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Accompanying document to the

Recommendation for a Council decision authorising the Commission to negotiate a Free Trade Agreement with the Republic of Korea on behalf of the EC and its Member States

Impact Assessment

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INTRODUCTION

This impact assessment accompanies the Commission's recommendation to Council to negotiate a Free Trade Area (FTA) with the Republic of Korea (hereafter "South Korea").

The recommendation contains a proposal for negotiating guidelines, on the basis of which the Commission would be authorised to negotiate a comprehensive agreement, providing for the establishment of a deep and comprehensive FTA. As such, the proposal which is the subject of the present impact assessment does not constitute a legislative proposal and does not attempt to prejudge the precise commitments of the agreement which eventually may be negotiated, since these will depend entirely upon the final result of negotiations.

This impact assessment thus assumes that the negotiations will prove successful and the resulting agreement will largely reflect the elements contained in the draft negotiating directives. Applying the principle of proportionality, this impact assessment is only able to describe the potential impact of such an agreement based upon the current situation and available information. A more complete assessment of the impact of such an agreement will become possible at a later stage once negotiations have commenced and once the potential commitments on each side are better defined. This more comprehensive assessment will take the form of a Sustainability Impact Assessment (SIA), which will be launched during the start-up phase of the negotiations.

PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

In the process of preparing these negotiating directives, the Commission engaged in a wide consultation with Member States, EU institutions and civil society (including European business). This was done in the context of the future orientations for EU trade policy, the related adaptations in its FTAs strategy and the specific prospects for an FTA with South Korea.

Consultations in the context of the “Global Europe” Communication setting out priorities for EU trade policy including bilateral policy, both in the process of preparing the Communication and following its adoption:

A specific workshop on trade and competitiveness in the framework of the Market Access Symposium in September 2005;

A presentation at the public hearing on “The effects of globalisation on the Internal Market” organised by the Committee on International Trade of the European Parliament on 6 October 2005;

Consultations with Member States between September 2005 and October 2006 (informal trade ministers meetings; discussions in the 133 Committee with MS trade representatives and in the European Policy Group and the Council working party on competitiveness and growth with MS industry representatives);

A presentation on 18 January 2006 to representatives of the major manufacturing and services sectors such as ACEA (automotive), EUROMETAUX (Non-ferrous metals), CEFIC (Chemicals), EURATEX (Apparel and Textiles) and ESF (Services);

Consultations with UNICE between January, April, July and September 2006;

A presentation to the "Civil Society Dialogue" organised by DG TRADE on 8 March 2006;

A presentation at the public hearing on "Global Europe: Competing in the World" organised by the Committee on International Trade of the European Parliament on 10 October 2006.

Specific consultations on EU FTA policy:

A specific workshop on FTAs in the framework of the Market Access Symposium in September 2005;

Consultations with Member States at the Informal meeting of the 133 Committee in Vienna on 30-31 March 2006;

Consultations with UNICE in April 2006;

Consultations with ACEA (automobile federation) on 7 April 2006;

Consultations with ESF (European Services Forum) on 26 September 2006.

Specific consultations on a possible FTA with South Korea:

Consultations with Member States on 3 March 2006 and subsequently (oral report on the results of the exploratory talks on the feasibility of an EU-South Korea FTA; regular discussions involving Ambassadors and Commercial Counsellors in Seoul);

Consultations with the EU industry in South Korea (European Chamber of Commerce in Korea).

Written contributions from Member States and European business were also received following these consultations.

The comments received through the consultation were taken into account in the preparation of the negotiating directives. The main conclusions of the consultation can be summarised as follows:

Broad support to a renewed FTA policy, giving higher priority to economic considerations and aiming at deep integration between partner countries complementary to the multilateral liberalisation;

Broad support to the use of economic criteria, in particular market potential and level of tariff and non-tariff barriers against EU interest, to identify priority partners;

Call for attention to be given to countries which have already or are negotiating free trade agreements (FTAs) with EU competitors and where we are losing market share.

Broad support to the need to secure our market shares in rapidly growing Asian countries;

Call for tackling non-tariff barriers including export restrictions, technical barriers to trade, Intellectual Property Rights (IPR) protection, obstacles to trade in services and public procurement;

Broad recognition that South Korea is an important partner for the EU and there is a large untapped potential to facilitate and expand bilateral trade and we should be cautious not being marginalised by South Korean FTAs with EU competitors;

Shared analysis that potential benefits of an FTA would mainly arise from addressing the regulatory issues which are hindering the full development of our relations;

Expression of sensitivities in the automobile sector due to the competitiveness of the South Korean industry and the fact that access to the South Korean market is difficult mainly due to non-tariff barriers while the EU market is protected by tariffs only. While an FTA would remove tariffs between both parties, the challenge would be to ensure action to effectively tackle non-tariff obstacles to trade;

Hence broad support to an FTA with South Korea provided it addresses real barriers to trade.

Further consultations of industry and civil society will be undertaken before and during the negotiations.

PROBLEM DEFINITION

2.1. Carefully chosen FTAs should strengthen trade policy's contribution to growth and jobs

The Commission has recently adopted a Communication[1] reviewing the contribution of EU trade policy to the European Growth and Jobs strategy and setting out priorities for the years ahead. For trade to contribute to growth and jobs in Europe and open markets around the world, the Communication argues that we must have the right policies at home, which reflect the challenges we face and maintain our openness to trade and investment. This internal agenda must be complemented with an external agenda that creates opportunities in a globalised economy. Rejection of protectionism at home must be accompanied by activism in creating open markets and fair conditions for trade abroad.

