



# An EU–Korea Free Trade Area

## Playing Catch-Up or Taking the Lead?

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### Summary points

- Both Korea and the EU are pursuing free trade areas (FTAs) aggressively as part of their trade policy strategies. Korea is much further down the road.
- There are strong incentives on both sides to conclude an agreement. However, specific issues and EU's desire to do at least as well as, and preferably better than, the Korea–US FTA may delay or even preclude success.
- Korea and the EU are not principal suppliers to each other, so while an agreement is predicted to be economically favourable to both sides, the effects are not expected to be very large. Korea has the higher barriers and is expected to make the bigger economic gains.
- There are sensitive sectors on both sides, notably automobiles for the EU and services and processed foods for Korea. Both sides have important agricultural constituencies to protect.
- Korea's key role in the East Asian production system suggests that rules of origin could be an area of particular difficulty in the negotiation.

## Policy Context

The EU, as an entity and through its member states, and Korea are founding and active members of the World Trade Organization (WTO). They are key players in the Doha Development Agenda (DDA) negotiations, although Korea has taken a less forward position because of domestic agricultural policy concerns. Both are prolific users of preferential agreements. Negotiations on an EU–Korea Free Trade Area (FTA) were launched on 6 May 2007.

### The EU

Trade preferences have been a major tool of EU foreign economic policy since its inception. Currently about 70% of EU goods trade is on a preferential basis (WTO, 2007). This includes agreements in place or under negotiation with the European Economic Area (EEA) and Switzerland, with Turkey and with the countries of the western Balkans, with the African, Caribbean and Pacific group of countries, with neighbouring East European and Mediterranean countries, with the EFTA, with the Gulf Cooperation Council states, with Mercosur, with Mexico and Chile, and with the Least Developed Countries, as well as under the Generalized System of Preferences (GSP). These existing agreements and negotiations, the EEA and Switzerland apart, have largely been restricted to trade in goods.

A new phase of EU trade policy emerged in 2006 with the publication of *Global Europe* (EU Commission, 2006). *Global Europe* set out a market access strategy (Rollo, 2006) aimed at the emerging trade powers and energy producers, using preferential trading agreements as the main tools. It explicitly included services, investment and regulatory integration (collectively known as deep integration) as well as the more traditional border barriers on goods. The target markets for this new policy are India, the ASEAN countries, the Republic of Korea and Russia, as well as Mercosur and the GCC (where negotiations have long been under way with no signs of a breakthrough). As a result of this policy only the US, Japan and China, among the top trade powers, are not targets of EU bilateral agreements.

### Korea

Until recently Korea had, following in Japan's footsteps, avoided bilateral trade agreements and only pursued its trade policy interests multilaterally in the GATT and then the WTO.

Korean bilateralism is thus a very new phenomenon. Since 2004 Korea has agreed FTAs with Chile (2004), EFTA (2006), Singapore (2006), ASEAN (2006) and the US (2007). Negotiations for an FTA between Korea and Japan seem to have reached a standstill, however. Negotiations are under way for FTAs between Korea and Mexico, Canada and India as well as the EU. There have also been preparatory studies on possible FTAs between Korea and China, Mercosur and the GCC. Actual agreements or those in negotiation covered almost 45% of Korea's trade in 2005 (Copenhagen Economics, 2007, table 2.1:6).

