certainly a step towards a more balanced and fairer trading system.

The agreement also recognizes the growing importance that non-tariff, behind the border barriers play in modern trade. Addressing regulatory and technical issues has become a priority for the EC since it has realised that new obstacles, ones which are more difficult to tackle than customs tariff were increasingly hampering a sound access of EU goods and services in third country markets. In response to the growing concern by the business community, the Commission included in its "*Global Europe*" communication a specific, *ad hoc* strategy on market access.

However the Korea agreement does not only include positive elements. Trade concessions granted to Korea are quite extensive and will certainly serve as a benchmark for future trade agreements negotiated by the EU. It is obvious that what was acceptable for Korea, a developed, industrialised country of around 50 million inhabitants, may represent a serious threat to the EU industry and service sector if applied to countries like India, China or the ASEAN group.

This concern has been voiced by many Member States and other European stakeholders, who urged the EC to make it clear that the provisions included in the Korea FTA were in no way automatically extensible to other present and future EU trade agreements. The EC has, in this respect, adopted a relatively ambiguous position, probably fearing to undermine the already difficult negotiations with other key trade partners.