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Stepping into Asia's Growth Markets: Dispelling Myths about the EU-Korea Free Trade Agreement

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Four years after the launch of Global Europe – the European Union's trade strategy from 2006 – policymakers are now confronted with the first negotiated agreement with one of the rising economic powers in the Far East. The EU-Korea Free Trade Agreement (hereafter EUKOR) is the first of Europe's "new" Free Trade Agreements (FTAs). Traditionally a sceptic of bilateral, or preferential, trade agreements unless they were part of a broader political strategy (like a stepping-stone to full accession to the European Union), the EU in 2006 ventured in to a strategy which had FTAs front and centre.

It is well known to trade economists and practitioners that preferential trade agreements are far from ideal. Principally, they are based on discrimination against third countries. Practically, they are often difficult and cumbersome to negotiate, and are seldom of great value to global firms who cannot adjust sales or sourcing strategies after a bilateral agreement. Economically,

SUMMARY

The EU-Korea Free Trade Agreement (EUKOR) is the most ambitious FTA negotiated by the European Union. It is clear that the EU has negotiated an agreement with emphasis on getting new market access rather than exposing domestic industries to greater competition. The EU receives market access in almost all its key sectors, including agriculture, automotives, pharmaceuticals, electronics and services. Non-Tariff Barriers (NTBs) in Korea will be cut in sectors where the EU has export interests.

Yet there is a fear that the deal may be rejected by the European Parliament, primarily because of EUKOR's effect on the automotive sector. But the notion of a Korean car invasion is a myth. Critics have grossly misrepresented the agreement and its results. Firstly, Korean automobile manufacturers only have a small share (12 percent) of imported cars to the EU. Korean cars compete principally in one segment of the market – small cars – and compete to a large extent with other foreign producers. All the other segments of the auto market are largely unaffected by Korean competition.

Secondly, export of heavy goods (cars) concentrated to a small number of firms (Hyundai and Kia) will to a large extent be substituted by foreign direct investment. This is already a pattern in the sales of Korean car brands on the EU market. Concentrated to two brands, it has proven much more efficient for Korean automotive firms to locate production in Europe rather than to export from Korea to Europe at high transport costs. If anything, the trade deal with Korea is likely to have a positive effect on the scale of Korean auto FDI in Europe.

Thirdly, European auto exports to Korea stand to benefit as Korea not only eliminates its tariffs on vehicles (also at a faster pace than Europe eliminates its equivalent tariffs), but also reduces its NTBs significantly. A study suggests an increase of over 400 percent – albeit from very low levels.

Finally, the biggest myth is the notion that saying no to the agreement is a cost-free option. A rejection of the agreement would undermine Europe's credibility in trade talks, and is not likely to make Korea more amenable to re-write the agreement in Europe's favour.

the benefits are typically not substantial when there are only two parties involved in a trade agreement, and the inherent discrimination provokes (sometimes profound) trade diversion.[1]

Despite such concerns, it is easy to understand Europe's desire to negotiate new FTAs with other countries. Firstly, the impetus for global trade liberalisation – in the context of negotiations in the World Trade Organisation (WTO) – had slowed down remarkably in the middle of the noughties. The Doha Round had already had serial collapses and the prospect for improvements was bleak. It does not look better today. Regardless of the fate of the Doha Round, it is reasonable to think it will be long before the full set of WTO members in a post-Doha world can coalesce around an all-encompassing trade agreement which substantially liberalises trade. A diligent actor, then, will not pause its trade strategy till that moment arises, if it ever will. It seeks, and rightly so, other means to achieve trade liberalisation that brings economic benefits.

Secondly, there are trade barriers that are very unlikely to be liberalised multilaterally, even under the assumption that the Doha Round will resurrect and the WTO will regain its centrality in global trade policy. Non-tariff barriers (NTBs) – which are far bigger than tariffs and increasing– are one of those barriers, but they are not alone. Rightly pursued, bilateral trade negotiations can reduce NTBs – often in a non-discriminatory fashion, bringing the benefits to a larger set of countries.

Thirdly, many emerging markets still have significant trade barriers and in some markets these are prohibitive and severely restrict the ability of European firms to increase sales or investment to them. In emerging markets whose economic size is already substantial, it is imperative that improvements of market access move faster than the speed of multilateral trade liberalisation. South Korea ticks all of these boxes and should be a candidate for a trade agreement with the EU. The United States also thought of Korea in similar terms and negotiated an FTA with Korea a few years ago.[2] Yet the EUKOR agreement has run into opposition – mainly from small but vocal sector interests. One member state vetoed the agreement, and the start date of the agreement had to be postponed to get its support. As it was proved possible to open up the agreement again – even if only on the issue of starting date – there are again mounting fears that the process in the European Parliament will be difficult and that new political demands will have to be taken on board to get the acceptance of the Parliament.

Yet, the opposition to EUKOR is surprising – even to chastened political cynics. One could have seen a material rationale for opposing the agreement if it had been ventured by free-trade ideologues with deep affinity to multilateralism, or simply sceptical of its liberalising coverage. Such criticism is partially warranted. The EUKOR is a good distance away from free-trade purism. Its structure and motivation is closer to "soft mercantilism" than free trade. It is clear that the EU has negotiated an agreement with emphasis on getting new market access rather than exposing domestic industries to greater competition – with smaller than potential dynamic gains from the agreement as a consequence. There are critics arguing that the EU has not negotiated as much new market access as it should have. It is correct that the deal does not come close to reducing or eliminating as much barriers as would have been ideal. Perhaps it is also correct to say that the EU could have done a better job bending up Korea's market. But that is an unknown – even an unknown unknown. What we know, however, is that EUKOR goes much farther in reducing barriers to trade than most other FTAs on record. This, however, is not the immediate concern of the free-trade purist. It is rather that EUKOR does not provoke as much import competition as would have been possible.

The surprising part is that most critics of EUKOR are offspring of the same trade ideology and profess mercantilism, soft or hard, as the guiding principle for trade negotiations. By that standard, the EU has negotiated a good deal. The mercantilists overall got what they desire. Yet it is they who want to throw the deal in the dustbin.

Their opposition to EUKOR is, however, largely based on a number of myths. Premier among them is the notion that EUKOR will deal a hard blow to the European automotive industry, threatening substantial volumes of production and jobs. At a time when the European automotive industry is already battling with collapsing sales, and many firms have survived only through government support, it is alleged that EUKOR will have a menacing effect, far greater than it would have had in normal times.