The Communication recalls that the EU's priority in recent years has been to pursue an ambitious, balanced and fair multilateral agreement in the WTO to liberalise international trade further. The WTO is the most effective way of expanding and managing trade in a rules-based system. It is a cornerstone of the multilateral system. The suspension of the Doha negotiations is a serious missed opportunity for global growth and development. The Communication delivers a clear message that the EU is fully committed to the WTO and the DDA remains its first priority. The EU is committed to the resumption of negotiations and their successful outcome.

However, the Communication argues that we can and should build on the platform created by the WTO to generate new opportunities for growth by opening markets further to trade and investment. To create open markets in the 21st century, Europe needs to look beyond tariff reduction to the trade barriers that lie behind borders. As tariffs fall, these barriers – such as unnecessarily restrictive regulations – become increasingly important. We also need to step up our engagement with the major economies of the next generation, particularly in Asia, where there is huge potential for growth, but where Europe is not performing as strongly as it should.

1 COM(2006) 567, "Global Europe: competing in the world", 4 October 2006

The Communication sets out a series of linked trade policy initiatives complementing our efforts to resume negotiations in the WTO. As part of these initiatives, it proposes to develop a new generation of carefully chosen bilateral free trade agreements. FTAs, if approached with care, can go further and faster in promoting openness and integration, by tackling issues which are not yet ready for multilateral discussion.

FTAs are not new for Europe. But while our current bilateral agreements support our neighbourhood and development objectives well, our main trade interests, including in Asia, are less well served. The content of these agreements also remains limited. The Communication stresses that we should continue to factor other issues and the wider role of trade policy in EU external relations into bilateral trade developments. But in order for trade policy to help create jobs and drive growth, economic factors must play a primary role in the choice of future FTAs.

The key economic criteria for new FTA partners should be market potential (economic size and growth) and the level of protection against EU export interests (tariffs and non-tariff barriers), while taking account of our potential partners' negotiations with EU competitors.

In terms of content, new competitiveness-driven FTAs would need to be comprehensive and ambitious in coverage, aiming at the highest possible degree of trade liberalisation including far-reaching liberalisation of services and investment. Future FTAs would also need new ways of addressing non-tariff barriers. They should include new provisions for investment, IPR, public procurement and competition and state aid. There will also be a need to work to strengthen sustainable development through our bilateral trade relations. This includes incorporating new co-operative provisions in areas relating to labour standards and environmental protection.

The Communication stresses the need to ensure that we share similar ambitions with our prospective partners at the outset in order to avoid negotiations later stalling because of a mismatch of expectations.

The Council conclusions of November 2006 GAERC state that "as one of the policy initiatives, the EU should aim at a new generation of WTO-compatible FTAs that extend beyond present agreements and build towards future multilateral negotiations. The agreements should strive for the highest possible degree of trade liberalisation, taking into account their positive contribution to the EU's competitiveness and their impact on internal European policies. The agreements, which should be part of a coherent framework of the EU's relations with each partner, should include far-reaching liberalisation of services and investment and should place special emphasis on the elimination of non-tariff barriers and on regulatory issues. In setting geographical priorities for these agreements, economic considerations should play a primary role, notwithstanding other, political considerations.". Based on these criteria, the Council supports the early launch of negotiations with ASEAN countries, India and South Korea and invites the Commission to submit proposals for the negotiating directives without delay.

2.2. An FTA with South Korea would strongly serve EU offensive economic interests

South Korea is one of the few countries combining a sizeable market, high economic growth and substantial tariff and non-tariff barriers to trade against EU interests. It is also rapidly opening its markets to EU competitors, which puts EU positions at risk. For these reasons, South Korea fully meets the economic criteria set out above. South Korea also shares EU level of ambition as regards potential negotiations. A deep and wide FTA with South Korea would thus secure our positions and bring significant market opportunities for the EU.

a) Size and perspectives of the South Korean market

South Korea is an important and expanding market. It is the sixth world largest economy (counting the EU as one) after the EU, the US, Japan, China and Canada, with a GDP of $810bn. This makes it a market of the same size as Mexico combined with India, bigger than Brazil combined with Russia. It is nearly on equal terms with the ten countries of ASEAN taken together. South Korea is the seventh world largest trading power (3.5 times as big as India).

EU trade and investment has a significant presence in South Korea. The two way trade has reached around €70bn yearly. It is the EU fourth largest non-European trading partner (8th overall) ahead of India, Mexico, Canada, or Mercosur. EU FDI stocks in South Korea amounted to €35bn at the end of 2005. European companies provide goods and services to export oriented manufacturers, and consumer goods to increasingly affluent South Koreans.

South Korea is the fastest growing economy in the developed world. Its GDP growth averages 7.5% over 20 years. Over the past decade, productivity growth has been twice as high as in the US. South Korean labour force is extremely well qualified (ranking third in terms of share of the population with university degree). The increase of FDI in the service sector in 2005 is a good sign for the growth potential of the service sector where productivity is much lower than the OECD average, unlike the manufacturing sector. South Korea's FTA policy will also add important momentum to structural adjustment in South Korea. The South Korea-ASEAN FTA will connect the Northeast Asian market centred on South Korea with the Southeast Asian market. This will lead to the creation of a base for the East Asian Community, and make South Korea a potential hub for regional integration. South Korea, as well as Japan, will continue to benefit from China’s growth – which has already become its first client. Future growth prospects are therefore positive: 4.8% is expected in 2006 while the World Bank estimates for 2007-2025 averages 4.7%.

