SAIS | US-KOREA 2010 YEARBOOK

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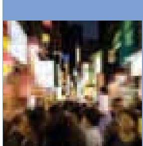
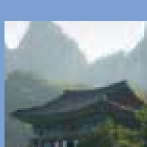


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Another Korean FTA with Latin America: ¿Sí o No?

By Lubomir Sokol

I. INTRODUCTION

Historically, South Korea and Latin American countries have not been major trading partners. However, several political, social, and economic developments in the past 10 years have reshaped their interactions, resulting in a boom in interregional trade. This growth can be attributed to a number of factors ranging from the adoption of neoliberal economic policies in many Latin American countries to Korea's growing need for mineral resources. As a result of this increase in trade, Korea decided to pursue signing free trade agreements (FTAs) with a few Latin American countries in order to avoid the extra costs that both countries incurred through existing trade restrictions. It ratified its first FTA with Chile in 2003 and went on to sign another with Peru earlier in 2010. Furthermore, Korea has expressed interest in signing an FTA with important regional entities including Mexico and the Mercosur trading bloc.

This paper seeks to examine the reasons why South Korea chose to sign an FTA with Chile but not with Mexico. Through a series of case studies, it will assess the discernable differences signing and not signing FTAs has on Korea's economy. Finally, based on these case studies, it will offer recommendations as to whether or not Korea should pursue an FTA with Mexico and other regional powers.

II. THE PROLIFERATION OF FTAS IN EAST ASIA

Following the Asian Financial Crisis of 1997, several East Asian nations, including China, Japan, and Korea, realized the need to address areas of trade and investment in order to sustain their economy's growth and its overall stability. The governments of all of these countries intended to use FTAs to address these mounting issues. There are three other main factors, apart from the crisis, that triggered the proliferation of FTAs throughout the East Asian region. First, was the belief that trade and foreign direct investment (FDI) could help further eliminate "cross-border impediments" and thus deepen the economic connections between nations, including broadening supply chain and production networks. Second, European and North American regionalism worked to motivate countries in East Asia to improve their own economic integration by expanding economies of scale and strengthening bargaining power. The creation of the North American Free Trade Area (NAFTA) and the expansion of the European Union have both contributed to this phenomenon. Finally, the stagnation of the WTO Doha Round presented bilateral FTAs as a suitable avenue of trade liberalization.

The Japanese government thought an excellent way to address its economic integration issue would be through signing FTAs. In 2002, Japan signed its first FTA with Singapore. This FTA went into effect later that year and caused considerable worries for other regional actors, including Korea. These countries believed Japan's first-mover advantage in regard to FTAs would lead to a perpetual cycle of FTA signing by Japan. They feared this proliferation of Japanese FTAs would decrease the competitiveness and market access of their own goods in the world market. In turn, Korea decided its best move would be to launch its own FTA strategy.

III. BACKGROUND OF THE KCFTA

Korea first hinted at signing its first FTA on November 5, 1998, when its External Economic Coordination Committee (EECC) passed a resolution stating that Korea will work towards signing an FTA. Following this decision, the EECC targeted Chile as its first FTA partner because of Chile's complementary industrial structure, its prior experience with FTAs, and the size of its economy. Chile primarily exports natural resources, such as copper, and imports finished goods. The opposite is true for Korea. Prior to the signing of the FTA, Chile's export of nonmanufactured goods constituted nearly 90 percent of its total exports, whereas nearly 85 percent of Korea's exports were manufactured goods. Chile also possessed extensive experience with FTAs. Prior to entering into FTA negotiations with Korea, Chile had already secured FTAs with three other potentially valuable trading partners for Korea including the EU, Mexico, and the Mercosur trading bloc. It was also in the process of signing the Chile-U.S. FTA. Upon completion of the Korea-Chile FTA (KCFTA), Korea believed it would be able to use the knowledge gained from this agreement in negotiations with other, strategically more important, trading partners, such as the United States or Japan. Finally, Chile was chosen due to the small size of its economy. In 2001, its GDP was $66.5 billion compared to Korea's $423 billion. Korea assumed this fact would give it an advantage over Chile in terms of bargaining power. Additionally, Korean officials believed a small complementary economy would provide relatively few problems during the negotiation process.

