KOREA-EU FTA:
SIGNIFICANCE AND CONSEQUENCES FOR THE PARTNERS

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Abstract

Korea, a dynamic newly-industrialized economy, and the EU, the largest economic block, have negotiated an FTA. It came in force in July 1, 2011. Before the FTA was formed, the two were important trading partners of each other. Korea has enjoyed a trade surplus in merchandise trade vis-à-vis the EU. An overwhelmingly large proportion of EU-Korea trade is in manufacturing products. The EU has had a surplus in trade in services vis-à-vis Korea. The FTA protocol has specified lowering of tariffs and NTBs in a phased manner over a transition period. The FTA *inter alia* had sector-focused negations. Technological standards and environmental considerations are a part of the FTA protocol. The FTA has a comprehensive coverage and in trade economics parlance known as a "deep" or WTO-Plus regional integration arrangement. The WTO-plus FTAs are more trade efficient and have greater trade enhancing effect over time.

The impact of the FTA on the two partner economies would be positive but small. The empirical analyses predictably concluded that the FTA will benefit Korean economy relatively more in terms of welfare gains, while the EU economy will only gain modestly. For the most part, its gains will be sector-specific. An important fact that will influence the welfare gains is the magnitude of the EU trade with Korea; it is only 2 percent to 2.5 percent of total extra-EU trade. Sectoral impact of the FTA will be important for both the EU and Korea and this article elucidates which sectors will benefit more than others. To protect domestic producers and markets from sudden surge in post-FTA imports, there is a provision of a bilateral safeguard clause in the FTA protocol.

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1. Korean Economy: A Flourishing Trader

The Republic of Korea (hereinafter Korea) has earned accolade for being an economic success story. Since the latter half of the 1960s, Korean economy turned in a stellar performance. This performance was supported by a liberal domestic macroeconomic regime, robust growth in trade volume made possible by multilateral trade liberalization under the sponsorship of the various rounds of multilateral trade negotiations (MTNs) of the General Agreement on Tariff and Trade/World Trade Organization (GATT/WTO), improvement in the competitiveness of large Korean firms and availability of large open markets in the European Union (EU) and the United States (US).

Geographically Korea is a small-size country, with only 0.7 percent of the world population. It is presently a medium-sized economy and the seventh largest trader in the world. In 2010, value of its merchandise exports ($466 billion) was close to that of France ($521 billion), a mature industrial economy (WTO, 2011a). Korea accounts for 3.1 percent share in multilateral exports. This performance is not far behind France, the 6th largest trader with 3.4 percent share in the multilateral exports. Korea's top trading partners are the People's Republic of China (hereinafter China), the EU, the US and Japan, in that order. The EU is the largest trading bloc of 27 countries, accounting for $1,787 billion in exports in 2010, which is 15.0 percent of the total multilateral exports (WTO, 2011a).

Korean economy has been admired for its outer-oriented or export-led growth paradigm, which was later on appreciatively emulated by other developing economies. External sector was and continues to be one of the principal sources of Korean economic growth and present prosperity. With trade-to-GDP ratio of 96 percent, Korea is one of the most open and trade-dependent economies in the world. It has sustained high or medium GDP growth rates over the preceding four decades. It is widely regarded as a successful example of economic transformation in a short time span. It is known for its pool of skilled labor that is comparable to many EU economies. In the 1960s, Korean economy was a successful exporter of textiles and apparel and was able to generate a trade surplus. As its comparative advantage evolved, Korea moved up the technology ladder and to high-technology manufacturing sectors. Automobiles and electronics products like semiconductors, mobile phones, and flat-panel display are the items in which Korea is at present a globally successful exporter.

Until the mid-1980s reliance of Korean exporters on the US market was heavy. However, Korea's US market share peaked in 1986 at 40 percent of its total exports. Thereafter, Korean export markets began to diversity. Until the Asian crisis struck in 1997-98, exports to the

Association of Southeast Asian Nations (ASEAN)[1] economies and China continued to rise at the expense of the US. During this period, several of the ASEAN economies were industrializing rapidly and became substantive importers of capital goods from Korea. Rapid export growth to the ASEAN economies coincided with a surge in outward investment from Korea to them.