The table below summarizes the market potential of the EU’s top-25 trading partners (covering close to 90% of all EU trade), including regional groupings where appropriate (GCC, Mercosur, ASEAN), excluding countries with which the EU already has FTAs. The market potential here is defined as the countries’ average annual increase in market size. South Korea’s market potential appears to be of the same order as India, ASEAN and Mercosur. It is far above Canada, the GCC, Taiwan, Australia, Hong Kong, Iran or Ukraine.

Table 1: Annual average market potential and key economic indicators

	Market potential 2005-25 (€ bn)**	GDP 2005 (€ bn)	Annual average growth rates 2005-25 (%)
USA	449	10.144	3.2
China	204	1.573	6.6
Russia	21	526	3.0
Japan	74	3.920	1.6
India	58	607	5.5
ASEAN	57	714	4.9
South Korea	45	598	4.7
Mercosur*	35	677	3.6

Canada	28	849	2.6
GCC*	27	412	4.3
Taiwan*	18	268	4.3
Australia*	17	526	2.5
HK*	12	149	4.8
Iran*	10	151	4.3
Ukraine*	5	61	4.9

Source: World Bank, Global Insights and own calculations. *Note:* * Growth figures from Global Insights 2007-15. ** Indicates change in market size, *economic size x growth*.

b) Level of tariff and non-tariff barriers against EU exports

Tariffs

South Korean duties remain high compared to other OECD countries. The applied MFN rate averages 12.8%. High tariffs, averaging 52.2%, apply to agriculture with out-of-quota tariffs, often exceeding 200%, applying to many other commodities. By contrast, industrial tariffs average 6.7%. Calculations of the International Trade Commission (WTO-UNCTAD) taking into account the exports structure shows that “real” tariffs faced by EU products on the South Korean market average 62.8% for agricultural products and 7.5% for industrial products. Tariffs remain unbound for several products of interest to EU. Although 91% of tariff rates are bound, the predictability of the tariff is eroded by the considerable leeway to raise applied tariffs provided by the substantial gap between applied and bound MFN rates. South Korea has used this gap to apply higher "adjustment duties" as "flexible tariffs" on several products.

Some key EU export sectors face high tariffs and are subject to uncertainty due to a varying level of bound tariffs. For example in the automotive sector the average applied tariff is 11% with a range from 0-20% and with only an 82% of bound tariff lines. This allows the South Korean Government to raise tariffs if necessary without having to offer compensation to their trade partners. The tariff rates for a range of utility vehicles and motorcycles are bound at 16% and those on engines and most parts, at 13%. Tariffs on vehicles for the transport of goods remain unbound. The situation is similar on power generating machinery. In textiles, South Korea has harmonised virtually all tariffs on textile products at the level of the US rates: 7.5% for man-made fibres, 15% for yarns, and 30% for fabrics and made-ups goods.

An ambitious result of the Doha round would eliminate the uncertainty linked to the gap between bound and applied rates but would leave significant levels of protection. Due to the current gap between bound and applied tariffs, the actual impact of a Swiss 10 formula on applied tariffs in NAMA would remain limited to 2-3% cuts in most of the sectors. Tariffs on vehicles would remain above 6% and tariffs on apparel above 7%.

With regard to agricultural products, South Korea accepted the binding of all tariff lines, but tariffs remain high on a large number of agricultural products of interest to EU exporters e.g. wine (15%), oils (30%), juices (30-57%), dairy products like milk (40%) and butter (94%, in WTO quota 40%). On beverages, spirits and vinegar, the average bound tariff is 32.8% with a range from 8% to 270%. In addition, there are tariff quotas for 67 categories of agricultural products. The management of these tariff quotas involves associations of the domestic industries producing products competing with the imported products covered by the quotas or using this imported products. The WTO Trade Policy Review notes that this management system implies "potential conflicts of interest" which is an understatement. As mentioned above this system's lack of transparency and lack of predictability can limit business opportunities.

South Korea benefits from the "developing country" status in the WTO as far as agriculture is concerned. This should shelter South Korean agriculture from radical changes in agricultural protection as a result of the DDA. In the case of the above mentioned products, a G20 formula[2] would leave tariffs between 20% and 40% for oils, juices and milk, above 60% for butter and up to 150% for beverages, spirits and vinegar.

Non-tariff barriers

Unjustified regulatory obstacles are the root cause of most trade irritants with South Korea and constitute the bulk of the concrete impediments to market access. EU operators have to face numerous local instead of global standards, shortcomings regarding intellectual property rights, restrictions to do business and burdensome and non transparent procedures.

Examples of recent barriers faced by EU business include requirements for alcohol labelling, emission control of automobiles, pharmaceuticals and cosmetics. The two latter led to the opening of two trade barrier regulation (TBR) procedures. The provision of state aid to domestic industry is also a problem, with subsidies to the shipbuilding industry having led to the adoption of a TBR

Following the Commission's IPR enforcement survey and due to its level of production, transit and/or consumption of IP infringing goods, South Korea is now considered as a priority country for IPR enforcement. South Korea public procurements markets are also far from being totally open to EU companies despite South Korea's membership to the Government Procurement Agreement.

