

## **Korea's Policy Package for Enhancing its FTA Utilization and Implications for Korea's Policy**

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**Abstract:** Korea's trade with most of its 46 free trade agreement (FTA) partner countries has been expanded continuously. Its FTA utilization ratios were as low as 20% before 2010, and some suspicions regarding the benefits of FTA were raised, despite the government's active promotion. But Korea recorded higher than 70% FTA utilization in the case of Korea-US FTA and the EU-Korea FTA in 2013. Today's high performance could be achieved due to the strategic approach and diverse support mechanisms initiated by the government of Korea since 2010. The supporting programs for businesses included education courses for companies and consulting, workshops to explain the FTAs and provide information on FTAs, building the portals for FTAs, and the expos for FTAs in foreign countries. Several policy implications can be drawn from Korea's experience in assisting businesses with FTA utilization. First, the major barriers that prevent companies from utilizing FTAs should be clearly identified. Secondly, coordination among national supporting agencies is critical in increasing the efficiency of the infrastructure assisting FTA utilization. Thirdly, governments should promote FTAs with large economies, which are expected to bring high economic gains in general. Fourthly, authorities of trade and industry should understand the importance of the quality of FTAs.

**Key words:** Free trade agreement (FTA), FTA utilization, rules of origin (ROO), tariff elimination, ASEAN-Korea FTA

**JEL classifications:** F15, F53, O53

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## 1. Background

Korea has established a very wide free trade agreement (FTA) network by implementing 9 FTAs with 46 countries (Table 1), and the utilization ratios of these FTAs are fairly high, ranging from 40 to 80% as of December 2013, although the rates differ depending on the method of measurement,<sup>2</sup> and some FTAs record poor performance in terms of FTA utilization. Korean companies' utilization ratios of FTAs were quite low 5 years ago (in 2008), and some suspicions regarding the benefits of FTA were raised, despite the government's active promotion.

Today's high performance was achieved due to the strategic approach and diverse support mechanisms initiated by the government of Korea since 2010. This goes back to the period of 2007-9. When the ASEAN-Korea FTA was implemented in June 2007, Korean companies had high concerns over the FTA with ASEAN, which is geographically close and Korea's 5<sup>th</sup>-6<sup>th</sup> largest trading partner. However, it was reported that only few companies were utilizing the FTA in exporting their products to ASEAN countries. Despite the official announcement by the government of Korea on the implementation of the ASEAN-Korea FTA (June 1, 2007), only 5 ASEAN member countries officially effectuated the ASEAN-Korea FTA, and some countries were not ready to implement the agreement.<sup>3</sup> Moreover, the tariff rates were only partially liberalized, and the tariff schedules of the FTA were fairly complex.<sup>4</sup> It was difficult for Korean businessmen to comprehend the tariff schedules given in the FTA without a high level of knowledge on FTAs.

It was surveyed that utilization rates for Korea and Japan were 20.8% and 29%, respectively. The surveys by KOTRA (2008), KITA (2009) and Cheong (2008, 2009) had similar findings. Most of the FTAs that Korea implemented this time were concluded with

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<sup>2</sup> The utilization rates can be defined in several ways as Plummer, Cheong and Hamanaka (2010). One of those can be as follows;

Utilization rate =  $\frac{\sum_{h \in T} M_h^U}{\sum_{h \in T} M_h}$ , where h is a detailed tariff line,  $M_h$  is the value of imports of tariff line h from a FTA partner country,  $M_h^U$  is the value of imports of tariff line h from a FTA partner country with the preferential treatment under the FTA, T is the set of all tariff lines with preferential tariffs given in the FTA.

<sup>3</sup> The 5 ASEAN countries are Indonesia, Malaysia, Myanmar, Singapore and Vietnam. Customs authorities of Myanmar and Vietnam could not process the application of preferential tariffs under the AKFTA for the first two years after the implementation of the FTA. Now all ASEAN countries are under implementation of the AKFTA, and no technical problems are found in handling the FTA tariff procedures.