Also, it is assumed that saying no to the agreement will have no political implications: The cost for the EU of saying no, and what is really at stake, is largely missing from the debate.

The purpose of this paper is to dispel myths about EUKOR. Other scholars have given full presentations of the agreement and estimated the gains and losses from it.[3] These need not to be rehearsed in this paper. The paper rather looks at the agreement in the broader perspective of EU trade strategy – without too much jargon or the usual sales pitches for the agreement – and addresses in greater detail the effects of the agreement on certain sectors, the automotive sector in particular. It aims at giving a dispassionate account of what is likely, and what is not likely, to be the consequence of EUKOR.

THE EUKOR TRADE-OFF: THE LOGIC OF BIG NUMBER VERSUS LIBERALISATION

EUKOR IS THE first "next generation" FTA that addresses trade concerns beyond tariffs. Chief among these concerns are non-tariff barriers (NTBs); they are significant barriers to trade both in Korea and the EU. In fact, NTBs have been estimated to have the same protection level as a tariff at 76 percent in Korea and 46 percent in the EU[4]. Meanwhile, the average tariff is "only" 12.2 percent in Korea and 5.6 percent in the EU[5]. Tariff reductions are very much "an orange almost squeezed dry" as (the then Trade Commissioner) Catherine Ashton put it.[6] Thanks to various rounds of multilateral negotiations and other forms of liberalisation, tariffs have progressively been reduced to now represent only a small portion of total trade protection. In the EUKOR, the EU has taken full advantage of its relative size to receive better market access for its exports, most notably services, food and agricultural products. It will also benefit from levelling the playing field for its car industry which has experienced difficulties in gaining access to the market in Korea. For instance, it appears that Italy has not been able to export a single car to Korea in the last five years[7]. The NTB provisions in EUKOR, focusing on automobiles, electronics, pharmaceuticals and medical equipment, clearly reflect the export interest of the EU. They will seriously shrink NTBs in Korea, especially in the electronics and automotive sectors, and – to a lesser (but still significant) extent – in pharmaceuticals and medical equipment. The main approach of the EU has been to oblige Korea to comply with international standards, with which the EU regulations already comply.

EUKOR is fairly modest in the use of exemptions for politically sensitive goods. The EU has largely chosen to make transition arrangements for sectors in which Korean firms have already invested in factories and jobs inside the EU, notably automotives and electronics. Tariff elimination in these sectors will be phased in over 3-5 years. Meanwhile, Korea's political sensitivities and exceptions are focused on limited agricultural products (such as milk, bovine meat and tobacco) and enjoy transition arrangements between 5-15 years, while rice – the culturally important crop for Korea – and its derivative products are exempted.

While the benefits of EUKOR could have significant sectoral effects, it is unlikely that they would amount to measurable effects on employment or welfare.[8] One needs to bear in mind that the EU is a market eighteen times larger than Korea – which is partly the reason why the EU chose to commence the negotiations with Korea in the first place. Korea is an advanced middle-sized economy with which the EU could strike an ambitious FTA. Korea's relatively high trade barriers could be translated into real trade gains for Europe, while Korea's size of economy made it unlikely that concessions to Korea would require considerable political change in Europe. Hence, the EU could offer improved access to its big market through tariff reductions and demand much deeper liberalisation in Korea in return.

WEIGHTING THE BENEFITS OF EUKOR

VARIOUS STUDIES HAVE already analysed the economic implications of the agreement. They are based on solid economic modelling, but one should nevertheless be cautious about the use and interpretation of any results from them. No quantitative method is better than the assumptions and approximations going into the model – and at the end of the day, assumptions, even informed ones, are only assumptions. Yet the studies show plausible estimates on the costs and benefits, and they all arrive at results in the same vicinity. Briefly put, EUKOR will give good production and welfare effects for Korea, but negligible effects for the EU. While an increase of 1-2 percent in GDP is expected for Korea,[9] no study shows effects higher than a 0.08 percent GDP increase for the EU, which is equivalent to less than 7 euro per person per year. Hence, the agreement does not carry any significant social impact; the increase in employment is insignificant.

The small economic value of a trade agreement is largely due to two factors. Firstly, all trade agreements create winners and losers, and the political motivation is often aimed at minimising the number of losers. This may sound politically commendable. But it is not a strategy that will produce economic gains. For the dynamic benefits of a trade agreement to be significant, they need to provoke behavioural change. If an agreement has little or no effect on production or productivity, the dynamic gains from trade are small.

This is how the mercantilist logic bites itself in the tail. By maximising own exports and trade balance, and minimising displacement through import competition, consumers and producers are denied the possibility of choosing better and more efficient goods and services abroad, making the EU less productive in turn. Consequently, an FTA without losers at home means no advantages and efficiencies have been imported. Arguably, the EU could have used this FTA to further open its market to greater competition. But even under such conditions, it is difficult to see how the economic gains from EUKOR could have been profoundly greater for the EU. This leads us to the second explanation.

Secondly, the sheer difference in size between the EU and Korea makes it unlikely that any negotiation outcome would have significant impact on either productivity or employment rates in the EU. The potential increase in sales and import competition is simply not big enough to provoke significant economic gains. This is the problem with many FTAs: a big economy will not find many candidates with whom a bilateral trade agreement will make significant economic difference. A worthwhile strategy, however, could be to focus on certain sectors and use negotiations as a crowbar for reducing entrenched protection – perhaps also to set precedents for future agreements. This is also what Europe has done: it has concentrated on selected sectors with entrenched support and set a bar for future FTA negotiations in Asia that cannot easily be lowered.

Europe stands to benefit the most in the services sector. According to the CEPII/ATLASS study, the agreement is expected to produce an additional bilateral trade surplus in services worth €3 billion, on top of the €6 billion the EU already enjoys. Another sector in which Europe is expected to gain substantially is in animal and food products, particularly in meat and dairy products. Contrary to other industries, the agricultural sector is greatly affected by tariff removal. The EU is expected to improve its bilateral trade balance in agriculture and food products by €5 billion as exports will increase by €8-10 billion. This is an important political bargaining chip in future reform of agricultural subsidies in the EU.

Furthermore, the EU will improve its bilateral trade balance with Korea in chemicals by €3.6-5.1 billion, thanks to the protocol on NTBs. In machinery and electronics, which accounts for one-third of total EU exports to Korea, studies suggest a substantial growth in exports. Bilateral export growth may amount to 65% and 84% in electronics and machinery respectively. Korea is highly competitive in these sectors but the over-specialisation leads to inter-dependence; the industry in both countries relies on unique and highly value-added components from the other country, with little head-to-head competition between them. It will bring about employment creation in a sector that accounts for 4.3% of total EU employment.