As the emerging-market economies (EMEs), a new group of markets, came into their own, and Korea became a successful exporter to them as well. As the middle-classes expanded in the EMEs, Korean exports to them began to accelerate. For instance, exports to China, India and the other Asian EMEs surged in a dramatic manner in the mid-1990s, but they were interrupted by the Asian crisis. After the Asian crisis, exports to China increased at a robust pace. China accounted for 11 percent of total Korean exports in 2000. They crossed 20 percent mark in 2005 and reached 25 percent mark in 2010. This demonstrates the growing concentration of Korean exports in one large market. Since the mid-2000s electronics and automobiles exports emerged as important sectors for the rapidly burgeoning Chinese markets. Korea's trade with the EU grew slowly and stabilized around the mid-1980s. After this point in time, exports to the EU stabilized around 15 percent of the total. In terms of the proportion of the total they did change but in the negative direction (section 2).

2. The EU- Korea Trade

Diplomatic relations between the EU and Korea were established in 1963. Since then they have strengthened dramatically. The same can be stated about economic relations. In the recent years, importance of China as an export market went on increasing. After 2006, China became the premier trade partner of Korea and the EU was relegated to the second position. The EU continues to be the second largest market for the Korean exports accounting for 13 percent of total Korean exports in 2009, after China which accounted for 24 percent. The EU is the third largest source of Korean imports accounting for 10 percent of the total, while China (17 percent) comes first and Japan (15 percent) second. During the 2000-09 decade EU-Korea trade grew at an annual rate of 8.4 percent. Please note that 2009 was a crisis year and global trade had contracted by 12 percent and Korea EU trade had also contracted. Since 2005, in terms of volume, EU-Korea trade as been higher than Korea-US trade.

Flip side of the EU-Korea trade is that Korea's trade with the EMEs in general has increase at a relatively faster pace in the recent past. This applies particularly to China, India and Vietnam. Due to the new EME focus of exports, Korea's market share in the EU has decelerated from 15.4 percent in 2005 to 11.5 percent in 2010. In terms of export volume, in 2010 Korean exports to the EU reached $53.5 billion, but they were far behind that to China ($116.84). As Korean exports to the EMEs continue their rise, those to the EU may well decelerate further (Kim, 2011). This applies particularly to the large markets in the EU, like Germany and the United Kingdom, where Korean market share steadily declined. Calculations of Relative Comparative Advantage (RCA) indicate that Korean goods are losing their RCA in the EU market. At the same time the

[1]The Association of Southeast Asian Nations (ASEAN) was founded by five Southeast Asian economies, namely, Indonesia, Malaysia, the Philippines, Singapore and Thailand in August 1967. Since then its membership has expanded to include Brunei, Myanmar, Cambodia, Laos and Vietnam.

products exported by Korea's competitor economies to the EU, namely, China, the US and Japan, are winning (Kim, 2011). This implies that Korea is in for a phase of weakening trade ties with the EU. Also, as Korean firms are establishing automobile and other manufacturing bases in the Eastern European member countries of the EU, Korea's export pattern to the EU has been undergoing a transformation. Korea was principally an exporter of finished products to the EU. It is now increasingly exporting intermediate products.

Although a successful and competitive trading economy, Korea is not known for large current account surpluses. The principal reasons are large merchandise imports and a perennial deficit in trade in services. This deficit has persisted since 2000 and is regarded by Korean policy mandarins as chink in the armor of the Korean economy. EU-Korea trade in following services has suffered from chronic deficit: business services, travel and patents and royalties.

In merchandise trade, principal export items from Korea to the EU are automobiles, semiconductors, computers, ships and wireless telecommunications devises. The EU exports machinery, semiconductors, jewelry and a range of chemicals to Korea. Thus, an overwhelmingly large proportion of EU-Korea trade is in manufacturing products. They account for 94 percent of Korea's total exports to the EU. The EU and Korea have a complementary industrial structure in the manufacturing sector (Lee, et al, 2010) Over 80 percent of EU exports to Korea come in this category. So did 87 percent of Korean exports to the EU. Machinery and transportation equipment were the principal trade items for the two sides. The same product range dominating trade of the two partners implies a great deal of intra-industry trade, which is export and import of the same products or similar products within an industry. This reflects vertically integrated production and trade networks that operate in Korea and the firms in the EU are involved in it.

Although bilateral trade in services also increased, it is smaller than that in merchandise. EU exports in the services sector increased 42 percent over 2004-08 period, while Korea's export of services increased by 36 percent over the same period. The two sides exported to each other the same set of services, namely, transportation, business services, travel and receipts and royalties from the use of intellectual property. Although the EU is a provider of financial services to Korea, there is little reverse trade in financial services. While Korea has enjoyed a surplus in merchandise trade since 1999, the EU has had a fairly large surplus in trade in services. This trend has persisted for some time.