<sup>4</sup> Most FTAs adopt the categories of tariff liberalization for easy understanding of tariff reduction schedule for a specific product. But ASEAN's FTAs tend to classify products into several groups. For example, the AKFTA has goods for Normal Track and Sensitive Track, and Sensitive Track has the Sensitive List and the Highly Sensitive List.

small and medium-sized developing countries. Moreover, in these FTAs, the preferential margin of tariffs is not big; as such, only one out of five enterprises was found to be utilizing FTAs in Korea. On the other hand, half of the enterprises that had been surveyed responded that they intended to utilize FTAs in the future. These Korean enterprises are thought to have responded with the implementation of the Korea-U.S. FTA (KORUS) in mind, and most of the enterprises are expecting its early implementation.<sup>5</sup>

Korea was embroiled in a controversy over the negotiation of the KORUS when the ASEAN-Korea FTA became effective. Anti-FTA groups advocated the cancellation of the FTA with the U.S., and the government of Korea was criticized for its handling of various aspects of the deal. The poor utilization rates of the FTA with ASEAN could be one of the arguments against the Korea-U.S. FTA. That is, even though the government promoted the economic gains of FTAs for the general public, low utilization rates meant a contrary outcome; a similar argument could apply to the KORUS. The controversy over the KORUS continued in 2008 and 2009, more logical arguments were raised over various areas such as the investor-state dispute settlement mechanism (ISDS) and the mistranslations of the agreement into Korean.

For an FTA to be implemented, it had to be ratified by the National Assembly (congress). The government planned to ratify the KORUS in 2009. However, with the exception of the FTA with Chile, Korea's low utilization of FTAs was not improved, and along with other issues could be a critical pretext for not approving the agreement in Korea. Therefore, improving the utilization rates of existing FTAs became one of the most urgent tasks for the trade authority in 2009-2010. A more serious issue was the fact that most small and medium enterprises (SMEs) did not utilize FTAs, and were losing interest in the FTA policy, since they interpreted that FTAs were for large companies, and most of SMEs suffer from trade liberalization under FTAs.

The Korean enterprises, on the whole, consist of a small number of big corporations (1% of the total number of companies in Korea) and a large number of SMEs. Most of the 30 largest Korean corporations are classified as multinational corporations, whose exports account for roughly 70% of Korea's total exports. These corporations are not only friendly to the FTA policies but are also actively utilizing the existing FTAs for their respective businesses. It is not difficult for them to utilize the existing FTAs, since they have considerable manpower that can be dedicated to the task. However, most SMEs did not fully

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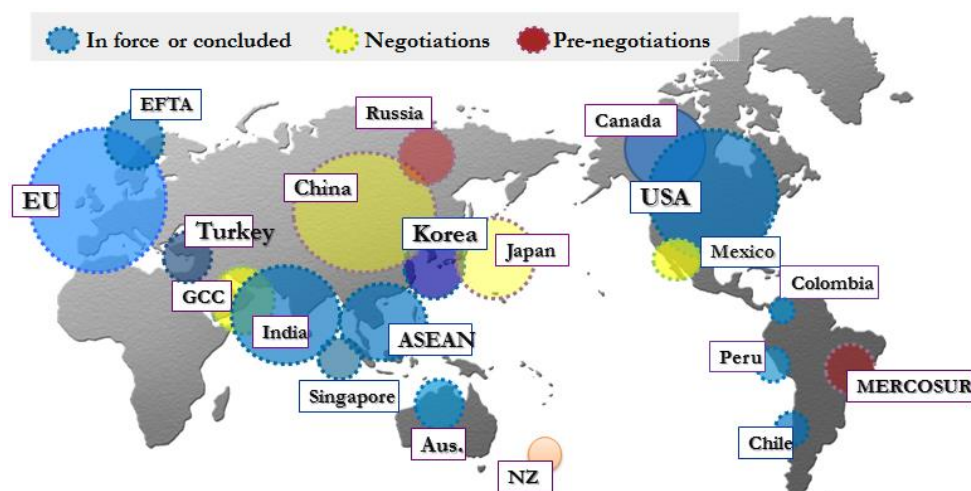
<sup>5</sup> KORUS was initially signed on June 30, 2007. The agreement was re-negotiated due to the demand by the U.S. Congress. The new agreement was signed on February 10, 2011, and entered into force on March 15, 2012.