To conclude, the effect on bilateral trade balance ranges from €6 billion (Francois, 2007) to €10-18 billion (CEPII/ATLASS, 2010) to the EU's advantage. The vast difference between these two studies depends on the fact that only the latest study from CEPII has taken NTBs in the automotive sector into account. This topic will be discussed further below, but it is evident that EUKOR clearly caters to the demands of export interests.

Finally, both Korea and the EU have responded to the concerns of vocal constituencies that oppose free trade and imports. The EU has chosen to include extensive special provisions for its automobile sector with transition periods, dispute-settlement proceedings and safeguards. It has also catered to the lobbying of France's audiovisual sector and excluded it from the service schedules. Korea has been given time to prepare a transition for the agricultural sector, which will also give Korea time to wait for the upcoming CAP reform in the EU.

In conclusion, the EU has obtained most of what it wanted –at least when it comes to moving the trade balance in its favour.

AUTOMOBILES – DISPELLING MYTHS

No other issue in EUKOR is as controversial as its effect on the automotive sector. The Commission has been under great pressure to make amendments to the draft. To a certain extent, the sensitivity around the issue is understandable. The timing could be better. The agreement was negotiated while the EU car industry went through a restructuring of historic proportions. The implications of the financial crisis for the car industry are felt worldwide, and it is by no means a problem isolated to the developed world. For instance, China has dealt with huge manufacturing overcapacities in the auto sector. Finalised automobiles are the single most important export product for South Korea – of its 3.5 million cars produced per year, approximately 2.5 million (73%) are exported.[10] Cars and electronics are the two pillars of the Korean export sector and have for decades enjoyed protection and subsidies at home. Exposing them to global competition is part of the Korean rationale to conclude an FTA with the EU.

But the European auto crisis was not caused by increased imports, let alone imports from Korea. The structural crisis in Europe was brought on by an inherent gap between consumers and manufacturers – a gap between market demand that shrank faster than manufacturers could adjust their production capacities. It is absurd to attribute this to Korean imports that are a very small feature of the EU market. Moreover, European consumers have changed their preferences towards smaller and different kinds of cars than those produced in Europe. Inflexibilities caused the crisis, not trade. In fact, when EU manufacturers could not find a market for their cars at home, trade helped them tap into other markets, where their motor vehicles were still in demand.

History has proven time and again that favouring domestic producers to foreign ones will only help to make the cause of the problems and inefficiencies permanent. It insulates manufacturers from economic realities, and more importantly, from their customers and what they want. It discourages innovation and adaptation of modern production methods – in short, it makes the sector less competitive. For a sector which is dependent on exports, attempts to protect domestic markets are fatal. All auto manufacturers, including European ones, depend on economies of scale in both selling and producing cars – it is a volume-driven business. While we have established the economic case for addressing Korean market and investment protectionism, it is equally indisputable that favouring domestic production for imports will not help to save the industry but only secure Europe's early exit from it.

In hindsight, it is not surprising that automotives have become the focus of the political debate around the FTA. This sector has for a long time punched above its weight. It employs around 2.29 million people and accounts for 3.5 percent of the GDP,[11] but the political weight that the issue carries is much more than possible jobs or number of sold cars annually that is claimed to be at stake. The debate may not be about cars or even trade, but coming to terms with a Europe that cannot take perpetual growth and increasing exports for granted.

THE VALUE OF MARKET ACCESS IN KOREA

To assess the gains and opportunities of the agreement for the auto industry, it is important to understand the current trade barriers in Korea. So far, only one study has aimed to quantify the entire extent and level of protection (including NTBs) that European exporters face in Korea. The study was conducted by CEPII on the request of the European Commission after the agreement was negotiated. Hence, it is based on actual negotiation outcome[12]. Understandably, the results have been subject to debate as it concludes that the EU will have its largest export gain in cars and trucks, totalling €8 billion – which implies an increase in bilateral exports to Korea of more than 400 percent. A report for the European Parliament has been cautious of the results, given the methodology of the study.[13] The European Automobile Manufacturers' Association, ACEA has gone as far as calling it "a typing error" by the European Commission.

Notwithstanding potential problems of the result, the study helps to provide an idea of what kinds of forces come into play once one of the two most overprotected economies in the developed world (second only to Japan) opens its borders. Current market share of imported cars in Korea stands at 6 percent, which is only second to Japan, where the share of imported cars is just above 3 percent. The case for improved market access for European cars is clear, and the effects from scaling back NTBs exceed the effect of tariff eliminations. While the Korean tariffs amount to 8 percent, the NTBs are estimated to be around 90 percent.[14]

Judging by number of imports, the extent of burdensome regulations in Korea appears almost prohibitive. The severity of NTBs prompts two questions. Firstly, has the offensive interests, i.e. exporters concerns, been adequately addressed in EUKOR in order to unleash the export potential? Secondly, could an effective dismantling of Korean NTBs lead to such increase in EU exports as suggested - and can the Korean market realistically accommodate such growth?

The answer to the first question seems to be affirmative. As the box below shows, the NTB reforms negotiated by the EU are significant and comprise most of the NTBs that the EU car industry has reported to be seriously preventing market access.

The second question is, more precisely, whether the FTA, providing an effect equivalent to such discount, could actually lead to the rise in EU exports up to five times today's levels? It goes without saying that such effects are rare. But they are neither impossible nor unprecedented. In fact, the predicted growth is in line with the historical development of EU exports to Korea in the past ten years, which multiplied by more than 13 times while the domestic growth rate over the period was approximately 29 percent (Table 1) – in fact, a growth rate of 32 percent would be sufficient to reach the stipulated growth of 400 percent during the five year transition period while the actual growth has actually been even higher in the past ten years. EU exporters effectively outgrew Korean domestic producers, thanks to changing attitudes and regulatory reforms that are minor compared to the package of reforms that the FTA will introduce.