Among the individual members of the EU, Germany and the United Kingdom (UK) are the largest trading partners of Korea, followed by Italy, the Netherlands and Spain. The EU-Korea economic ties are not limited to trade in goods and services but extend to foreign direct investment (FDI). Traditionally the US business firms and transnational corporations (TNCs) were the largest investors in Korea, but in 1999 the EU firms surpassed them. Both in terms of stocks and flows, presently the EU is the largest investor in Korea. EU's total FDI stock in Korea was € 29.9 billion in 2008. The areas that that have attracted large EU FDI in Korea are energy, electrical and electronics, telecommunications and wholesale and retail businesses. EU firms have made major investments in semiconductor, automobile parts and cosmetic distribution.

The largest individual EU investors are the Netherlands, Germany, the UK and France, in that order. Forming a free trade agreement (FTA) with a large FDI donor economy provides dynamic gains to the FDI recipient economy. It enables the recipient economy to benefit from the transfer of advanced technology, connect with the important global markets and promote trade.

FDI flows from Korea to the EU economies also took place, but in much smaller amount than those from the EU to Korea. In 2008, stock of Korean FDI in the EU was € 7.3 billion. Initially there was not much of a trend in Korean FDI flows and they were marked by volatility. In the mid-1990s the Korean won was strong, which supported Korean FDI flows. They slowly reached their high point of $580 million in 1995. Over a quarter these foreign investments were made in the central and eastern European economies, which later became members of the EU. The Asian financial crisis of 1997-98 took the wind out of these flows. After 2000, Korean FDI flows began to gain momentum and were directed towards the new EU members. This trend continued to strengthen due to improved investment environment in the new EU member states. Also, Korean firms were eager to gain market access to the large EU market and they considered FDI an important instrument for that purpose.

3. Compatibility and Overtures

Notwithstanding the difference in the size of the two economies, from an economic and non-economic perspective Korea is an attractive bilateral FTA partner for the EU. In the early 1960s it was a penurious agricultural economy. It succeeded in transforming itself into a successful newly-industrialized economy by the 1990s. Korea impressed the academic and policymaking conclaves around the globe by its economic dynamism. According to the *World Development Indicators 2011* Korea's 2009 per capita income in current dollars was $19,830, which is comparable to countries like Portugal ($21,910) and several new EU members. No doubt it was almost half that of the EU ($34,358) average. Measured in purchasing power parity (PPP) terms it was $27,249 (WDI, 2011). With GDP of $16.4 trillion, the EU is the largest global economy. As stated above (section 1), it is also the largest trading group in the global economy, its market size is approximately eighteen times larger than that of Korea. Still, there is strong economic rationale for Korea to pursue the concept of forming an FTA with the EU because it is a credible instrument for expanding its exports, increase GDP, both of which have welfare implications. The external sector has been an important source of growth and employment for the Korean economy. In the recent years, exports were more than 45 percent of the Korean GDP.

GDP growth rate, structural transformation and the pace of change in Korea is faster than that in the EU. An FTA with such an energetic economy will undeniably mean long-term gains for the EU. In addition, Korea has paid a great deal of attention to honing its human capital, and made impressive investments in it. Development of human capital alone will stimulate transformation of the Korean economy. An FTA with such an economy would have long-term dynamic implications for the EU. Rapid pace of evolution of R&D and human capital formation in Korea reinforced its ability to innovate and be more competitive. According to the *Global Competitiveness Report 2011*, Korea's competitiveness increased from 27 to 19 between 2000 and 2010. It is reasonable to expect Korea to be highly competitive in high-technology industrial and some selected services sectors (like construction and transport) in the near future.

Traditionally both the EU and Korea were skeptical about the value of bilateral or multilateral preferential trade agreements of any sort, unless they were a part of a broad economic and political strategy. The EU, like Korea, remains largely committed to multilateralism in world trade. During the last couple of decades, the newly-industrialized economies (NIEs)[2] of Asia and several of the EMEs have grown rapidly and have come to be both fairly large economies in terms of their size and trade volume. Many of them still have trade barriers that the EU firms find it difficult to overcome. They cannot increase their sale or investment to these NIEs and EMEs. Various rounds of MTNs have so far failed in removing this kind of entrenched protectionism. One instrument of improving access to these markets is bilateral or regional negotiations. Korea is one such NIE and therefore appropriate for being an FTA partner of the EU or any other comparable economy like the US.