The first round of the KCFTA negotiations commenced in December 1999, following a joint announcement at an APEC conference earlier that year. The first four rounds were completed by December 2000, and contained about 80 percent of the final version of the KCFTA. Three more rounds of KCFTA negotiations took place that year, however, due to the failure to reach a compromise in regard to tariff elimination on agricultural goods and manufactured goods, the ensuing two years presented serious difficulties for the FTA. South Korea was keen on protecting its domestic agricultural base; specifically it wanted to exclude apples, pears, grapes, and rice from the agreement, while Chile insisted on the abolishment of tariffs on all agricultural goods within a 10-year period. In 2002, talks resumed, producing two additional rounds of negotiations, in which both parties were able to agree to a mutually acceptable tariff concession schedule. By February 2003, the KCFTA was signed by both governments, but only after the language of the agreement was agreed upon. The Chilean Congress ratified the KCFTA unanimously in January 2004. In Korea, the agreement encountered opposition from representatives from rural districts. This development delayed the ratification of the KCFTA three times, until the National Assembly ultimately approved it on February 16, 2004. The agreement was accepted by a vote of 162 in favor of the KCFTA and 71 against it. The KCFTA went into effect on April 1, 2004, at which time 66 percent of Korean exports were able to enter Chile tariff-free.

IV. CONTENTS OF THE KCFTA

The KCFTA was designed to reduce costs of doing business between two highly complementary economies. Korea's main exports to Chile include automobiles, mobile communication equipment, and electronic goods. Chile's exports comprise mainly raw materials such as copper and lumber. The agreement embraces manufactured goods, as well as investment, services, government procurement, and intellectual property rights. It also contains five time periods for tariff elimination on Korean exports to Chile: immediate, and five, seven, ten, and thirteen years. Goods featured in the thirteen-year category include a six-year grace period for Chile to completely abolish its existing tariffs. Sixty-six percent of Korean exports were able to enter the Chilean market on a tariff-free basis immediately. By 2014, nearly 90 percent of Korea's exports to Chile will enter the country without any tariffs. The remaining items are considered to have a comparative advantage against Chile's national industries and were either included in the thirteen-year window or excluded altogether. The extra three years were included in order to give the underproductive Chilean industries more time to improve their competitiveness with Korean goods. Within this category are textiles, footwear, and polyethylene. A small amount of Korean exports remain excluded from the KCFTA, including refrigerators, washing machines, and retreaded tires. The Chilean government believes Korean exports of these items would cause a sufficient distortion in its domestic market and has thus chosen to exclude them.

Chilean exports to the Korean market face six tariff schedules: immediate abolishment, and five, seven, nine, ten, and sixteen years (with a six-year grace period). Nearly 88 percent of Chile's non-copper exports were able to enter the Korean market tariff-free after the five-year mark. Copper cathodes, which make up 41.9 percent of Chilean exports to Korea, however, will not be free of tariffs until 2014. This coincides with the time period when most of the controversial agricultural products such as grapes will be able to enter the Korean market tariff-free.

V. RESULTS OF THE KCFTA

Upon the enactment of the KCFTA in 2004, Korea's trade with Chile realized a sudden surge in volume. Overall trade between the two countries increased nearly four-fold from 2003 to 2007. Korea's exports to Chile rose from $698.6 million in 2003 to over $3.1 billion by the end of 2007, while its imports climbed from a level of $1.1 billion in 2003 to $4.2 billion in 2007. The previous amount exported to Chile averaged approximately $540 million from 2000 to 2003. Chile quickly became the fifth most popular export location for Korean products by January 2007. However, this tremendous growth rate of Chilean exports to Korea, combined with a substantial increase in the international price of copper over the same period, resulted in a widening of Korea's trade deficit with Chile.