## Bilateral trade performance and structure

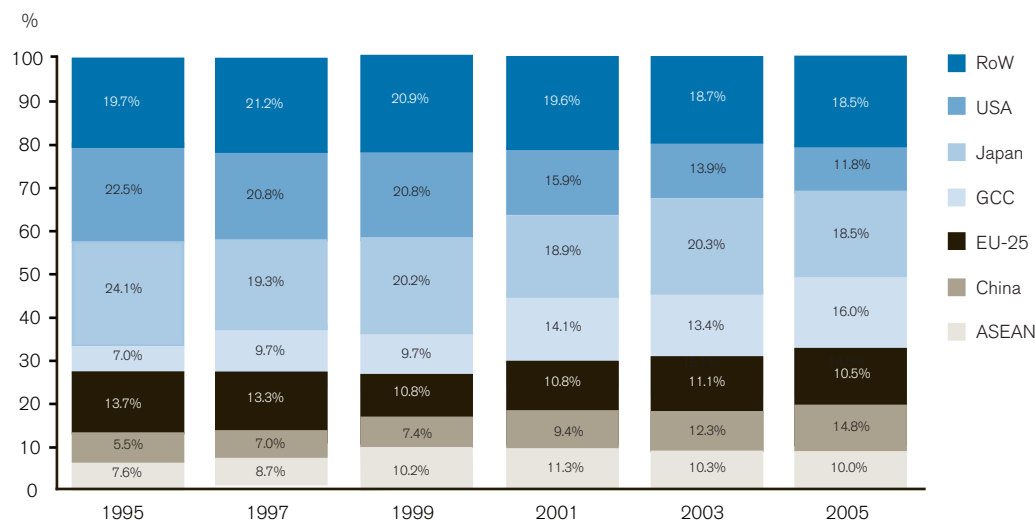
### Goods trade

Korea is one of the most successful economies of the post-Second World War development boom. Emerging devastated from the war in the Korean peninsula, the economy has grown at an average rate in excess of 5% p.a. since the early 1950s. Korea is a member of the OECD and has an income per head approaching that of the most advanced developed countries. This has been achieved on a classic development strategy of export-led growth driven by the manufacturing sector. As in Japan, agriculture and services were highly protected while manufacturers tested their competitiveness on the world market.

The EU's share of Korean imports of goods fell from about 14% in 1995 to around 10% in 2005, when it was Korea's fifth largest supplier (Figure 1). This decline is shared by the US and Japan. China and ASEAN (as key partners in the East Asian production system), along with the Gulf Cooperation Council countries (as energy suppliers), have increased their shares. Nearly half of EU exports to Korea are in the machinery and transport category (Figure 2).

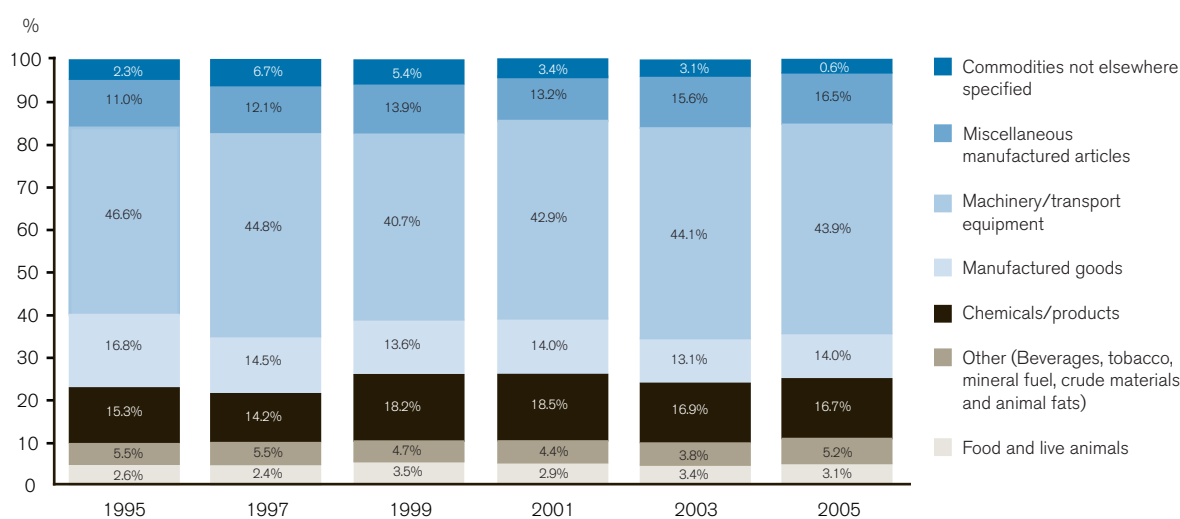
The EU was the third largest export market for Korea in 2005 after China and the United States (Figure 3). Exports to the EU are predominately machinery and transport (over 80% in 2005 – Figure 4).