Slow and torturous progress of the Doha Round and finally its suspension proved to both of them that forming an FTA would be a profitable option. Both the economies saw value in a new class of FTAs. They believed that they would contribute to their growth and competitiveness as FTA partners. Besides, there are trade barriers that are difficult to liberalize even if the Doha Round is resuscitated and produces desired results. Some non-tariff barriers (NTBs) fall under this category, albeit they are not the only ones. Properly pursued such NTBs can be reduced or eliminated in bilateral negotiations.

The EU-Korea FTA represents the trade strategies of the two partners, which is to strengthen economic ties outside their own respective regions. The objective is to build on the surge in trade and investment between the two partners during the last decade. It is important to note that neither partner of the FTA was eager to enter into bilateral FTAs before the early 2000s. The EU did enter into regional trade agreements earlier, but its apparent focus was regional agreements with former colonies. In a show of support for the problematic Doha Round of MTNs, the EU had clamped a moratorium on FTA formation between 1999 and 2006. The EU-Korea FTA is a part of the European initiative that is called the “Global Europe”, publicized by the EU in 2006. The objective of this strategy was to cultivate close trade and economic relations with emerging trade powers and energy producers, like the Gulf Cooperation Council (GCC), so that the EU business firms could access these rapidly growing markets. Preferential trade agreements with these groups of economies were considered the appropriate instrument for achieving this objective (Rollo, 2006). In Asia the EU started negotiating FTA with the ASEAN economies, India, Korea, Singapore and Malaysia in April 2007. Likewise, Korean President Lee Myung Bak had proposed a parallel strategy termed the “Global Korea”.

Impressed by Korean economic performance and its bold and confident approach towards free multilateral trade, the EU made a proposed to form a bilateral FTA. Negotiations between the EU and Korea were launched on May 6, 2007. After eight formal rounds of negotiations the text

[2] The four Asian newly industrialized economies are Hong Kong SAR, Korea, Singapore and Taiwan.

of the agreement was finalized and initialed on October 15, 2009. Some of the contentious points in negations were tariff reduction schedule, rules of origin (ROO) trade in services and autos. In October 2010, the two signed a bilateral FTA. The agreement was signed by the 27 member states of the EU, the EU Commission and the Republic of Korea. It was ratified by the European Parliament in February 2011 and the Korean National Assembly in May 2011 and will come in force on July 1, 2011. It will be the largest FTA in terms of market size that Korea has entered into.

Launching FTAs was adopted as a strategy by the two FTA partners. Both of them not only entered into several bilateral and multilateral FTAs but they did so at a progressive rate. In the recent past the EU has also attempted to form preferential trading agreements of various kind with several Asian economies enumerated above as well as with Russia and the GCC. Likewise, Korea has attempted to negotiate FTAs with Chile, the European Free Trade Area (EFTA), Singapore, the ASEAN group and the US. Negotiations for a Korea-Japan FTA did not make progress but those with Canada, India and Mexico are afoot. FTA negotiations are usually a long drawn out process. Korea is the first Asian economy to sign an FTA with the EU.

4. Creating a “Deep” or WTO-Plus Free Trade Agreement

The FTA agreement is a 1,200-page document. Under the EU-Korea FTA protocol, tariffs and NTBs are to be lowered and eliminated in a phased manner over a transitional period. This would enable domestic producers to adapt to lowering of existing trade restrictions. Implementation of the FTA protocol will benefit consumers by lowering the prices and producers by enhancing competitiveness. According to the mutually agreed protocol, the EU will remove all of its tariffs on Korean goods within five years after the FTA come into force. Korea will have a longer period—seven years—to comply. To implement the FTA without delay, the EU will eradicate 99.4 percent of its tariffs on Korean imports within three years. Of these 97.3 percent will be abolished forthwith. Korea will eliminate 95.8 percent of its tariffs on imports from the EU within three years. Of these 90.7 percent will be eliminated immediately (Lee, et al, 2910). As regards trade in manufactured goods, the objective is to lift all tariffs, with minor exceptions, in five years after the implementation begins.