Foreign Direct Investment (FDI) doubled within a year after the KCFTA went into effect but essentially remained relatively insignificant for both sides. After the signing of the KCFTA, there has been a shift in the composition of Korea's exports to Chile. While consumer goods, such as cellular phones and electronics, declined slightly from 23.1 percent to 21.7 percent of total exports;

intermediate goods realized a significant increase, from 53.5 percent in 2006 to 70.5 percent of total exports in 2007. Capital goods such as machinery and equipment declined drastically, amounting to only 7.8 percent of total exports in 2007. While Chilean exports to Korea increased five-fold over the period, they maintained a similar composition throughout. Exports of natural resources, including copper-based goods, represent 80.2 percent of Chile's exports. The rest of its exports are composed of agricultural goods responsible for 1.3 percent of its exports and industrial goods such as foodstuffs, textiles, furniture, and basic chemical products.

As a result of the KCFTA, the market share of Korean products in the Chilean import market rose from 3.0 percent in 2003 to 3.1 percent in 2004 to 3.6 percent in 2005. This highlights the increased competitiveness Korean products have against other countries' goods in the Chilean market.

Investment has also shown a rise after the ratification of the KCFTA. Prior to the enactment of the KCFTA, from 2001 to 2003 both Korean and Chilean investment combined was a measly $6 million. Since the enactment of the KCFTA, the Korean government has funded 107 different projects in Chile totaling $115.6 million. Furthermore, according to the Chilean Embassy in Seoul, investment in the Korean stock market by Chilean private pension funds totaled over $1.2 billion.

The much-feared impact on the Korean agricultural sector has thus far been mitigated by the fact that most Chilean agricultural goods are not set to enter the Korean market tariff-free until 2014. Additionally, Chile typically exports its agricultural products to Korea during the winter in the Northern Hemisphere. During this time there is little to no production of similar Korean products and thus little competition with domestic producers. Chile has also pursued a strategy of diversification with its agricultural exports, targeting many other markets besides Korea. This has prevented a potential flooding of Korea's agricultural market with cheap Chilean exports. Statistically, agricultural products represented only 1.0 percent of the total imports in 2006 and 1.3 percent in 2007, reinforcing the fact that the impact of these goods was extremely limited.

VI. HISTORY OF KOREA-MEXICO TRADE RELATIONS

Mexico's strong liberalization policy started with the signing of the North

American Free Trade Agreement (NAFTA) in 1992 under President Ernesto Zedillo and continued through Vicente Fox's tenure. Following the actualization of NAFTA in 1994, Mexico became a key destination for countries looking to reach the North American market, of which Korea was one. Mexico's trade with Korea increased substantially throughout the decade, and in 1999, it became the top destination for Korea's exports to Latin America. Excluding NAFTA, Mexico managed to be a signatory to 10 FTAs from 1994 to 2001. It is currently the most open economy in the world, having trade agreements involving 41 countries. Nevertheless, in late 2003, due to overwhelming skepticism in Mexico's private sector as to the benefit FTAs offer to the country, then economics minister Fernando Canales declared a moratorium on its FTA agreements. However, the Fox administration then changed its mind and proclaimed that Mexico would be willing to form a Strategic Economic Complementary Agreement (SECA) with Korea. As a result, the Korea-Mexico Joint Experts Group on the Strengthening of Bilateral Economic Relations ("the Group") was formed in April of 2004. The role of the group was to determine whether a SECA would be viable and beneficial to both countries. After several meetings of the Group throughout 2004–5, the Group concluded that a SECA would be a mutually beneficial solution.

In response to the Group's conclusion, three SECA meetings were held throughout 2006. A year-long hiatus followed, and in August 2007, the Calderon administration announced that it had reevaluated its position and expressed its interest to reopen negotiations over an FTA with Korea. The ensuing two rounds of FTA debates produced little substance as the Mexican side was continually worried about the worsening of its trade balance. Mexico believed that a serious trade deficit would develop, similar to the one that formed after Mexico signed its FTA with Japan in 2004.