BOX 1: THE NEGOTIATION OUTCOME OF THE FTA

- Regulatory convergence approach based on UNECE standards
- Positive list of products that will be recognised as complying with importing party's regulations on entry into force.
- EU list: 74 items or rules
- Korean list 51 items or rules; OBF and Emissions for Gasoline engines: transitional quota system until 2013
- Certain positively listed regulations shall be harmonised with UNECE within 5 years, i.e. 1 EU regulation and 29 Korean regulations
- Revisions of list of products every 3 years
- Ban on introducing new regulations that diverge from UNECE, unless proven that they do not fulfil safety concerns
- MFN treatment on internal taxes and emission regulations
- Products with new features shall be allowed unless demonstrated that it creates risks for health, safety, environment; obligatory notification if product taken out of the market
- Establishment of a working group on motor vehicles and parts
- Chapter Fourteen (FTA dispute settlement system) applies, accelerated procedure]

TABLE 1: KOREAN AUTOMOBILE MARKET

Year	Growth Rate of Imported Cars Share	Growth Rate of Domestic Market
2000	61.54%	16.13%
2001	71.43%	0.71%
2002	80.56%	15.03%
2003	46.92%	-18.23%
2004	38.74%	-14.36%
2005	23.40%	6.48%
2006	26.91%	2.42%
2007	23.61%	5.42%
2008	17.74%	-2.79%
2009	-18.21%	22.52%

Source: KAMA; KAIDA.

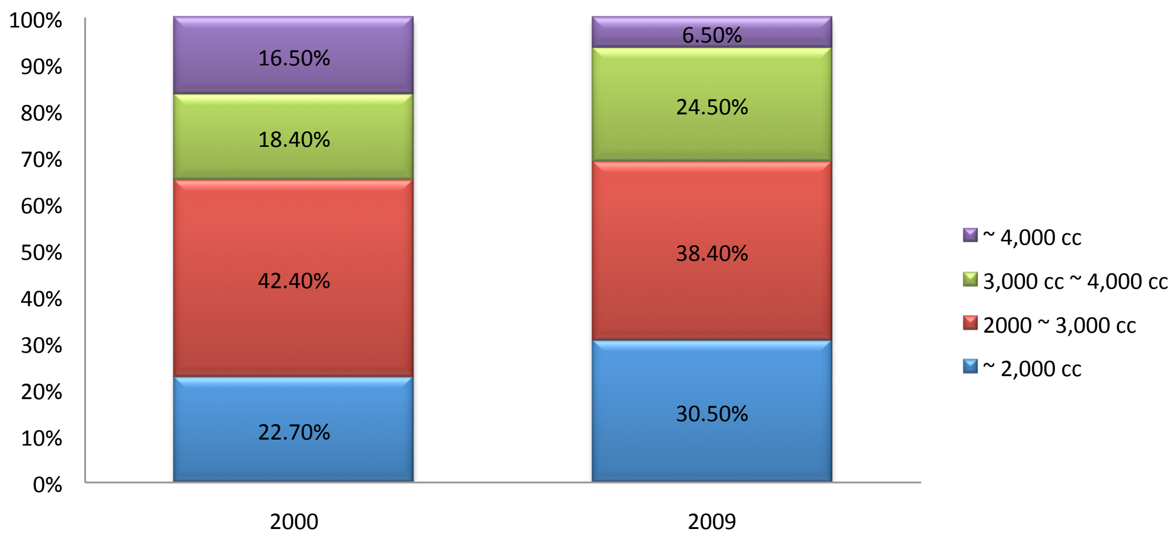
The Korea Automobile Importers & Distributors Association (KAIDA) reports that out of Korea's total imports of cars, the share of mid-sized cars is increasing. Ten years ago, imports were dominated by cars with an engine displacement size of 3000-4000cc (42%; graph 3). By 2009, a change of pattern is evident; the share of large cars declines in favour of small cars with engine size below 3000 cc (from 18.4% to 24.5%). The structure of imports suggests that imports are becoming more balanced for foreign exporters and that low-medium size producers are likely to grab the major share of the market growth. An analysis of EU comparative advantages demonstrates that besides from large-sized cars, the manufacturers of mid-sized cars in the EU also enjoy higher competitiveness (table 2). In a cross-country comparison with Japan and China, it becomes evident that the EU has positive comparative advantage (measured as revealed comparative advantage) in the exact same sub-sectors, which suggests that this is not a market exception in Korea but a common aspect of EU exports – cars made in the EU are outselling all other imports and currently, every second imported car in Korea is today manufactured in the EU (see graph 3a), and the lead is even more noticeable for diesel cars (graph 3b).

TABLE 2: REVEALED COMPARATIVE ADVANTAGE ANALYSIS OF EU-KOREA

Code	Category	RCA
87032	FUEL Other vehicles, with spark-ignition internal combustion reciprocating piston engine:	1.037
870321	Of a cylinder capacity not exceeding 1,000 cc	0.017
870322	Of a cylinder capacity exceeding 1,000 cc but not exceeding 1,500 cc	0.013
870323	Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc	1.211
870324	Of a cylinder capacity exceeding 3,000 cc	1.924

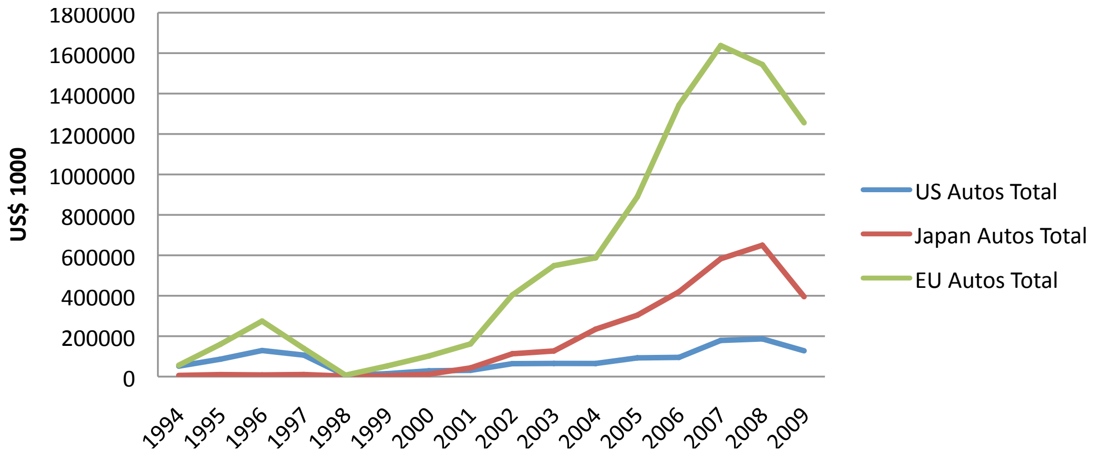
Source: COMTRADE, own calculations.