Automobiles are a large trading item. Tariffs on trade in autos will be eliminated in three to five years, which will benefit auto producers in both the economies. Coverage of this FTA also includes trade in services, harmonization of “regulatory” measures and provisions on FDI both in services and industrial sectors. The EU took a great deal of interest in the liberalization of services sector. The reason was that major gains to EU were believed to emanate from this source. The EU negotiators carefully studied the on-going negotiations of the Korea-US FTA and pressed for at least comparable degree of liberalization in the services sector. The two partners finally agreed to gradually opening up several services sectors, including legal services. Korea also consented to reforming the domestic legal system. The two partners will allow wider market access to each other in telecommunications and environmental services markets. Trade-related activities like government procurement, strong discipline in intellectual property rights (IPRs) and other intangible and tangible assets, labor rights and mobility and environmental issues have also been included in the EU-Korea FTA. These issues are believed to be difficult to negotiate in a multilateral framework (OECD, 2003). In addition, the EU-Korea FTA also addresses NTBs on trade in all the major trade categories, namely manufactured goods, agricultural products and services as well as investment in goods and services.

In trade parlance such a comprehensive coverage makes this FTA a “deep” or WTO-plus regional integration arrangement. Agreements between advance industrial economies and developing ones generally take a WTO-plus form. In this Korea is not a developing country but a well-established NIE. Also, over the decade of 2000s forming WTO-Plus FTAs regional integration agreements became an important feature of FTAs and other kinds of preferential trade agreements. The reason why the agenda of FTAs expanded was that there was a continuing decline in the border barriers in the international economy. The deep integration arrangements span various facets of product and market regulations, as alluded to in the preceding paragraph. They also tend to cover competition policy. Covering regulatory policy became important in preferential trade agreements because services became more tradable, and with that their importance in both trade and FTA negotiations rose (Hoekman and Winters, 2009). Using vector auto-regression (VAR) framework based on the two time-series derived from the gravity model Herz and Wagner (2011) show that as FTAs of the recent period are deep, and therefore more comprehensive, they have become more trade efficient. Trade enhancing effects of modern FTAs have enhanced over time. This outcome of an FTA could be expected from the EU-Korea FTA.

One sagacious use of FTA is to focus negotiations on specific sectors. This strategy is more valuable when the welfare impact of FTA formation is not large on the FTA partners. Some sectors of the economy, that have entrenched protection built around them, can be liberalized in exhaustive FTA negotiations. For the EU-Korea FTA, such sector-focused negations took a lot of time and attention. Individual sectors will have large impact of the FTA in both the partner economies. For instance EU exporters in the following industrial sectors would increase as a result of the FTA: pharmaceuticals, refined chemicals, industrial machinery, electronic parts, automobiles particularly large auto vehicles, auto parts, agricultural products and processed foods. Empirical studies show strong gains for the last named sector in the EU, namely agriculture and processed foods (section 6).

The two sides to the agreement demonstrated a lot of interest in technical and environmental issues. The EU was particularly interested in sustainable trade and supply chain management. High levels of technical and environmental standards have to be maintained by firms on both the sides. For instance, in automobile all vehicles are required to adhere to the standards set by the United Nations Economic Commission for Europe (UNECE). Meticulous product standards are also set for all electric and electronic products, including fixed and wireless communications devises. Similarly in trade in chemical substances the FTA facilitated product norms. In chemical analyses and management both the FTA partners agreed to adopt Good Laboratory Practices (GLP). General provisions were stipulated regarding development, access and facilitation in pharmaceutical products and medical devises. The two sides pragmatically compromised and reached a middle ground on such contentious issues as the ROO and duty drawbacks. These are regarded as exceedingly complex and contentious issues in negotiations.

The EU-Korea FTA has been welcomed by most of the business organizations in Korea and Europe, including the powerful Bundesverband der Deutschen Industrie (BDI) or the Federation of German Industries, which is an association of associations. The EU-Korea FTA is being seen as the first of the "new" FTAs, or a "next generation" FTA. Conventional FTAs focus on tariff reduction and they completely avoid sensitive sectors. The EU-Korea FTA is a departure from the conventional type and is more ambitious than the previously concluded FTAs by Korea with the ASEAN group and EFTA. It lays a good deal of emphasis on lowering or removal of NTBs. For both the FTA partners NTBs are a nuisance in that they have proved to be significant barriers to trade. According to one estimate (Deceux, et al, 2010) they have the protection effect of a tariff level of 76 percent in Korea and 46 percent in the EU. Owing to various rounds of MTNs and unilateral trade liberalization average tariff barriers are low in most large trading economies, which include the EU and Korea. Average tariffs in Korea are 12.2 percent while in the EU 5.6 percent (WTO, 2011b).