Another source of contention was agriculture. The Korean side argued for the sensitivity of its agricultural sector and the necessity of safeguards, while Mexico insisted that such actions would exacerbate inequality in trade. Furthermore, according to Kim Chong-sup of Seoul National University, other problematic areas include Korea's steel and chemical exports to Mexico. While these are some of Korea's main exports, Mexico has taken a protectionist stance on them due to strong business lobby opposition. FTA talks broke off yet again, but in 2010, Lee Myung-bak met with his counterpart Felipe Calderon and both confirmed their intentions to restart FTA talks.

VII. TRADE IMPLICATIONS OF AN FTA WITH MEXICO

Unlike Chile, Mexico conducts over 90 percent of its trade with countries with which it has signed an FTA. Mexico's sector structure is similar to that of Chile it mostly exports raw materials such as oil and agricultural products. It imports mostly intermediate, capital, and consumer goods in relatively similar proportions to those of Chile. Although the sectorial makeup in Mexico also includes a significant portion of manufactured goods, nearly all of these are destined for the U.S. market and should be disregarded for the analysis. Korea's chief imports are crude petroleum and machinery, while its top exports are semiconductors, chemicals, and manufactured goods. Overall, the two economies are highly complementary.

The sectorial similarity between Mexico and Chile and the complementary link between the economies of Korea and Mexico led me to choose the KCFTA as the basis of my analysis. One can see the substantial benefits an FTA can have on the economies of both countries through the construction of a simple extrapolation. In order to estimate the growth a potential Korea-Mexico FTA agreement would yield, I took the Korea-Mexico overall trade figure for 2004 ($2.8 billion) and imposed the average growth rate Chile experienced after signing the KCFTA onto this base. Thereafter, I compared this with the growth rate and trade Mexico de facto experienced during this era. According to the WTO, from 2004 to 2009 Korea's average growth rate of overall trade hovered around 9 percent. Even though Mexico experienced an above-average growth rate of 22.1 percent, growth in Korean-Chilean trade during the same period totaled 27.1 percent. This difference of 5 percent per annum, when applied to Mexico's 2003 total trade figure, would result in a 2009 total trade figure of approximately $11.7 billion. Based on this prediction, since 2003, Korea and Mexico have foregone nearly $3.6 billion in total trade by not signing an FTA. I further examined the effect an FTA would have on Mexico's current trade with Korea. By using the aforementioned method and applying it to Mexico's current total trade base of $8.1 billion, I reached a figure of $26.9 billion versus $22 billion with Mexico's previous growth rate. Given these results, the cost of not signing an FTA increases to $4.9 billion in mutual trade by 2014. Additionally, this estimate is a rather conservative one because it factors in the years of the "Great Recession," when global trade declined at an average rate of 12 percent. According to the WTO, global trade is predicted to increase at an average rate of 13.5 percent in 2010—the fastest trade expansion since 1950. If one takes into account that Mexico-Korean trade was increasing at triple the rate of the WTO average before the Great Recession, this only further supports the claim that my previous estimates are indeed conservative.

In my final trade estimation, I decided to correct the data for the Great Recession years of 2008 and 2009. I did so by assuming zero-growth rates of trade during those years and factoring this into the average growth rate for Chile experienced after the KCFTA ratification. This yielded a growth rate of 31.6 percent per annum and an estimated combined trade figure of $32.1 billion by 2014, if Korea and Mexico were to sign an FTA agreement by the end of 2010.

The aforementioned simple extrapolation of growth yields similar conclusions to Cheong Inkyo's calculations in regard to benefits an FTA agreement would pose to both Korea and Mexico. In his computable general equilibrium (CGE) analysis, Cheong determined that Korean exports to Mexico under an FTA agreement would increase by approximately 30 percent, while imports would increase by 25 percent. This would lead to a real GDP growth increase for Korea of 0.01 percent in the short term and 0.03 percent in the long term. Mexico's expected growth in real GDP would be 0.02 percent in the short term and 0.15 percent in the long term. Cheong concludes that a free trade agreement should be signed. He further mentions that trade could further be expanded with increasing trade in final goods and the growing intra-industry trade.