recognize FTAs, and have not secured the dedicated manpower for international trade. (Cheong and Cho 2009b)

## 2. Korea's FTA performance

Korea was to participate in the global trend of regionalism by implementing the FTA with Chile in April 2004. Ten years later, Korea has developed one of the widest FTA network in the world. Korea's FTA partners are the U.S., European Union (EU), European Free Trade Association (EFTA), Canada, Australia, India, the Association of Southeast Asian Nations (ASEAN), Turkey, Colombia, Peru, and Chile. Korea has established free trade infrastructure with 49 countries through the conclusion of 11 FTAs, covering about 60% of world economy (Figure 1 and Table 1).

**Figure 1: Korea's FTA Network**



*Source:* Prepared by the author based on Cheong (2013)

The country is negotiating an FTA with China, expecting negotiations to be concluded by 2014. Korea commenced negotiations for a China-Japan-Korea (CJK) FTA and the Regional Comprehensive Economic Partnership (RCEP) agreement in the first half of 2013. FTAs with Japan, Mexico and the Gulf Cooperation Council (GCC) are progressing slowly, compared to currently effective (concluded) FTAs. Korea is in discussions for FTAs with Russia, the Trans-Pacific Partnership (TPP) and the South American Common Market (MERCOSUR).

**Table 1: Korea's FTA Performance**

|   | Country and Region (Key timing)  |
|---|--|
| FTAs implemented (concluded)            | Chile (implemented in April 2004)<br>Singapore (March 2006)<br>EFTA (September 2006)<br>ASEAN (June 2007)<br>India (January 2007)<br>EU (July 2009)<br>U.S. (March 2007)<br>Peru (August 2011)<br>Turkey (May 2013)<br>Colombia (to be implemented in 2014 after ratification)<br>Australia (signed in March 2014)<br>Canada (concluded in March 2014) |
| FTA partners under official negotiation | China<br>Japan<br>China-Japan-Korea<br>Regional Comprehensive Economic Partnership (RCEP)<br>Mexico<br>Gulf Cooperation Council (GCC)<br>New Zealand   |
| FTAs under consideration                | Trans-Pacific Partnership (TPP)<br>Russia<br>South American Common Market (MERCOSUR)   |

**Sources:** Compiled from various sources

It can be said that Korea is one of most successful countries in concluding FTAs with major trading partners in the world during the last decade. In addition to the number of FTA Korea implemented and concluded, Korea's FTA policy has been developed step by step in terms of quality and its recent FTAs with developed economies are very broad in terms of market access and comprehensive in coverage. That is, Korea has concluded 'deep and comprehensive' FTAs. Especially, KORUS is likely to be the world's most exemplary, as being the most advanced FTA can be seen.

In spite of establishing a wide FTA network, the government of Korea was criticized domestically because of low FTA utilization ratios. Although the country has provided several FTA support programs for companies since 2007, most companies had difficulties in utilizing FTAs. In 2009-2010, Korea introduced a comprehensive package for supporting companies in terms of FTA business information, various programs for staffs of trade companies, graduate courses for FTA experts, FTA business models for beginners and 'toll-free' phone for free consulting for utilizing FTAs. Also the country has been tried to improve the

efficiency of the package from the eyes of companies. Currently FTAs have become a basic infrastructure for most of trading companies.