Several barriers also impede the access to the market by EU service providers, especially in legal, banking and news agency services. With regard to legal services, the market is currently closed to foreign lawyers, who are only able to provide some cross-border service from Hong-Kong. European law firms want to be able at least to offer legal consultancy services. On banking, South Korean rules on equity do not follow the practice in other OECD countries. There are also difficulties as regards nationality and residency requirements for directors for financial institutions: while South Korea has refrained from introducing these requirements in law, practice shows that they are enforced in practice through "moral suasion". There are also trade-restrictive regulatory requirements in the insurance sector (e.g. banc assurance). On news agencies, Korea has a quasi-monopoly on disseminating news. Foreign news agencies are not allowed to distribute news directly to media clients in South Korea.

Potential for bilateral trade growth

Although it is already the EU fourth largest trading partner outside Europe, there is still a large potential to be exploited to facilitate and expand bilateral trade. Estimates based on gravity models reveal that the EU-South Korea trade is below its potential: bilateral trade between South Korea and the EU is in average smaller than it is with their other trading partners[3]. South Korea is one of the countries where the gap between the actual position of EU producers and their usual position in

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2 For developing countries the G20 parameters are: thresholds 30/80/130; cuts 25/30/35/40, cap 150.

3 Kim, H.C. & Lee, C. (2004), "Korea-EU Trade Relations: Over-traded or Under-traded?" *Asia-Pacific Journal of EU studies*.

comparable countries is the most important. South Korea accounts for only 2.4% of EU exports, while it accounts for 3.3% of the external demand. EU market share in South Korea (15%) is significantly below its market share in India (21%) or Brazil (31%). The EU position appears to be below its performance in comparable countries in 23 sectors out of 57 sectors analysed. Its is namely the case for heavyweight products of EU exports such as special purpose machinery, electric apparatus, iron and steel, electronics, IT and aeronautics. And the situation is even worse as regards the EU share in domestic consumption: our share in pharmaceuticals products or automotives is far below its average share in other countries. In both cases, this is linked to well-known trade irritants, which can only with difficulty be addressed in the current context.

c) Risk of trade diversion created by South Korea's FTA policy

<u>South Korea's FTA policy</u>

South Korea is rapidly opening its markets to EU competitors. A traditional supporter of WTO, South Korea was (with Mongolia) the only member of the WTO, which had no FTA at all until 2004. After the failure in Cancun, in order to maintain a continuous external pressure to sustain the rhythm of reforms and in complement to its WTO commitment, South Korea embarked into an ambitious programme of bilateral FTAs negotiations. It has already concluded FTAs with Chile, Singapore, EFTA and ASEAN. Negotiations with Canada have started. Most importantly, negotiations with the US were launched at the beginning of this year. They move forward very rapidly and both parties are committed to conclude in 2007. China will probably follow. Only South Korea-Japan talks are stalled amid political tension and due to agricultural sensitivities.

The level of ambition of these agreements is very high, with high sectoral coverage (the South Korea/Chile agreement covers 99.6% of tariff lines) and (apart from ASEAN for which a second stage of negotiations is foreseen) inclusion of commitments on services, investment, competition, public procurement, and IPR. The speed with which South Korea is negotiating some FTAs is also remarkable. For example, an agreement with EFTA was reached in less than 7 months.

<u>Potential impact on EU exports</u>

The EU risks losing out if South Korea’s FTA policy were to give trade and investment preferences to major EU competitors. EU trade and investment has a significant presence in South Korea. The EU is the largest foreign investor with a stock investment of $35 billion. In 2005, the investment from the EU accounted for 41% of the total foreign direct investment.

Initial surveys of EU companies underlie the risk of trade diversion in certain sectors as a result of South Korean bilateral agreements. Although concluded with a small partner, the FTA with Chile has already produced some effects. For example, increased imports of Chilean pork are squeezing EU exports. French and Italian wines are already facing difficulties: for the first time since 1998, French exports sharply decreased last year, although South Korean overall imports increased by more than 20%. Chilean wine reached a 20% market share in 2005 (from 6.5% in 2003), making Chile the number two supplier for wine. A traditional leader of the market, France could be overtaken by Chile as soon as this year. This unexpected success of Chilean wine (which cannot be explained solely by the limited tariff reductions which are being phased in gradually over 5 years) also underlines the psychological impact of an FTA in altering business patterns.

In the automobile sector a South Korea-Japan or South Korea-US FTA would enhance the competitiveness of Japanese and US cars significantly. The chemicals industry also considers that an FTA with Japan would weaken EU position in the specialty and fine chemicals sector, accounting for 61% of EU exports to South Korea. In addition to the pure tariff advantage effect, such an FTA could lead to chemical restructuring between Japan and South Korea firms. South Korea would concentrate on petrochemicals in which it is more competitive than Japan while Japan would concentrate its chemical activity on specialty products where the Japanese industry is still strong, especially in technology and innovation. The EU would be further weakened. An FTA with the US would add to this disadvantage, although its effect should be less severe.

Service providers are concerned about the impact of FTAs with EU competitors in banking, insurance and legal services areas, particularly any FTA with the US. The US is thought to place greater access for financial and legal services at the top of its services agenda for a South Korean FTA. European service providers worry that even a short head start by US firms in hitherto closed sectors (e.g. legal services) could put them at a competitive disadvantage should they later enter the market.