GRAPH 1: KOREAN CAR IMPORTS, BREAKDOWN BY ENGINE DISPLACEMENT (2000/2009)

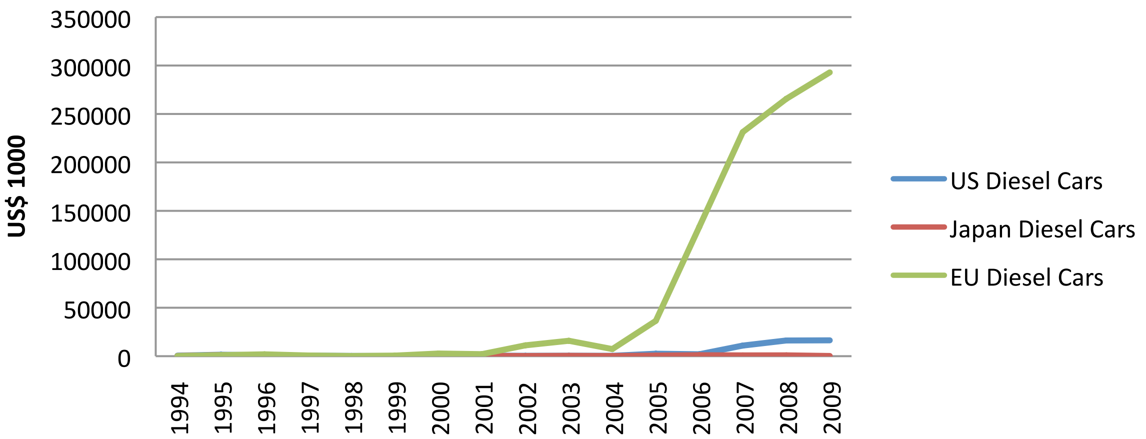


Source: KAIDA

GRAPH 2A: AUTO IMPORTS BY KOREA, COUNTRY BREAKDOWN, US 1000



GRAPH 2B: DIESEL AUTOS IMPORTS OF KOREA.

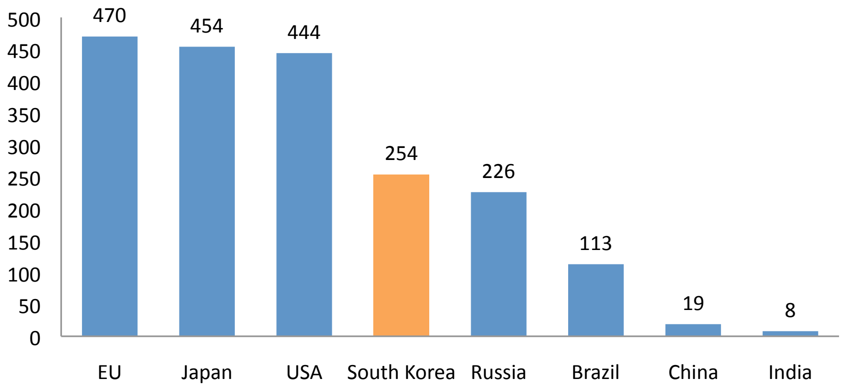


Source: COMTRADE

The historic development of EU exports to Korea, and its comparative advantages, shows that EU manufacturers have the pre-requisites to expand their exports. But could the Korean market accommodate that growth? The suggested growth of 400 percent is equivalent to a total market share in Korea of 16-17 percent for European manufacturers. This is a reasonable level for an open market, especially given that it starts from a very low level.

Furthermore, there is no evidence that suggests a break in the trend on the demand side. Korea is a highly developed economy with a GDP per capita that is expected to exceed the EU27 average by 2012.[15] However, Korea has some features that are still similar to emerging markets, and one example is the remarkably low car density. With 254 cars per 1000 inhabitants, Korea is still far behind Japan or the EU and it puts the country closer to markets like Russia and Brazil (graph 4) – emerging markets where the prospects for exporters are high for European car producers.[16]

GRAPH 3: CAR DENSITY IN THE WORLD (PER 1000 INHABITANTS), 2008



Source: ACEA, Eurostat: Global Insight.

There are other factors that come into play, such as exchange rate instability of the Korean Won that could have strong detrimental effect on imports, even potentially wipe out the effects of the FTA. Consumers in Korea have also shown tendencies to be import averse, although the increase of auto imports from the EU show preferences are rapidly changing. However, these systemic errors have been constantly present throughout the past decade of growth, and EU export to Korea has multiplied despite them.

It is clear that the gains of the FTA cannot be reaped in the first year after ratification due to transitional provisions in the agreement. The distribution and services network that are needed to meet such increase in demand will also be established gradually over several years. However, it should be clear that the FTA will, at least, support recent growth of exports. If the effect is not bigger than that, it still represents a significantly bigger increase in exports than professed by EU sectoral interests.

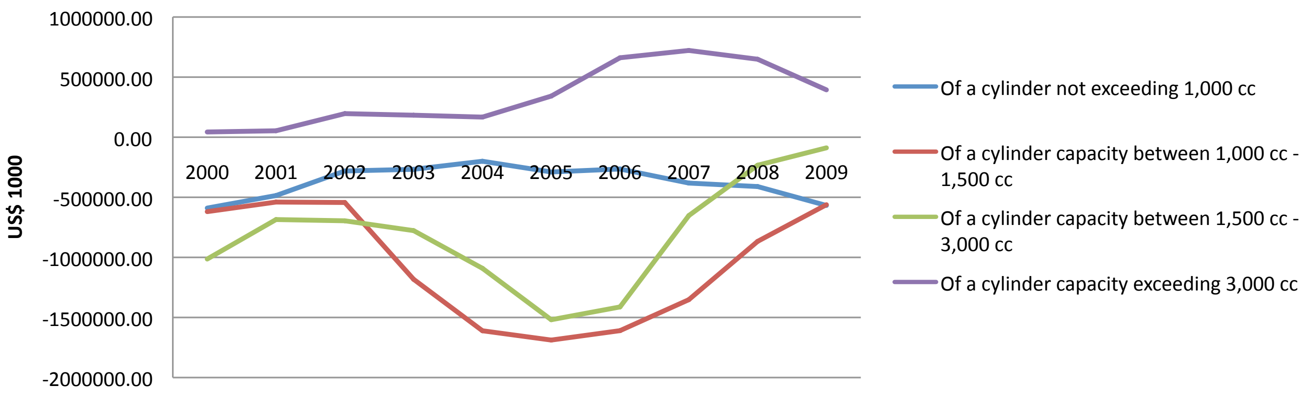
A final complication with recorded trade should be observed. European manufacturers might wish to serve increasing Korean demand by production in Korea rather than elsewhere. Such a scenario is not unlikely given that market proximity is an important factor in automotives and as it would further increase the profit margins of EU exporters. So far only one manufacturer in the EU, namely Renault, has chosen that strategy in Korea (as well by acquiring the ailing motor division of Samsung). But this coin has two sides: Korean manufacturers are increasingly investing in production facilities inside the EU to serve the EU market.