### **3. Survey results of 2008-2010**

In 2010, the Korean trade authority reviewed the status of FTA utilization and made a commitment to prepare a government-level policy package for FTA utilization by private companies. At this time, the pros and cons of KORUS were being fiercely debated in Korea, and the government at the time needed to increase the level of support for the FTA in the business sector. The low utilization ratio of existing FTAs was an appealing logic against the ratification of KORUS, as it suggested that the economic gains from the implementation of the FTA would be smaller than the government's estimates.

Low utilization was reproved in governmental survey for manufacturing and trading companies. Before the policy package for FTA utilization was created, extensive research on the FTA utilization ratios for each FTA, and major hurdles of discouraging the utilization were identified. It was revealed that most companies had the misunderstanding that the implementation of FTAs would automatically bring economic gains for them, without any action required on their part. They argued that the government had promoted a similar message in order to gain the support of the Korean people.

Korea was able to conclude negotiations for FTAs with Singapore, EFTA, ASEAN, India, the US, and the EU in the 5-year period of 2004-2008 due to high trade performance with its first FTA with Chile, which was implemented in April 2004. However, similar performance did not happen for subsequent FTAs.<sup>6</sup> Several surveys at that time showed that most companies did not take advantage of the FTAs under implementation. The finding that most of the companies surveyed were not properly utilizing the FTA preferential tariffs was also substantiated in the results of the KOTRA (2008) survey, which showed that only 19% of all respondent firms were utilizing FTA preferential tariffs. The survey by Cheong (2008) provided a similar result: only 21% of firms utilized FTAs in their business in applying preferential tariffs.

Cheong (2009) reported that the majority of Korean businessmen were unaware of the

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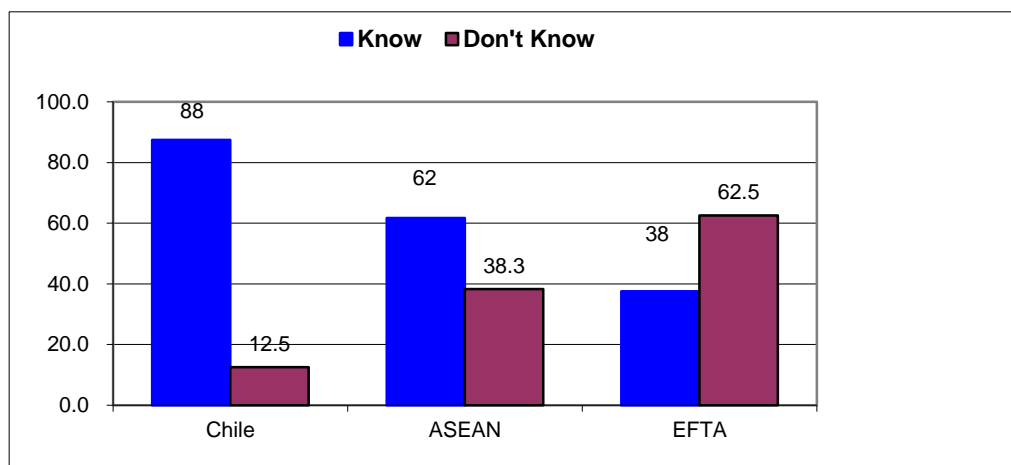
<sup>6</sup> Korean companies' high utilization of the FTA with Chile can be explained in several points. First, most Korean companies trading with Chile are large ones with enough numbers of trade experts and staffs, facing no technical problems dealing with FTA utilization of preferential treatment. Second, companies see large preferential tariff margins given by the FTA. Third, Korean companies had high expectation for business chances with Korea's first FTA, and prepared those business for long time.

implementation of FTAs, and their perception was not very favorable regarding the FTA, although the government of Korea promoted the message that FTAs would provide lucrative business opportunities for Korean companies. Over the past several years, Korea's foreign-trade authorities have extensively publicized the promotion of FTAs among the Korean people, with the aim of increasing political support for FTA policy and enhancing the policy environment.