As European interests are not only in the area of tariffs, the EU would also stand to lose on behind-the-border issues like standards, rules and regulations. These already hinder some significant trade with South Korea and it would be damaging to the EU if other FTA partners were to obtain a de facto advantage. A bilateral agreement by South Korea with the US would strengthen the argument for using US standards and regulatory approaches, while South Korea is already very US minded. This would be especially important in cases where international standards do not exist or the standards are disputed. Experience with the recent US-Singapore FTA suggests that even in a market as open as Singapore’s, the US was able to obtain preferences to the detriment of the EU.

Overall, a study undertaken by Copenhagen Economics[4] (based on tariffs and services liberalisation only) shows that if South Korea concludes FTAs with other partners (US, Canada, India, China, ASEAN and Japan), but not with the EU, the EU25 will lose a market share of total South Korean imports of 2.8 percentage points, making EU25 share of total South Korean imports go down from 17.5 to 14.7 percent.

d) Readiness to achieve a comprehensive and ambitious FTA and address real obstacles to trade

There are a number of reasons why negotiations with South Korea could meet EU's ambitions and proceed smoothly:

South Korea has a strong interest in embarking on FTA talks with the EU. The EU is South Korea's second largest export market after China, ahead of the US and Japan. South Korea has already commissioned a feasibility study[5] which concludes that the EU would be one of the most attractive partners for FTA for South Korea and that adjustment costs (e.g. in agriculture) would be lower than with the US. And contrary to the US, an FTA with the EU would not raise sensitivities in the movie sector. South Korean authorities repeated several times their clear interest in launching as soon as possible negotiations for a comprehensive FTA with the EU and their conviction that negotiations could proceed quickly with a high level of ambition in terms of content.

South Korea has demonstrated its ability to negotiate broad agreements rapidly. As already indicated it seeks, like the EU, to conclude WTO-plus agreements with large sectoral coverage and including a wide range of non-tariff issues. The level of ambition of its more recent FTAs is

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4 Copenhagen Economics, "Economic impact of a potential FTA between the EU and South Korea", Report for DG Trade, August 2006.

5 Kim, H.C. (2005), *An Analysis on the Economic Effects of a Korea-EU FTA and Policy Implications on the Korean Economy*, KIEP Policy Analysis, 2005-12-30.

actually higher than that of the EU-Chile FTA. The South Korean administration is now well organised to negotiate FTAs and can build on previous experiences of negotiations with a broad coverage. Prior to negotiating with big economies, South Korea’s tactic has been to develop agreements with smaller, neighbouring markets as a test case for the larger one: Chile before Mercosur, Singapore as gateway to ASEAN, Canada could lead to the US and finally EFTA as a test case for the EU. The South Korea-EFTA FTA is a good illustration of the speed and pragmatism with which South Korea can approach FTA negotiations. South Korea based the discussion with EFTA on an existing EFTA-Singapore text in order to avoid the problems that might have derived from EFTA links with the EU under the EEA. This allowed securing an agreement in less than 7 months.

Exploratory discussions showed that South Korea aims at the negotiation of a high quality comprehensive and ambitious FTA with the EU. Exploratory talks on a possible FTA were launched following agreement in May 2006 between Commissioner Mandelson and Minister Kim Huyn Chung. Aim was to check the common level of ambition and the added value such an FTA would bring to effectively address real – especially non-tariff – obstacles to trade. Two rounds of discussions on a possible FTA were held in July and September 2006 covering issues such as tariffs on goods, rules of origin, custom procedures, NTBs, services, TBT, SPS, public procurement, investment, competition and state aid, IPR, social and environmental issues and dispute settlement and flexible mediation mechanisms. This proved to be vvery useful and productive meetings with positive results. No major problem spotted, although a number of issues were left "for the negotiation". South Korea appears ambitious and well prepared and has not indicated any red line as to the degree of ambition. South Korea was also prepared to show a good deal of flexibility on issues which they have not covered till now in their negotiations (e.g. social and environmental issues).

MAIN OBJECTIVES

A key objectives of an FTA with South Korea would be to secure EU positions on the South Korean market and limiting potential trade deflection created by other FTAs.

The following are amongst the market access gains the EU can aim to achieve through a comprehensive FTA:

Highest level of elimination of duties possible;

Elimination of all forms of export restrictions except justified by security of environmental reasons;

Addressing unjustified non-tariff barriers to EU exports and investments: regulatory transparency, SPS, TBT, customs procedures, competition and state aid;

Delivering better market access in services – across all modes;

Improving investment climate;

Opening public procurement markets;

Enhancing IPR protection.

POLICY OPTIONS

There are three options to enhance trade and investment links between the EU and South Korea, albeit at different levels: (A) continuing co-operation under the existing framework, (B) a shallow FTA and (3) a comprehensive FTA.

Option A: No change

A first option is to maintain the status quo, continuing co-operation on the basis of the 2001 Framework Agreement on Trade and Co-operation. This option is not satisfactory for several reasons:

Experience in cooperating with South Korea under show that, being non-preferential in nature, the Framework agreement in itself offers modest scope for applying pressure or offering positive incentives to address market access barriers and specific trade irritants. There has therefore been limited progress in dealing with a wide range of long-standing issues, many of which are regulatory in nature. Negotiation of an FTA with South Korea would provide considerable scope for making progress in resolving many such issues.