VIII. RECOMMENDATIONS

South Korea's FTA agreements with Chile and Peru were signed, in part, because Korea believed that these agreements would serve as gateways to the broader Latin American market. The Lee Myung-bak administration is now presented with a potential FTA with one of Latin America's largest economies and its largest trading partner in Latin America. Overall trade between Mexico and Korea exceeded $8 billion in 2009. Assuming a Korea-Mexico FTA would yield growth rates in trade and FDI similar to those that followed the signing of the KCFTA, it would be hard to make an argument against the FTA on a purely economic basis.

Moreover, given the current stagnation of the KORUS FTA under the Obama administration in the United States, Korea is still in need of a partner to help it reach the U.S. market. More than 65 percent of its exports to Mexico are intended for re-export to the U.S. market. Although Chile also possesses an FTA with the United States, the NAFTA agreement is more favorable when it comes to the export of manufactured goods, Korea's main export to the United States.

Moreover, given the geographic proximity and the cost of labor, Mexico is much more profitable for Korean exporters looking to reach the U.S. market.

Mexico's current trade deficit with Korea stands at $6.1 billion and declined by over 10 percent in 2009. While Mexico shouldn't disregard the trade deficit issue completely, I believe it shouldn't be overemphasized either. Korea could alleviate Mexico's fears in this regard by addressing the issue from an international trade perspective: Mexico need not worry about its trade deficit as it has a floating exchange rate. This will depreciate its currency, thereby increasing the demand for its outputs and reducing the demand for imports. Alternatively, a large trade deficit would further indicate a stronger Mexican peso. This would naturally give Mexican consumers the ability to buy a larger quantity of Korean goods at relatively lower prices.

Korea should also use its entrepreneurs' serious interest of in Mexico as a bargaining point in FTA talks. Korean FDI in Mexico has continued to climb and increased almost two-fold, from $55.7 billion in 2006 to $160.8 billion in 2008. This FDI has a strong effect on the Mexican labor market, as it provides employment for approximately 40,000 Mexican workers. Moreover, the number of Korean companies based in Mexico has tripled since 2006, reaching 1,400 by the end of 2009. These companies are primarily concentrated in the electronics, steel, and automotive sectors. In addition to the strong existing economic ties between the two economies, Korea should cite evidence from the KCFTA, highlighting the increase in FDI inflows that occurred in the years after the KCFTA went into effect.

If Korea intends to pursue an FTA with Mexico, it should act swiftly and aggressively. Moreover, if Korea has learned something from the KCFTA negotiations, it is that halting talks only gives the opposition more time to mobilize and does little to silence it. During the tumultuous years of the KCFTA several anti-FTA unions joined forces in order to combat the agreement. Among these were the Korea People's Action and Korean Farmers Solidarity, which organized and enacted a massive demonstration of thousands of farmers in front of the National Assembly in November 2003. In order to appease the farmers, the government agreed to a $100 billion package to help modernize Korean agriculture. Although this quelled some of the farmers' protests, most were still left dissatisfied. Moreover, this presented considerable cost in lost trade and FDI to the Korean government, a cost that could have been avoided if such a subsidy package had been presented earlier or if the KCFTA had been signed faster.

Korea does not enjoy the same leverage it possessed with Chile when it negotiated the KCFTA. This is mainly due to the relative importance of Mexico to Korea as a regional partner. Other reasons include the size of the Mexican economy and Mexico's existing trade deficit with Korea. In this regard, Korea should be prepared and willing to make some minor concessions in regard to Mexico's agricultural exports. Korea should look to the Japan-Mexico FTA negotiations, where the same dispute existed, particularly over Mexico's pork imports. In the end, Japan agreed to tariff-free entry of Mexican pork in exchange for a removal of tariffs on Japanese automobiles. Additionally, it was still able to have 50 percent of Mexican agricultural imports exempt from the agreement. Korea could possibly boost the $100 billion allocated towards the modernization of the agricultural sector during the KCFTA in order to appease its politically powerful farm sector. In the end, this may still be a small cost compared to the benefit of increased market share in the Mexican market.