5. Managing the Sensitive Industries and Trade Sectors

For both the partners, there were sensitive sectors to deal with. Both sides agreed to concessions that took into account the industrial sensitivity of the other. Given its recent history, automobile was a highly sensitive sector for the EU. There were apprehensions among trade economists that the EU-Korea FTA may not be ratified by the European Parliament because of its effect on the European auto industry, which was piquantly opposed to the FTA. The European Parliament was blamed for delaying approval on the EU-Korea FTA (Moreira, 2010). There was a misperception among the European policy makers that FTA would result in a Korean car invasion of its auto markets. Political opposition in Korea argued that the FTA failed to provide enough protection to Korean farmers and companies.

For Korea services, machinery, chemicals, agriculture and processed foods were the sensitive sectors. Therefore Korea secured special treatment on rice and barley while negotiating the FTA. It also asked for and was given a long enough period for making transition in its agriculture sector due to trade liberalization in this sector. In this context, the forthcoming reforms in the common agricultural policy (CAP) of the EU may turn out to be beneficial for Korea. Businesses in Korea will need to quickly prepare for wine and pork imports from the EU because tariff reduction on them will be in force immediately after the EU-Korea FTA comes in force. A period of seven years was agreed to eliminate tariffs in the sensitive sector.

6. Potential Impact: Positive but Small

Korean GDP is close to one-fifteenth in size in comparison to that of the EU. Therefore, the EU market is far more important to Korean firms than the other way around. To the EU firms the FTA provides better market access to the Korean markets. It is more meaningful for their exports in the services as well as in processed foods, meat, dairy and agricultural products. As regards the impact of the EU-Korea FTA on the two partner economies, first as Korea has higher trade barriers than the EU, greater gains are expected to accrue to it from the FTA. Secondly, the FTA created an opportunity for Korean firms to access the largest market in the world without trade barriers, although absolutely unconditional market access is a theoretical concept. Price competitiveness of Korean exports in the EU market will increase. Thirdly, the FDI from the EU business firms in Korea will rise, which will be instrumental in upgrading Korean business systems. Fourthly, it will increase the extent of transparency, credibility and openness in the Korean economy, which in turn move it closer to the advanced economy status. These will be the principal sources of welfare gains to the Korean economy.

Reduction and elimination of tariff barriers in a phased and timely manner, as stipulated in the FTA protocol, is expected to increase Korea's exports to the EU at the rate of $2.52 billion per year and imports from the EU at the rate of $2.13 billion (Kim, 2011). If the EU does dismantle all the tariff barriers on the imports of manufactured products in five years, it can not only generate more bilateral trade but substitution of other trade sources.

Various empirical studies have analyzed the economic implication of the FTA. Most model-based analyses inferred that the welfare implications of the EU-Korea FTA will be positive, significant but not large. An important fact that will influence the welfare gains is that the magnitude of the EU trade with Korea; it is only 2 percent to 2.5 percent of total extra-EU trade (Breuss and Francois, 2011). The empirical analyses predictably concluded that of the two, the FTA will benefit Korean economy relatively more in terms of welfare gains, while the EU economy will only gain modestly.

The payoff from trade liberalization under the FTA will be relatively higher in Korea because pre-FTA Korea has higher tariffs and NTBs in comparison to the EU. For the most part the EU economies will benefit from liberalization in trade in services. The miniaturization of overall welfare gains from the FTA for the EU is consistent with the fact that both the FTA partners have been highly open economies and well integrated with the global economy. Additionally, the EU is already the largest group of 27 regionally integrated economies, which have formed a purposeful economic and monetary union. The two partner economies of the FTA will be influenced far more by the other factors and by other economies with which they have stronger trade and investment ties as well as global economic and financial variations and business climate. Also, domestic factors like consumption, government spending and investment will have a large effect on them than that of the FTA formation.

One rule of thumb is that further liberalizing trade and eliminating tariffs and NTBs benefits both the trading partners. Computable general equilibrium (CGE) modeling exercises are customarily deployed for measuring these gains. Empirical estimates based on CGE modeling, put gains for Korean GDP of the order of 1 percent to 2 percent while that for the EU in the vicinity of 0.05 percent.