Given South Korea active policy of FTA negotiations with the main EU competitors, maintaining status quo would effectively be a set-back. It would entail a risk of marginalisation for the EU compared to other trading partners.

Option B: Shallow FTA

A second option is a shallow FTA, which would cover only trade in goods.

Such an option would have the advantage of being easy to negotiate and to provide rapid results in a short period of time. However, there are several reasons why this option is not desirable:

Such an FTA would not tackle real obstacles to trade: restrictions to the services sector and non-tariff barriers would be left untouched while it is the bulk of the market access barriers faced by European business seeking to export to South Korea.

As a result, its impact would therefore be pretty limited as far as the EU is concerned and would not be to the advantage of the EU a far as the balance of offensive and defensive interests is concerned. For example, any preferential tariff liberalisation in the automobile sector in Europe – which is protected by tariffs only – would greatly benefit the South Korean industry, while the EU industry would still be hindered by substantial non-tariff obstacles to trade on the South Korean market and would not be able to effectively seize the advantages of trade liberalisation.

Such a shallow FTA would not support further multilateral trade liberalisation by covering issues which are not yet ready for multilateral discussion. It would send a very bad signal for the way Europe approaches FTAs. It would lead to trade diversion rather than trade creation. It would not lead to a real integration between both economies. It would not lead to economic reforms in South Korea nor any progress in terms of regulatory transparency or IPR protection that would benefit to all trading partners.

For all these reasons, such an FTA would match neither the objectives nor the criteria set out in the Commission's Global Europe communication.

Option C: Deep FTA

The third and preferred option is a deep and wide FTA. To create new trade bilateral agreements have to be ambitious. An EU-South Korea FTA would have to be deep and substantive: not just tariffs on goods, but services, non-tariff barriers and rules on issues such as investment, competition and state aid and public procurement as well. It would also need to improve the enforcement of rules on the protection of intellectual property rights. To be a stepping stone rather than a stumbling block of multilateral trade liberalisation, they have to build on the WTO framework and go beyond WTO rules and disciplines where it is not yet possible or feasible at the multilateral level.

EXPECTED IMPACT FROM THE SELECTED OPTION

5.1. Impact on growth, competitiveness and jobs in Europe

c) Impact on trade and production

An important economic rationale for an FTA with South Korea is defensive, to counter the risks of trade diversion implied by South Korea current FTA policy. In this regard, the above mentioned study undertaken by Copenhagen Economics shows that even in the less ambitious scenario of trade liberalisation between the EU and South Korea, the EU market share in South Korean imports would increase by 5.8 percentage points from the baseline level assuming South Korea has concluded FTAs with all EU competitors. EU market share in South Korea would increase from 14,7 percent to 20,5 percent of total imports, thereby not only regaining EU's positions before any FTA between South Korea and its competitors but also expanding its market share vis-à-vis this initial level.

In addition to that, an FTA, especially deep and wide as South Korea is able to commit, would bring several benefits in terms of facilitating trade, enhancing market access and creating new market opportunities for the EU. In the less ambitious scenario, EU's exports to South Korea would increase by 19.1 billion Euros, or 48 percent. The largest trade impacts for the EU are found within business services (22% of the total increase in the value of South Korean imports from EU25), machinery (16% of the gain) and processed food (11%).

The Copenhagen Economics study is based on tariffs and services liberalisation. Most of the gains for the EU are attributable to the services liberalization. This would account for 70 percent of the gains even in the most conservative scenario as regards services liberalisation. EU would increase particularly in the following key tradable service sectors: wholesale and retail trade, transport services, communication, financial services and banking, other business services and other services, with an average increase expected to be between 40 and 60 percent. The reason for such dramatic increases is that South Korea needs these advanced services to fuel the growth of their own economy, and that the South Korean service sector is highly protected by non-tariff barriers. A large part of the expected output expansion for South Korean manufacturing (especially in electrical machinery and other machinery, but also in motor vehicles) would actually be generated by better access to the key competitive services in the global economy, namely transport, communication and business services, which could be provided by the EU under a FTA. Put in short: by succeeding in exporting advanced services, the EU can help South Korea succeed in exporting advanced manufacturing. A free trade agreement can make this possible - to the benefit of both economies.

While output on average will increase in both economies, on industry level, some industries in both economies will in fact expand while others are expected to contract. The study expects a drop in merchandise production for the EU, while the output for European services will increase. The relatively largest decline is found in the motor vehicles sector, while processed food sectors are expected to grow.

Yet the meaning of these results needs to be strongly qualified: the study covers tariffs and services liberalisation only and doesn't address non-tariff barriers which are the root causes of most of the EU difficulties to enter the South Korean market, while obstacles to South Korean exports in the EU are much more linked to tariffs. An important result of this study is thus that in several key sectors for the EU economy an FTA with South Korea would bring positive effects only to the extent that is effectively address non-tariff barriers to trade.

c) Impact on small and medium enterprises (SMEs)

While they constitute a key asset of the EU economy, SMEs find it more difficult than multinational enterprises to access third markets, due to their limited capacity to cope with non-tariff barriers.