IX. OUTLOOK

Although the state visit by Lee Myung-bak to Mexico in June 2010 produced hope among those in favor of an FTA, the prospects for one remain bleak. The political situations in Korea and Mexico are currently quite different, but look similarly unfavorable in the future. While the Lee Myung-bak administration currently supports a potential FTA and enjoys a majority in the National Assembly, Calderon's National Action Party (PAN) controls only 147 out of 500 seats in the Chamber of Deputies and 52 out of 128 seats in the Senate. The opposing Institutional Revolutionary Party (PRI) has been a fierce critic of Mexico's FTAs and has signaled that it is prepared to vote against an FTA with Korea. The PRI won the 2009 elections for the Chamber of Deputies and is predicted to further bolster its power by winning positions for Los Pinos in 2012. Similarly, Korea is scheduled to have both presidential and National Assembly elections in 2012. It is likely that the strong majority the Grand National Party currently holds in the National Assembly will be considerably eroded, assuming a similar outcome to the 2010 municipal elections. Likewise, it is entirely possible that a candidate from the opposing Democratic Party will win the Blue House in 2012, possibly further hindering a potential FTA.

According to Ko Hee-chae, senior researcher at the Korea Institute for International Economic Policy (KIEP) at this time, a potential Korea-Mexico FTA does not represent Korea's primary bilateral interest. Possible FTA agreements with China, Japan, the United States, and the European Union will be favored over an FTA with Mexico. Simultaneously, Ko believes that the burden currently rests with the Calderon administration in Mexico. He remains confident that if Mexico were to sign an FTA with Korea, there wouldn't be any issues in regard to its confirmation by the Lee administration and the National Assembly.

Cho Seong-dae, chief researcher at Korea International Trade Association, agrees in essence with Ko's assessment, albeit for slightly different reasons. He cites the Mexican business sector's lack of support for the FTA as the main reason behind its current stagnation. He references the business sector's firm opposition to increases in global regionalism and therefore being anti-FTA. Additionally, he mentions that support for President Calderon is low, and until the elections of 2012 there is little chance for change. Cho remains optimistic in regard to the ratification of the KORUS FTA, which he believes will be signed within the next two years. In his opinion, if KORUS is ratified, Korea will no longer need Mexico as an intermediary in order to reach the U.S. market. Cho points out that this will significantly lessen the chances of a Korea-Mexico FTA.

X. CONCLUSION

Korea, like much of East Asia, has taken a turn towards regionalism in the twenty-first century. It did so by pursuing FTAs. It has currently enacted FTAs with three countries directly, Chile, Peru, and Singapore, as well as with two trading blocs, ASEAN and EFTA. Its proliferation of trade with Latin America has been growing, and Mexico remains its largest trading partner in the region, with bilateral trade between the two nations totaling over $8 billion in 2009. While Korea's growth in trade with Mexico has been impressive, it should pursue an FTA as a means to further increase these gains.

An FTA would be the most effective method for spurring further economic and political connections for both Korea and Mexico. Mexico is currently Korea's tenth-largest trading partner, and Korea is Mexico's sixth. Assuming a similar increase in trade would occur upon the signing of an FTA with Mexico, as was the case with Chile, it is predicted that both countries would experience an increase in their economic connection through an FTA. Even under conservative circumstances, the growth in trade between Korea and Mexico should be on average 5 percent greater than the growth realized without an FTA. Furthermore, Cheong Inkyo's CGE analysis shows that an FTA would result in an increase of real GDP in both countries.