The survey was carried out in relation to 3 FTAs with Chile, ASEAN and EFTA which were implemented in 2009.<sup>7</sup> The enterprises that responded to the survey included 221 SMEs that manufacture automotive parts, electrical goods and parts, machinery, petrochemicals, textiles, steel and metal products, and sundries. These companies were selected from across the country in order to minimize the bias coming from sample selection.

The survey result shows wide differences in the perception among the Korean enterprises on the implementation of FTAs. The enterprises' degree of recognition of the countries with which FTAs have become effective was highest for the FTA with Chile. 88% of respondents knew the implementation of the FTA with Chile, followed by the ASEAN countries (62%), and the EFTA countries (38%) (Cheong and Cho, 2009a).

**Figure 2: Perception of Implemented FTAs (%)**

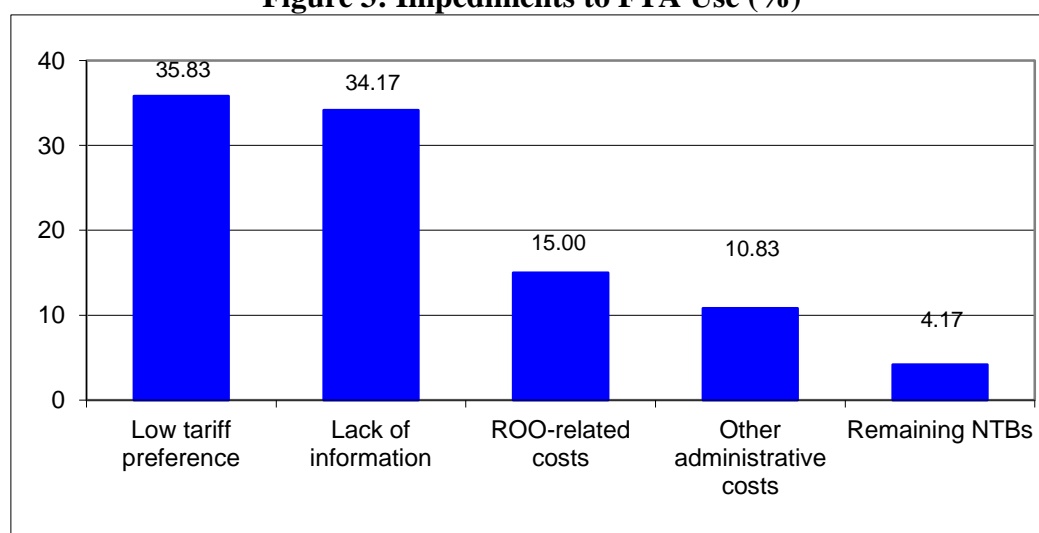


*Source:* Cheong and Cho (2010)

<sup>7</sup> The Korea-Singapore FTA was implemented at the time of the survey, but this was not included in the survey since its Most-Favored-Nation (MFN) tariff rate of Singapore is low or near zero and thus the Korea-Singapore FTA was not likely to be used much.

Several impediments were identified by the survey. Contrary to initial expectations, small tariff preference, that is, low incentive for utilizing FTAs, was the most frequently cited reason for not utilizing FTAs, followed by the lack of information, difficulties related with the rules of origin (ROO), and other administrative costs.

**Figure 3: Impediments to FTA Use (%)**



*Source:* Cheong and Cho (2010)

**Table 2: Barriers to Korean businesses' FTA utilization**

|         |          | 1 <sup>st</sup>         | 2nd                     | 3rd                                 | 4th                          |
|---------|----------|-------------------------|-------------------------|-------------------------------------|------------------------------|
| Imports |          | Lack of FTA information | Problems with ROOs      | Low tariff margins                  | Other                        |
| Exports | Survey 1 | Lack of FTA information | Problems with ROOs      | Importers' intention for using FTAs | Other institutional barriers |
|         | Survey 2 | Low tariff margins      | Lack of FTA information | Importers' business mind            | Customs clearance            |

*Source:* Cheong and Cho (2010)

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