Several components of an FTA with South Korea would directly support them in their efforts to enter the South Korean market. This is particularly the case of provisions related to regulatory issues (regulatory transparency and regulatory co-operation). The inclusion of ambitious trade facilitation provisions in our future FTAs would also directly benefit SMEs as transaction costs are deadweight costs disproportionately felt by them. As SMEs are particularly vulnerable to IPR violations, the specific provisions on IPR enforcement would be of particular benefit to them. South Korea is a specific target of EU's IPR enforcement strategy.

d) Impact on jobs

Creating new market opportunities and enhance bilateral trade between the EU and Korea will spur economic growth in Europe (see impact on trade and production) and thus contribute to job creation. While jobs will increase as a result at the level of the EU, on industry level, some industries will create jobs while others are expected to contract. The Copenhagen Economics study expects a drop in skilled and above all unskilled labor employment in several manufacturing sectors, while jobs in services especially communications and non financial business services will increase.

A key objective should be to ensure smooth and progressive evolutions for sectors and workers which are particularly weak or particularly vulnerable to international competition. They will receive particular treatment, with longer transition periods. We should also better anticipate these changes, which helps minimise costs, facilitate and accelerate transitions.

The Sustainability Impact Assessment (SIA) that will be carried out during the negotiations will constitute an irreplaceable tool to allow such anticipation and dialogue. Social dialogue, supported by public authorities, plays an important role in identifying and mitigating these adaptation needs.

The results of the SIA on an EU-South Korea FTA should be further used in the framework of the EU's new generation of cohesion policy programmes for 2007-2013 which provide opportunities to anticipate and prepare for changes linked to globalisation. The partners concerned - the national and regional authorities and the Commission – should ensure that they create a sound basis for investment in new activities and in the re-training of the workforce.

Whatever our efforts to anticipate and manage change, there will always be unexpected trade shocks which will provide adverse effects for some workers. Again the new generation of cohesion policy programmes for 2007-2013 make it possible to set resources aside for unforeseen events arising over the period – such as trade-induced restructuring. The European Globalisation Adjustment Fund (€500 millions a year), soon to be established, will also provide a swift answer to one-off, clearly defined problems resulting from restructuring and changing global trade patterns. It will cover training, relocation of workers and outplacement (the costs of action to help find a new job).

5.2. Impact on development

The Communication on “Global Europe” recalls that we should take into account the development needs of our partners and the potential impact of any agreement on other developing countries, in particular the potential effects on poor countries' preferential access to EU markets.

a) Development needs of South Korea

The EU’s agenda for market opening under the “Global Europe” framework focuses on the major emerging countries and regions which are able to sustain competition, which already draw huge benefit from their integration into the world trading system and whose opening to trade is an increasingly important factor in the prospects for growth around the world.

South Korea is an advanced economy with a GDP per capital above several EU Member States. It is able to sustain competition and already draws huge benefit from its integration into the world trading system. Its opening to trade is an increasingly important factor in the prospects for growth around the world.

South Korea has already concluded or is in the process of negotiating FTAs with several partners with different level of development (e.g. ASEAN, EFTA, the US, Canada). It has commissioned a feasibility study on an FTA with the EU which concludes that the EU would be one of the most attractive partners for FTA for South Korea and that adjustment costs (e.g. in agriculture) would be lower than with the US. Other traditional South Korean sensitivities (e.g. audiovisual) won’t be relevant either with the EU. South Korea has a broad experience of multilateral and bilateral trade negotiations and doesn’t need any form of assistance from the EU to negotiate an agreement with the EU.

b) Potential effects on poor countries' preferential access to EU markets

As regards the impact on other developing countries, an element of preferences erosion is inherent in any form of trade liberalisation, multilateral as well as bilateral. This will be an important issue to look at in order to identify sectors and countries affected. The planned SIA will help fine-tune our positions to limit the potential impact of preferences erosion on least developed countries.

There is however little concern in this regard on the EU-South Korea FTA. The analysis shows that the risk that an FTA between the EU and South Korea increase competitive pressure on the weaker developing country access to the EU market e.g. as regards ACP countries is extremely limited:

South Korea trade interests in the EU are quite different from current or even future ACP ones. Out of the 25 most imported products from South Korea, which accounts for ¾ of EU imports from South Korea, only 2 also appear in the list of the 25 most imported products from ACP countries. These are cars and large vessels for the transport of persons or goods. But this does not imply a real risk of trade diversion detrimental to ACP countries. In the case of cars, 93% of EU imports from ACP countries actually come from South Africa, which is very specific in the ACP group. Cars account for less than 1% of EU imports from ACP countries while it is already a major strength of South Korea on the EU market. In the case of vessels, South Korean and ACP countries do not specialize on the same range of products and shipbuilding is a specific area, where there are no import duties.

Some common interests exist as regards textiles, although this is, generally speaking, no longer a major strength of South Korean exports. The traditional textile industry is being rationalized, due to increased competition domestically and in third markets from low cost exporters, such as China. Production shrunk by some 20% between 2000 and 2003. Total textile exports declined from 10% of South Korean merchandise exports in 2001 to 7.5% in 2003. The liberalisation of textile trade since the beginning of 2005 has also lead to a further decline of South Korean exports in the sector.

The EU's commitment to development through trade is long-established. Increasingly, EU's major emerging partners such as South Korea also bear a responsibility towards poorer counties. As they grow, so does their role in providing market access to help spur development in other countries. That's why the "Global Europe" Communication suggests that in line with our position in the WTO, we encourage our FTA partners to facilitate access by least-developed countries (LDCs) to their market, if possible by granting duty and quota free access. South Korea was open to grant such a treatment to LDCs when the issue was discussed at the last WTO Ministerial Meeting in Hong Kong in December 2005.