Figure 1: Geographical distribution of Korean imports of goods (1995–2005)



Source: Based on data from World Bank WITS database.

Figure 2: Sectoral distribution of Korean imports from the EU-25 (1995-2005)



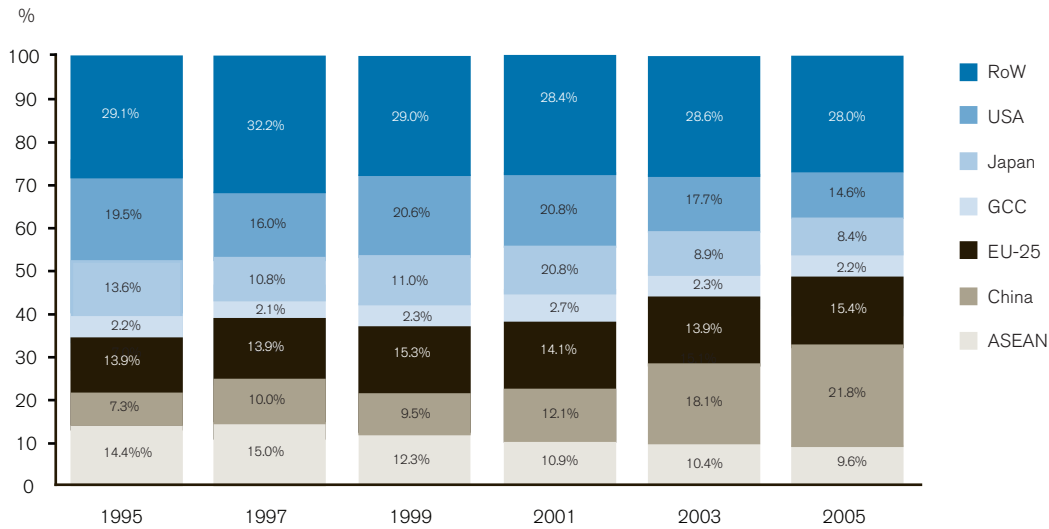
Source: Based on data from World Bank WITS database.

Korea is the EU’s 13th largest external goods market and represented 1.9% of total exports to the world. It was the EU’s eighth largest source of imports, at 2.4% of total imports from the world (Copenhagen Economics, 2007, table 2.3:11).

Looking at the goods trade numbers (Table 1), it is clear that the EU has a relatively similar export structure to Korea.<sup>1</sup> The EU and the US, in particular, have similar export structures (60% similarity, according to the last row in Table 1) and send similar products to