An early estimate made by Copenhagen Economics (2007) showed an increase in real income, output and GDP in both the economies. The effect was understandably found to be bigger for Korea, both in absolute and relative terms. Copenhagen Economics (2007) used CGE model based on GTAP data base and concluded that the EU-Korea FTA will yield a GDP increase of 1.01 percent for Korea and a modest 0.03 percent for the EU. This result was based on less than totally free trade between the two partners. When an ambitious liberalization was incorporated in the model, Korean GDP was estimated to increase up to 2.4 percent. The biggest gains were to come from liberalization in trade in services. The reason was that the barriers to trade were assumed to be the real resource costs. Liberalization in trade in services was estimated to yield as much as 2 percent gains in Korean real income.

A simulation exercise by the European Parliament estimated increases in two-way trade. EU exports to Korea were estimated to go up by €19 billion, which was a 48 percent increase in three years. Korean exports to the EU were found to increase by € 13 billion, which is a 36 percent rise (LSE, 2010). Small quantitative increases are explained by the well-appreciated fact that for the EU business firms Korea is a small market.

However, there are other empirical studies that estimated trade increases of much higher range. The reason was differing approach to computing. For instance, Deceux, et al (2010) took into account the NTBs in their computations of gains from the FTA. According to their estimates the trade surplus of the EU in services will increase from € 6 billion to € 9 billion. Tariff elimination in Korea will benefit the agricultural exports of the EU. They have been estimated to increase by € 8 billion to € 10 billion, which in turn will improve the bilateral trade balance in favor of the EU by € 5 billion. Also, due to the protocol on NTBs the EU will be able to improve its bilateral trade balance with Korea in chemicals by € 3.6 billion to € 5.1 billion. An important area of bilateral trade is machinery and electronics. Bilateral export growth in these two areas may range between 65 percent and 84 percent. Korean firms are highly competitive in both of these areas in the EU markets. A great deal of intra-trade has developed over the years due to specialization, sometimes over-specialization. Firms in both the economies rely on each other for specialized parts, components and subassemblies and are highly inter-dependent. There is little direct competition in these two produce areas among them. These two sectors are a large employment generating sector, therefore FTA will alleviate unemployment pressure.

Using GTAP world computable general equilibrium model, Breuss and Francois (2011) evaluated the economic impact of the FTA on the EU and Korea. Their results showed increases in total EU trade by 0.2 percent, extra-EU trade by 1.2 percent and welfare gains for the EU of merely 0.04 percent in terms of increase in GDP. They are small by any measure. For Korea the gains in trade were substantive, 5.3 percent and welfare gains were 1.3 percent increase on GDP.

An amber signal is essential here. It cannot be ignored that when CGE models are used to assess the welfare effect of FTAs, they tend to underestimate the dynamic role played by increased imports resulting from the FTA. They are the largest source of dynamic gains from trade. They not only provide access to larger variety of goods and services, but also contribute to better utilization of domestic resources, which in turn improves allocative efficiency of resources. When domestic producers are forced to compete with the imported products, the domestic producers are forced to behave in a more efficient and productive manner—or be extinct. These dynamic gains from an FTA are significant and are not calibrated by CGE models (Erixon and Lee, 2010).

7. Individual Sectoral Impact

Importance of negotiations in services sector was discussed above (sector 4). An independent study conducted by IBM (2008) concluded substantive increases in the EU exports of cereals and beef, albeit it will not require a great deal of market adjustment in Korea because it will have taken place as result of the Doha Round of MTNs. Similarly increases in EU exports of pork, horticultural products and processed food will also require only small market adjustments in Korea.

However, increases in EU wine and spirits exports will have trade diversion effect. Wine tariffs of 15 percent in Korea will be lifted immediately after the FTA come into force, which will reduce Korean wine prices by 12 percent to 13 percent. Other trade partners of Korea that are currently exporting wine and spirits would suffer partial loss of their market. Business firms in the services sector in the EU will gain markedly from the EU-Korea FTA. This applies to firms in the areas of retail and wholesale trade, transportation services, financial services and business services. FTA is going to further boost financial services exports of the EU to Korea.

On the Korean side of the equation, manufacturers of automobiles, auto-parts, ships, wireless telecommunications devises, chemical products and imaging equipments are likely to increase their exports to the EU countries. Korea is a net exporter of cars to the EU. The IBM (2008) study concluded that auto industry in Korea will benefit far more from the EU-Korea FTA than that in the EU. Expectations of Korean automakers regarding these gains are high. The present EU tariff on autos is 10 percent. Abolition of this tariff will reduce the purchase price of an average Korean car by € 1,000, making them more competitive in the EU markets. Also, Korean automakers are preparing for production in the EU. The Czech Republic and Slovakia are two locales that are being considered at present. Assembly and export costs of the Korean cars in the EU will be reduced if the 4.5 percent tariff on auto parts exported from Korea to EU is eliminated with the FTA coming in to force.