Given the current stalemate in the talks with Mexico, South Korea should take into account the costs and benefits of possibly making certain concessions to Mexico. Korea's strongest opposition to FTAs has been in the agricultural sector. This sector has been steadily declining and as of 2003 contributes only about 3.8 percent of Korea's GDP. Assuming its influence will also decline over time, this could favor Korea's bargaining position as it could grant Mexico more concessions in the much-debated agricultural sector. While opposition from the farm sector might wane over time, Korea should also consider the amount of trade it has forgone by not signing an FTA with Mexico up until now. Based on my predictions, this amount will increase, reaching $4.9 billion by 2014. Furthermore, concessions in the steel and chemical industries might be necessary in order to get talks moving. Moreover, Korea should factor the political situations in both countries into its analysis: currently the conservative Grand National Party occupies the Blue House and dominates the National Assembly, making both institutions favorable to signing an FTA with Mexico. Korea will continue to concentrate most of its effort on the KORUS FTA; however, it should be proactive in regard to the potential of a Korea-Mexico FTA regardless of the current improbability of its signing.

Figure 1. Korea's Total Trade with Mexico and Chile

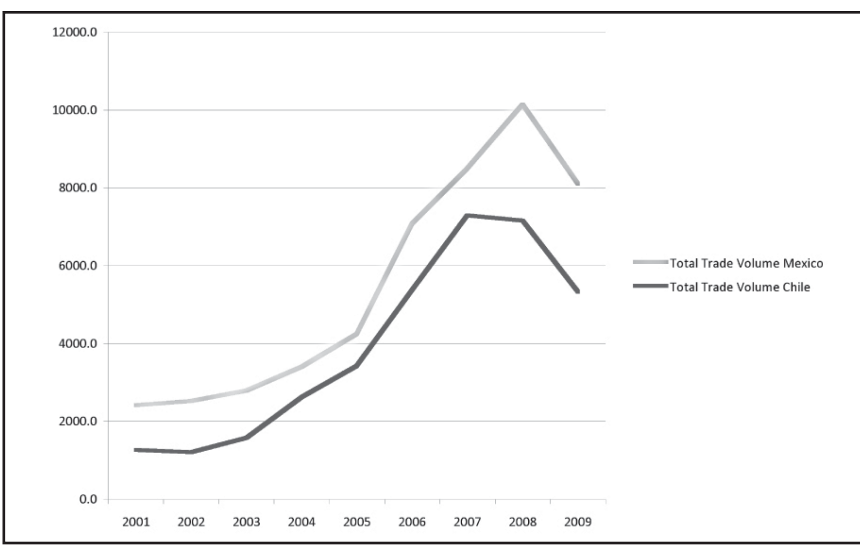
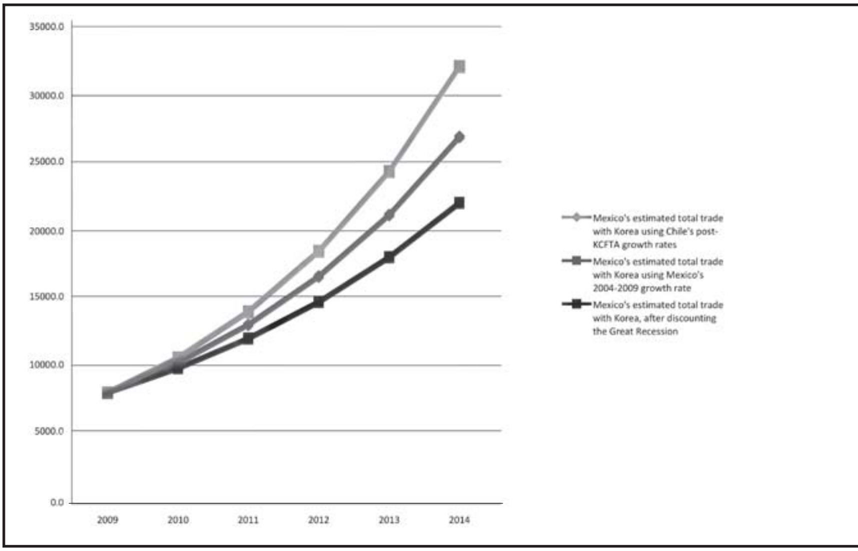


Figure 2. Predictions of Mexico's Total Trade



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