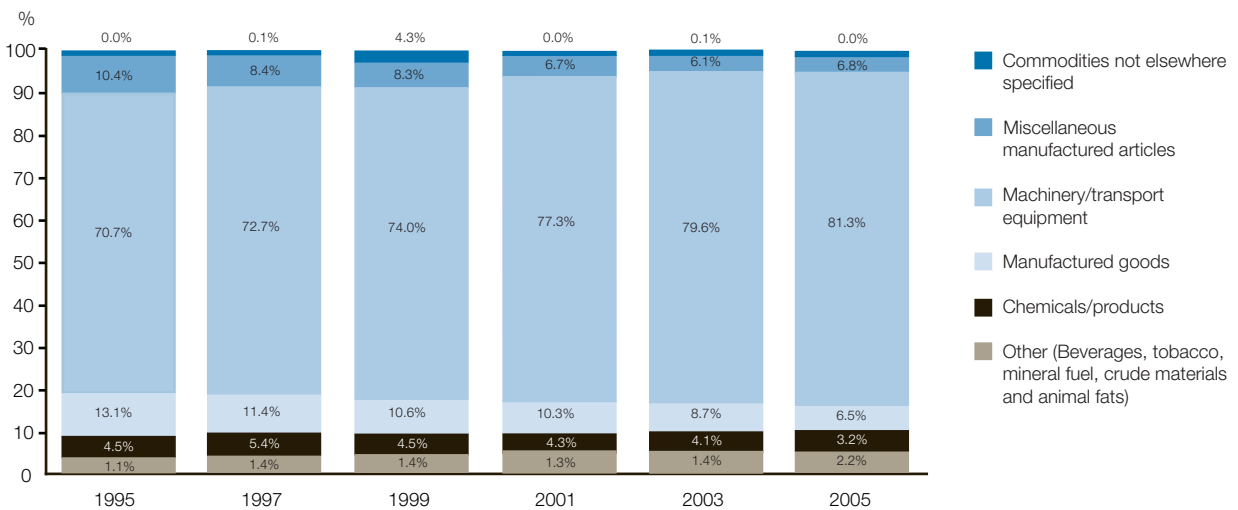
1. The Finger-Kreinin index is a standard measure of similarity between different economies’ trade, based on the composition of their exports and imports. A figure of 1, the maximum, would signify complete similarity.

Figure 3: Geographical distribution of Korean exports (1995–2005)



Source: Based on data from World Bank WITS database.

Figure 4: Sectoral distribution of Korean exports to the EU-25 (1995–2005)



Source: Based on data from World Bank WITS database.

Korea, whereas their similarity with Asian exporters is somewhat lower, at around 40–45%. This might suggest that the US–Korea agreement could cause particular problems and a loss for the EU if the US used its competitive advantage from the FTA to displace EU products from the market (known as trade diversion). But as Table 1 shows, the degree of similarity with the main actual and potential FTA partners for Korea is

also quite high, so this threat to the EU market share could go wider and be significant.

One other issue that is worth exploring is whether there is scope for the EU and Korea to expand intra-industry trade (IIT). This trade takes two main forms. First is trade in different varieties of goods, which offers the possibility of selling higher-quality goods for higher prices. The second form is trade in

components. This form of IIT has been increasing worldwide as production chains fragment – particularly in East Asia. Both types of IIT allow producers to increase productivity through specialization, thus generating potentially large economic benefits. This form of deep integration offers significant gains to both sides and may outweigh trade diversion costs. For EU–Korea trade the Grubel-Lloyd index is around 0.25.<sup>2</sup> This compares with a figure of about 0.60 for EU–US trade, which suggests that there is not as much IIT in EU–Korea trade as might be expected and the potential is therefore high for the FTA to unleash IIT and the accompanying productivity gains.

Table 1: Finger-Kreinin index of export similarity, 2005

	Korea	Japan	China	US	ASEAN	EU
Korea	1.000					
Japan	0.503	1.000				
China	0.382	0.322	1.000			
US	0.384	0.480	0.343	1.000		
ASEAN	0.417	0.347	0.422	0.405	1.000	
EU	0.420	0.453	0.390	0.609	0.404	1.000

Source: Calculated by Javier Lopez Gonzalez using data from WITS.

### Services trade

Statistics on services trade are less readily available but, according to the OECD, in 2005 Korea exported \$6.6bn worth of services to the EU-25 (14.8% of the total services exports compared with 11.6% in 1999) and imported services worth \$10.6bn (20.8% of the total compared with 14.1% in 1999). Total Korean goods exports to and imports from the EU-25 totalled some \$40bn and \$25bn respectively. Korea represented about 1.4% of EU-25 exports of services to the non-EU world in 2005. Import

share data for the EU-25 are not yet available on the OECD database.