Yet substitution of trade by FDI is less likely to be widespread amongst EU exporters as European industrial relations are vastly different than in the auto industry elsewhere. Many of the European auto manufacturers are subject to strong political pressure, partly expended by government subsidies or past political favours. For these firms, a move of production to Korea would be politically costly. Also, a certain production volume is required to initialise production elsewhere. While Korean sales in the EU are largely concentrated to one company group (Hyundai-Kia), the increase of EU volumes in Korea will be divided over several competing European company groups, where each one of them may not reach sufficient volumes. This makes it more likely that the EU will continue its export or possibly initiate joint ventures with Korean manufacturers. Korean manufacturer, however, are more likely to locate production for the EU market in Europe.

IS EUROPEAN AUTO MANUFACTURING UNDER THREAT?

But what about EU imports of Korean automotives, which is the more controversial element in the current debate in Europe. In the wake of consolidation and restructuring of the European car market, EU imports have contracted significantly. According to ACEA, the sales of passenger cars have decreased 13% in 2009 compared to 2007.[17] The change in consumer preferences is apparent. The smallest category of cars (with engines of less than 1000 cc) has grown by 19% against the general trend of decline.[18] This change is most likely not merely a result of financial turbulence but more likely a long-term trend – which is encouraging to Korean exporters, who are highly competitive in that segment. The entire trade surplus of Korea to EU can be found in this category (graph 5).

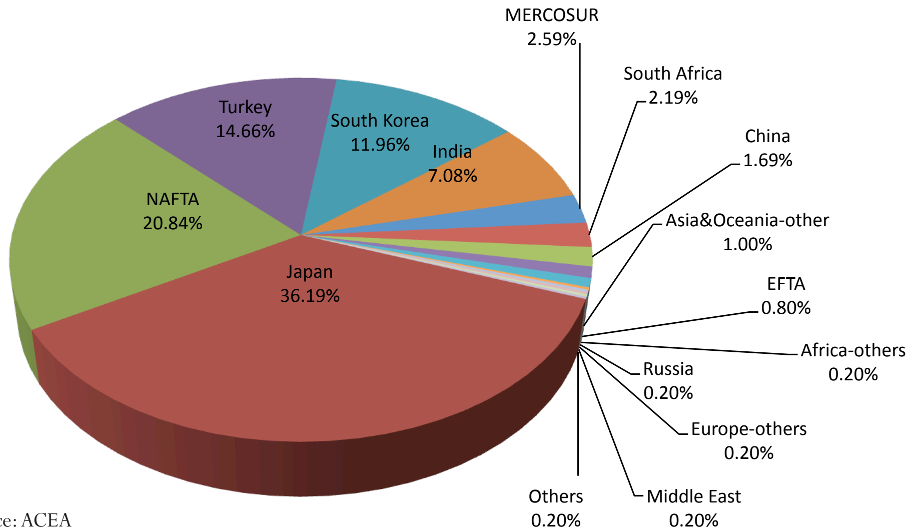
GRAPH 4: TRADE BALANCE WITH EU-KOREA 2000-2008, BY ENGINE DISPLACEMENT



Source: COMTRADE

Yet Korean car manufacturers are still lagging behind in terms of EU market penetration when compared to Japan or NAFTA. According to ACEA (graph 6), Korea currently holds 12% of the market calculated in import value, which is far less than Japan (36%), US and NAFTA (20%) and even Turkey (14%).[19]

GRAPH 5: PASSENGER CARS IN 2009, ORIGIN OF EU IMPORTS (IN VALUE)

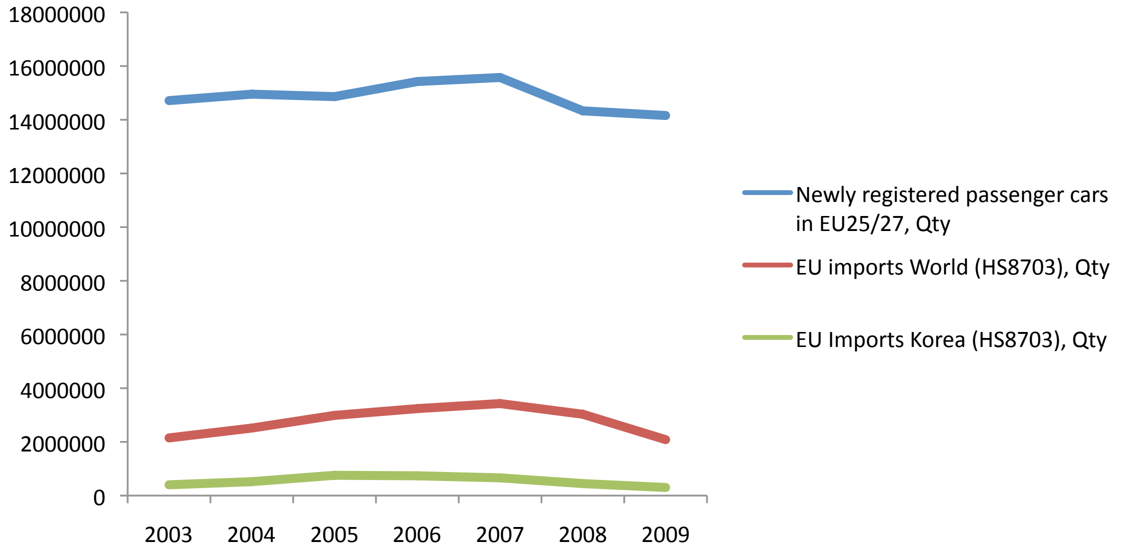


Source: ACEA

It is evident that imports were more affected by the crisis than cars made in the EU. Imports have decreased by approximately 40 percent since 2007 (graph 7a) although the EU demand only contracted by 9-10 percent. The decline of total imports from Korean manufacturers is even more palpable as it fell by over 50 percent (graph 7b), while imports of light cars have also contracted approximately to the same extent as European demand since 2007. So even if the Korean exports doubled following the FTA as some have suggested, it would barely regain the market share, and still be far behind the import volumes from Japan.