5.3. Contribution to EU international social and environmental objectives

In line with the specific call by the June 2006 European Council in the context of the renewed EU Sustainable Development Strategy, future FTAs including the EU-South Korea FTA will cover sustainable development concerns by addressing environmental and social issues in addition to economic considerations.

The coverage of these issues in the WTO is limited by the willingness of the WTO membership to address these issues, which many, particularly developing countries, believe are cover for protectionism. Bilaterally we can achieve more in these fields, provided we take a co-operative, not a sanctions-based approach. We will be aiming to do this.

The intention is to incorporate a sustainable development chapter including issues relating to the protection of core labour standards and co-operation on global environmental issues. It is also envisaged to include provisions covering in particular the necessity not to relax existing standards to attract foreign investment, the importance of enforcement, exception clauses related to the protection of human health and the environment, liberalisation of trade in environmental goods and services, the role of civil society and the public at large in the design, implementation and monitoring of relevant measures.

Adequate focus on core labour standards, facilitation and promotion of trade in environmental goods, technologies and services, in all sectors of the economy, as well as stronger co-operation in environmental issues would have positive social and environmental effects. On the other hand, potential negative potential environmental impacts may be caused by higher volumes of exports, imports, increased levels of economic activities, including the extraction and use of natural resources and the transport of goods and people, all of which could exacerbate pressures on our global climate, biodiversity, air and water quality, waste management, human health, etc. The challenge is to address these risks, both through the FTA itself and through other relevant agreements and instruments, and both by means of trade and non-trade related measures. In this connection, consideration will be given to measures aimed at preventing or, at the very least, minimising any negative effects that would result from enhanced trade, particularly in natural resource sectors. At the same time, attention will also be paid to provisions aimed at maximising the positive impact of trade liberalisation. All these aspects will be subject of the planned SIA.

5.4. Impact on the multilateral trading system

South Korea is a traditional supporter of the multilateral system. It was (with Mongolia) the only member of the WTO, which had no FTA at all until 2004. In many DDA areas the EU and the South Korean positions are quite close. South Korea has strong offensive interests in NAMA, services, trade facilitation and anti-dumping. Hence negotiations with South Korea would not risk sending the wrong signal as regards commitments to the DDA. On the contrary, negotiation of a deep FTA by two keen supporters of a multilateral system can be seen as a signal of our readiness to open our markets beyond what is currently possible in the WTO rather than as a threat to the WTO system.

Our priority will be to ensure that an EU-South Korea FTA such as any new FTAs is a stepping stone for progressive liberalisation within the WTO system, not a stumbling block to it. Building on the WTO, our aim will be to go beyond what can be achieved at the global level by seeking deeper reductions in tariffs; by tackling non-tariff barriers to trade; and by covering issues which are not yet ready for multilateral discussion.

Like the EU, South Korea seeks to conclude WTO-plus agreements with large sectoral coverage and including a wide range of non-tariff issues. As an example, the South Korea/Chile FTA covers 99.6% of tariff lines (including all agricultural products except rice, apples and pears) and a wide range of non-tariff issues (investment, competition, public procurement, and IPR).

An FTA with South Korea will also help maintain the dynamic of trade opening and economic reform, in South Korea like elsewhere. South Korean authorities explicitly seek the external pressure exerted by bilateral negotiations to further internal reforms. An FTA with the EU will thus support and lock-in South Korea's own domestic reform agenda. By doing so, we will help prepare and pave the way for the next generation of global trade liberalisation.

The risks in trade policy are not so much in the balance between multilateralism and bilateralism, but the choice between an open and ambitious approach to bilateralism that drives forward the dynamic of global liberalisation and a closed approach to bilateralism that looks for the quick political fix or opens some borders only to close others.

Finally, to cover the implementation phase of the Agreement, institutional structures will be put in place, building on existing structures where appropriate, including a platform for civil society dialogue. These structures will aim at monitoring and evaluating the impacts of a possible Agreement.

MONITORING AND EVALUATION

As explained in the introduction, the proposal considered is not per se a fully-fledged text. The implementation of the Council decision *stricto sensu* (i.e. the recommendation for a Council decision authorising the negotiations) will consist carrying our negotiations with South Korea. There will therefore be a need to monitor and evaluate the results and impacts of the proposal after the start of the negotiations

As mentioned above, a Sustainability Impact assessment (SIA) will be undertaken for the negotiations and provide an evaluation of their likely effects. The SIA will be launched by the Commission services in the start-up phase of the negotiations and will also entail further consultations with stakeholders concerned.

Finally, in the implementation phase of the agreement, there will be institutional structures put in place, which will be based on the existing ones under the EU-South Korea Framework Agreement Trade and Co-operation, but will be even further developed, including for example a platform for civil society dialogue. These structures will aim at monitoring and evaluating the impact of a possible agreement.

THE COMMISSION PROPOSAL

In line with the above preliminary analysis, the Commission proposes to negotiate a comprehensive and deep FTA with the Republic of Korea on behalf of the EU. Further consultations and in-depth analysis will be carried out as soon as the Council has authorised the Commission to negotiate and the Commission has started negotiations with the Republic of Korea.