A simulation exercise by the European Parliament estimated sectoral impact and concluded that it may not always be small. In some selected sectors trade increases could be substantive. For instance, results of this exercise found that the EU exports of business services to Korea would increase by 22 percent in value terms, machinery 16 percent and processed foods 11 percent. Korean exports to the EU will show sizeable increases in the automobile sector (40 percent), electrical machinery (13.5 percent) and textiles (9 percent) (EP, 2010).

8. Bilateral Safeguard Clause

There is a provision of a bilateral safeguard clause in the EU-Korea FTA. Accordingly, if after the FTA comes into force and its implementation causes a sudden and unexpected import surge in either economy, which threatens injury to the domestic producers, the safeguard mechanism can be invoked. Under such circumstances, both the parties to the agreement can suspend tariff reduction. Also, tariffs may be raised to the most-favored-nation (MFN) tariff level. As regards the initiation of the safeguard investigation, the procedure to be followed would be the internal EU legislation. Early in 2011, the International Trade Committee (known as the INTA) of the European Parliament approved several amendments in the Regulation proposal so that threat to

European industries may be detected at an early stage and the safeguard action can be set in motion.

In situations where there is a disagreement regarding whether conditions of deploying safeguard measures have been met, the issue will be settled by a three-member panel. As regards how this panel is to be set up, Article 14.5 of chapter 14 provides detailed guidelines. Chapter 14 of the agreement is dedicated to settlement of disputes.

9. Summary and Conclusions

Korea has earned the accolade of being a dynamic economy and for managing economic transformation of remarkable magnitude in a space of two generation. It was admired for its outer-oriented or export-led growth paradigm. With the trade-to-GDP ratio of 96 percent, Korea is one of the most open and trade-oriented economies in the world. It is now classified as a newly-industrialized economy. This small country is presently a small-sized economy and the seventh largest trader in the world, not far behind France.

The EU is the second largest market for Korean exports after China as well as the third largest source of Korean imports. In merchandise trade, principal export items from Korea to the EU are automobiles, semiconductors, computers, ships and wireless telecommunications devises. The EU exports machinery, semiconductors, jewelry and a range of chemicals to Korea. Thus, an overwhelmingly large proportion of EU-Korea trade is in manufacturing products. They account for 94 percent of Korea's total exports to the EU. The EU and Korea have a complementary industrial structure in the manufacturing sector. Although bilateral trade in services also increased, it is smaller than that in merchandise. Notwithstanding the difference in the size of the two economies, from an economic and non-economic perspective Korea is an attractive bilateral trade partner for the EU. Although traditionally the two economies preferred multilateralism over bilateralism, they turned to bilateralism belatedly after the mid-2000s.

After almost three years of negotiations, the EU and Korea composed an FTA which has a comprehensive coverage and in trade economics parlance known as a "deep" regional integration arrangement. The deep FTAs are more trade efficient and have greater trade enhancing effect over time. Under the EU-Korea FTA protocol, tariffs and NTBs are to be lowered and eliminated in a phased manner over a transitional period. According to the mutually agreed protocol, the EU will remove all of its tariffs on Korean goods within five years after the FTA come into force. Korea will have a longer period—seven years—to comply. The EU took a lot of interest in negotiations in trade in services because it saw gains accruing to it by expansion of trade in services. For the EU-Korea FTA, such sector-focused negations took a lot of time and attention. Individual sectors will have large impact of the FTA in both the partner economies. Technological standards and environmental considerations are a part of the FTA protocol. Meticulous product standards are also set for all electric and electronic products. For both the partners, there were sensitive sectors to deal with. Both sides agreed to concessions that took into account the industrial sensitivity of the other.

The impact of the FTA on the two partner economies would be positive but small. Various empirical studies have analyzed the economic implication of the FTA. The empirical analyses predictably concluded that of the two, the FTA will benefit Korean economy relatively more in terms of welfare gains, while the EU economy will only gain modestly. An important fact that will influence the welfare gains is that the magnitude of the EU trade with Korea; it is only 2 percent to 2.5 percent of total extra-EU trade. Sectoral impact of the FTA will be important for both the EU and Korea and this article elucidates which sector will benefit more in which economy. To protect domestic producers and markets from sudden surge in imports, there is a provision of a bilateral safeguard clause in the FTA.

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