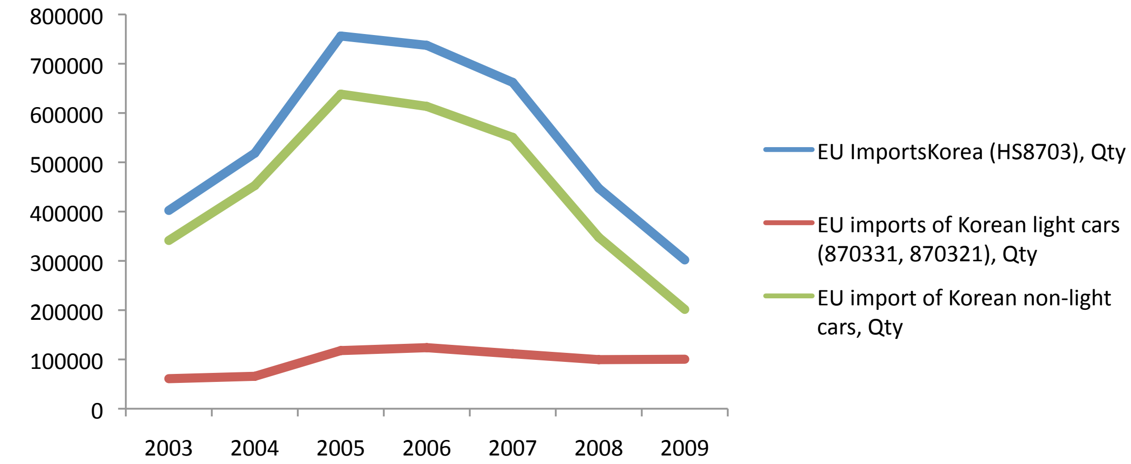
The rapid substitution for EU-made cars has three possible explanations. Firstly, one cannot exclude the possibility that consumers buy local during a time of economic hardship. Secondly, the worst performing segment in terms of sales has been the lower-medium segment, which is also a main target group for Japanese and Korean manufacturers. Korean exports are in fact not very

GRAPH 6B: KOREAN IMPORTS ON EUROPEAN AUTO MARKET, QUANTITY



Source: ACEA, COMTRADE

GRAPH 6A: IMPORTS ON EUROPEAN AUTO MARKET, QUANTITY



Source: ACEA, COMTRADE

well diversified and focus mostly on the small car segment below 1500cc (66% of all car imports), and about half of the imports come from diesel cars. Also, the production structure in Korea is less flexible and traditionally less able to adapt to new products, leading to production structures focused on longer production runs and fewer product varieties.[20]

Thirdly, and importantly, the Korean direct investments in the EU have ramped up significantly. New production plants have recently been established where Korean manufacturers have developed at least nine new models to meet the demand of cheap middle segment and reliable cars. There are two major production plants; one located in the Czech Republic, owned by Hyundai with an estimated value of €1.45 billion, and one owned by KIA, just across the border in Slovakia, of similar magnitude. These facilities are not only final assembly factories; they cover the entire supply chain. For example, some 75% of parts used to produce KIA Ceed are expected to come from local suppliers and this share is about to rise to 90%. The production capacities of these plants are at 300,000 units each, with 3,500 directly employed and another 1,000 employed indirectly. Kia also established a design centre in Germany, together with after-sales operations, a technical service facility and a pan-European IT hub. It is evident that foreign investments in the auto industry aim at establishing an integrated and comprehensive production base in each region.

Therefore, falling imports do not necessarily mean that foreign-owned enterprises are being squeezed out. This is supported by the statistics of newly registered automotives, which shows that the Korean brands have not lost sales and market shares to the same extent as their imports have fallen: the production has simply moved to the EU. Given the low-end market focus, especially in a time of falling margins, it is clear that service cost, delivery time, tariffs and transport costs would motivate such investments. Investment in the EU is most likely not driven by the import tariff but market proximity. Any investment is likely to have taken account of the likelihood of EUKOR. The EU has also relatively modest NTBs, estimated to be less than the effect arising from tariffs of 10 percent. This is largely unaffected by the FTA for Korean exporters, as the deal is about bringing Korea to EU standards.

The competitiveness of European car production, or rather its location and market proximity, is therefore telling, especially in a scenario with a weaker Euro. The suggestion by some that factories would be closed once EUKOR has been concluded does not make commercial sense, especially as Korean corporations have just recently made these investments. No one could realistically hold that Korean auto manufacturers have the financial ability to make such capital expenditure just to write them off.

It seems likely that enhanced bilateral trade liberalisation will lead to two different outcomes in Korea and the EU respectively due to market concentration, product dispersal and difference in preferences. It is more likely that increased competition imposed on European auto manufacturers will come from another car made in Europe by European workers with largely European components and subcontractors – though it may carry a Korean brand name. Moreover, even if EUKOR is ratified, the safeguards would create enough political uncertainty for imports from Korea to motivate continued production in the EU.

CONCLUDING REMARKS: THE COST OF SAYING NO

Members of the European Parliament will soon be confronted with the choice of ratifying or rejecting EUKOR. The European Parliament will find itself in a new position. The Lisbon Treaty grants it new constitutional power in EU trade policy, and EUKOR is the first trade agreement under the new treaty on which the European Parliament will have to give its final view. It has been argued by some that EUKOR might be held hostage to a Parliament that wishes the flex its new muscles, particularly to EU member states and the European Commission. This may or may not be true. At the end of the day, it is substance and the consequences in the real world that matters. Even if EUKOR is rejected by the Parliament for procedural reasons, such as tilting the institutional balance in the way the EU negotiates its trade agreements, the effects of a rejection will be felt in the substance.

This paper has aimed at weighing the case for or against EUKOR in a dispassionate manner. Two myths have been at the centre of the paper. The first myth is that the EU came off badly from the EUKOR negotiations, and that

Korea is the main, if not only, beneficiary of the agreement. It follows from this supposition that it is Korea that stands to lose from a rejection of the agreement. The EU, in contrast, might come off better by a rejection. At worst, EUKOR can be subject to a second round of ratification. At best, it can be renegotiated in order to give Europe further favours.

The second myth is that the agreement is unfair to the European automobile industry and will present this battered sector with yet another challenge of profound, if not existential, dimensions.

It should be clear from past chapters that these myths are just that: myths. They do not correspond with the actual substance of the agreement or its real effects. It is possible to challenge the agreement on material reasons: the benefits of EUKOR are small, perhaps too small for an agreement to be worthwhile. This argument, however, applies to most other bilateral trade negotiations. The conclusion, if this view is extended, is that Europe should bury its entire programme for bilateral trade negotiations plus a host of other agreements (like its neighbourhood policy) that fall short of delivering substantial economic benefits. Yet it is not criticism of this kind that forms the basis for current opposition to EUKOR.