## Levels of protection

### Goods

Korea has high tariffs (Table 2) relative to the EU and has not undertaken any substantial unilateral liberalization following the Uruguay Round. Agriculture is particularly highly protected both on average and in terms of the number of tariff peaks (tariff lines where the tariff is more than three times the sector average), and even in comparison with the EU (Table 3). This suggests that the EU could already be facing trade diversion in important sectors, notably for processed foods and beverages, if other preferential trade partners of Korea are producers in these sectors.

### Services

It is less easy to quantify protection directly in services sectors since there are no direct trade measures such as tariffs. Rather, it is regulation in the services sector that provides the obstacles to trade, whether deliberately or effectively as an unintended by-product of the regulation. For example lack of recognition of foreign qualifications in, say, the legal or medical professions is seen as consumer protection rather than as a trade measure *per se*. Copenhagen Economics made some indirect estimates of levels of service protection (Copenhagen Economics, 2007, table 2.6:16) using econometric techniques.<sup>3</sup> These give estimates of a tariff equivalent of 17% against imports of services into the EU and 46% for imports into Korea (i.e. imports into the EU face barriers equivalent to 17% of their market price). These figures are substantially above the levels of protection afforded to manufactures and in excess of the average tariff protection given to agriculture. Whether or not the absolute numbers are precisely accurate, it is likely that the relative levels are broadly correct. This also suggests that some regulatory

2. The Grubel-Lloyd index measures the proportion of trade in a given category that is IIT – i.e. an index of 0.5 means 50%.

3. Specifically gravity models; refer to technical appendix of Copenhagen Economics (2007) for details.

Table 2: Korea average tariffs (unweighted) by broad economic category (BEC), 2004 (%)

BEC	2004 average	2004 domestic peaks	% change in tariffs (1997–2004)
Food and beverages	40.59	203	-14.82
Industrial supplies not elsewhere specified	7.58	61	-16.98
Fuels and lubricants	3.73	0	-3.62
Capital goods (except transport equipment)	6.09	3	-22.22
Transport equipment and parts and accessories	6.14	0	-3.76
Consumer goods not elsewhere specified	9.25	13	14.48
Goods not elsewhere specified	0.89	0	-16.04
Total trade average	11.21	280	-12.42

Source: Data extracted using WITS from the TRAINS database (UNCTAD).

Table 3: EU and Korea average tariffs (unweighted) by BEC (%)

BEC	Korea simple average	EU-25 simple average
Food & live animals	30.88	10.12
Beverages and tobacco	20.45	11.21
Crude materials ex food/fuel	7.83	0.85
Mineral fuel/lubricants	5.37	1.62
Animal/veg oil/fat/wax	9.21	5.19
Chemicals/products n.e.s.	8.16	4.42
Manufactured goods	6.91	4.14
Machinery/transport equipment	6.07	2.27
Miscellaneous manufactured articles	8.1	5.79
Commodities n.e.s.	2.45	0
TOTAL	8.16	4.23

Source: Data extracted using WITS from the TRAINS database (UNCTAD).

approximation or mutual recognition of regulatory norms could generate increased trade and economic benefits.

## Economic effects of an EU–Korea FTA

In general terms the application of the Sussex Framework<sup>4</sup> suggests that, owing to the relatively high tariffs and levels of protection on services, Korea may already be suffering some potential trade diversion losses: competing producers with FTAs (see the export similarity indices in Table 1) are taking advantage of preferential access to the Korean market in goods (notably processed foods and beverages, where tariffs are high) and in services, where the EU has a comparative advantage. Equally there seem to be potential advantages in IIT and in services to reap substantial deep integration gains on both sides from full or partial liberalization if an EU–Korea FTA is agreed.

Overall, therefore, the Sussex Framework suggests that it is in the interest of both Korea and the EU to negotiate an FTA, not just to protect themselves from existing and future preferential partners on the Korean market but also to reap some of the potentially large benefits of deep integration.