The European Union comes off comparatively well, given the overall conditions for benefits from bilateral trade, from EUKOR. It has negotiated a deep-integration agreement that addresses NTBs and regulations that severely restrict market access for several important sectors. Such improvements are not only important in bilateral EU-Korea trade; they will also form the basis for future FTA negotiations with other countries. By the mercantilist standard, the EU has negotiated an agreement that will change the bilateral trade balance in Europe's favour. The current deficit in Europe's bilateral trade with Korea is estimated to be largely erased. Overall, Europe has used its predominating market size to engineer new market access that requires policy reform by Korea. Europe has "paid", or "given concessions", primarily by the "logic of big numbers" – preferential access to a big market has greater volume effects on trade than access to a smaller market – and without conditioning improved access in Korea upon policy reform in Europe. To reciprocate in a largely even-handed manner (measured in trade volume), Korea had to accept much more policy liberalisation on its part; considerably more barriers had to be reduced. This is good for Korea – and partly explains why the GDP effect of EUKOR is higher for Korea than Europe. But it does not fit will with the mercantilists and their criticism of EUKOR.

The second myth appears to be even more entrenched: the EU automobile sector will be the main loser of EUKOR as the agreement is unfair. To see why this view grossly misrepresents the agreement and its likely outcome one has to consider three facts. Firstly, Korean automobile manufacturers compete principally in one segment of the market – small cars – and on the EU market it competes to a large extent with other foreign producers. All the other segments of the car market – not to mention trucks, busses and large transport vehicles – are largely unaffected by Korean competition. Secondly, export of heavy goods concentrated to a small number of firms will to a large extent be substituted by foreign direct investment. This is already a pattern in the sales of Korean car brands on the EU market. Concentrated to two brands, it has proven much more efficient to locate production in Europe rather than to export from Korea to Europe at high transportation costs. If anything, EUKOR is likely to have a positive effect on the scale of Korean auto FDI in Europe. Thirdly, European auto export to Korea stands to benefit as Korea not only eliminates its tariffs on vehicles (also at a faster pace than Europe eliminates its equivalent tariffs), but also reduces its NTBs significantly. Furthermore, Europe's export of automobiles to Korea is dispersed on several segments and many brands, why outward FDI to Korea is less likely to substitute export.

These facts have not silenced the critique by parts of the EU car industry. One prominent argument used by ACEA is that the agreement gives Korean automobile manufacturers access to a market of 500 million citizens while Europe will gain access to a much smaller market. The EU car industry, it is concluded, has been a "bargaining chip" in Europe's approach to the negotiations – and not a sector that warrants fair and tailored action by the EU.

The argument is hardly convincing. Again, it grossly misrepresents the agreement and its likely outcome. But, more importantly, while the argument is ineffective as an argument against EUKOR (after all, the EU will increase export more than Korea), it is more effective (if one accept a hard mercantilist logic) as an argument against bilateral trade as such with smaller countries.

Yet the mythology of the Korean car invasion remains the key reason why ratification of EUKOR may be rejected in Europe. It has taken a life of its own and created what should be viewed as the third myth: that the cost of saying no is (at worst) zero. No one can tell the alternative cost of ratifying EUKOR. It is a counterfactual – or a known unknown. Two positions in this debate are on the extreme side: that there will not be any effect or that the effects will be disastrous. While it is difficult to point to anything on the plus side, it is easy to point to some real hazards that are likely to materialise, to a high or low degree, if EUKOR is rejected.

Firstly, a rejection is likely to lower the interest on the part of other countries the EU is negotiating Free Trade Agreements with. Bilateral negotiations, too, are cumbersome and time consuming. The decision to launch FTA negotiations is based on trust between governments and assurances that a negotiation is for real and has the political acceptance at home. It will be particularly difficult to convince new candidates for a FTA that they should accept an invitation by the EU to negotiate trade deals. Very small economies with little to nothing to lose will always be very keen to get preferential access to the European market, but the middle-sized and big economies that Europe should target in its bilateral policy will by any standard be hesitant, if not opposed, to venture into negotiations with Europe.

Secondly, a rejection is likely to lower the market access gains that Europe will be offered in other FTA agreements. If other countries doubt the EU is able to deliver ratified trade deals, they are less inclined to accept EU demands that are sensitive to their producer interests. Why take the political heat if one is doubtful about the probability that the agreement will ever enter into force?

Thirdly, a rejection by the EU is likely to be definite, more so than the rejection of KORUS by the United States. While the views of the US Congress can shift after an election, Europe does not have elections with such agenda-changing outcomes; policy in Europe is often a balance between many different country interests so that it is difficult to shift policy in one direction without causing reactions in the other end. If the deal is rejected, Korea may or may not be willing to go back to the drawing board to redesign the agreement to better fit Europe's appetite. The odds for Korea's acceptance should, however, be very high. But even if it was willing to renegotiate the agreement, it is not inclined to change the balance further in favour of Europe. Europe would lose from such a renegotiation. And it would never be able to get further flexibilities in the car sector than it has already received. It is simply unthinkable that a future EUKOR would not cover one of the key export sectors of Korea.

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ENDNOTES

1. Trade diversion is when a preferential agreement gives rise to a substitution of trade with a more efficient producer to a less efficient producer. This effect arises because a preferential trade agreement gives producers in one country preferential (or more favourable) access to a market than producers in other countries. One example of such favourable treatment is that tariffs are eliminated for one country's producers but not others.
2. This agreement is yet to be ratified. There is a new initiative by the White House to have a revised agreement ready for ratification in late autumn of this year.
3. See LSE and consortium partners (2010); CEPII/ATLASS (2010); KIEP (2005); Francois/Copenhagen Economics (2007); IBM SIA (2008); and CEPS KIEP (2007) et al.
4. The figures refer to NTB Ad valorem equivalents faced by EU exports in Korea, and Korean exports to the EU, weighted by current volumes of trade. Own calculations based on CEPII/ATLASS, "The Economic Impact of the Free Trade Agreement (FTA) between European Union and Korea"(2010).
5. World Trade Organization, *Integrated Database* (IDB). Figures based on tariff line based average.
6. Catherine Ashton, *The role of trade policy in fostering economic growth*, Speech at British Bankers Association Annual Banking Conference, London (30 June 2009).
7. KAIDA (2010). The figures exclude parallel or 'grey' imports.
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