Two studies have attempted to provide overall assessments of the impact on GDP: the Copenhagen Economics study already referred to and a study by the

4. The Sussex Framework is an analytical approach which allows the systematic assessment of the costs and benefits of any given preferential trading arrangement for any given pair of countries or regional groups. It is based in economic theory and allows empirically robust assessments of potential agreements without recourse to sophisticated quantitative methods. See Evans et al. (2007) for details.



Korean Institute for International Economic Policy (KIEP) (Kim et al., 2005). The Kim study is available only in Korean but an English summary is available on the KIEP website.<sup>5</sup>

The two studies use different versions of the same basic general equilibrium model and somewhat different scenarios. In the scenarios compared here Kim et al. assume free trade in manufactures but 50% liberalization in services and food and agriculture. Copenhagen Economics assume free trade in manufactures, a 40% cut in agricultural and food tariffs and also a 50% cut in protection to services.<sup>6</sup>

**Table 4: Impact of EU–Korea FTA – comparison of changes in GDP**

	Changes in GDP (%)	
	EU-25	Korea
<i>KIEP</i>		
Free trade in manufactures; 50% cut in protection to agriculture and Services	0.01-0.09	2.0
<i>Copenhagen Economics</i>		
Free trade in manufactures; 40% cut in agricultural protection and 50% cut in services	0.1	3.0

As Table 4 shows, the numbers point in a similar direction. The EU gains are small and less than Korea's (a matter of scale – the EU is more important to Korea than vice versa) but in the KIEP model the EU would lose out from trade diversion from the Korean agreements with the US and Japan if it did not sign an agreement. Most of the bang comes from services on both sides (in the KIEP study, if there were no services liberalization, the gains to Korea would be reduced to under 1% of GDP).

## Negotiating issues

There are clearly strong reasons for both sides to conclude an agreement – both to protect themselves

from trade diversion losses from existing agreements, and in particular from any US and Japan agreements should these be implemented, and to try to generate deep integration gains from increased IIT and from services liberalization. Other issues could get in the way, however. Overall EU enthusiasm for as much liberalization as possible and much deep integration on the services front in particular could trigger reactions from Korean economic interests. Similarly automobiles might present a problem for EU interests. Despite both sides being reluctant agricultural liberalizers, there may be difficulties if the EU pursues liberalization on processed foods and beverages. Rules of origin may also throw up problems. To qualify for preferential access to the European market, the EU usually demands that a product have a local content of around 60% of total value added. The Koreans use a transformation rule for origin – i.e. once an imported product has received enough processing to change its tariff classification it is taken to have local origin. That, combined with the integration of Korea into Asian production chains, suggests that many Korean products – and perhaps above all automobiles and electronics, where EU tariffs are high and fragmentation of production chains most advanced – may not meet the EU origin requirements. An agreement that effectively excluded autos and electronics would perhaps not hold much attraction for the Koreans.

## Conclusions

There is much to play for in these negotiations, primarily the reduction in trade diversion costs to both sides which arise from Korean agreements with the United States and Japan. But much more could be gained if intra-industry trade and services were at the heart of a deep integration agenda. There seems to be the makings of an agreement; after all, if the US can successfully negotiate an agreement with Korea then the EU should also be capable of doing so. But the ambition of the EU for a wide-ranging and highly liber-

5. [http://www.kiep.go.kr/eng/std\\_data\\_view.asp?num=131915&sCate=013001&sSubCate=&ITp=r&nowPage=2&listCnt=15](http://www.kiep.go.kr/eng/std_data_view.asp?num=131915&sCate=013001&sSubCate=&ITp=r&nowPage=2&listCnt=15).

6. See Copenhagen Economics (2007), pp. 47–49 for a detailed comparison.

alizing agreement along with its approach to rules of origin may in the end be too much to ask of the Koreans and the negotiations could fail, to the cost of both sides. The slow progress in the negotiations to date suggests that caution predominates and that, despite the potential benefits, agreement might be impossible to find.

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