

# 評析南韓與智利自由貿易協定之表現及其對韓中 FTA 的意義

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## 中文摘要

冷戰結束後，全球貿易規範 (regime) 因 1995 年世界貿易組織 (WTO) 的成立而出現戲劇化的進展。儘管如此，以 WTO 為代表的多邊主義 (multilateralism) 卻並未能擺脫區域主義 (regionalism) 的糾纏。每當多邊主義遭受挫折時，區域主義就變得活躍起來，就算是在多邊主義正在制度化的時代亦無例外。

南韓過去曾是多邊主義的堅定的信徒，而今則是雙邊主義 (bilateralism) 與區域主義的積極奉行著。美國亦屬此類的變節者。美國先在 1980 年代轉採區域主義的策略，與以色列、加拿大簽署自由貿易協定 (FTA)，其後又在 1990 年代初與墨西哥完成 FTA，華府的主要目的是為了要促進關稅暨貿易總協定 (GATT) 的烏拉圭回合 (Uruguay Round) 的多邊協商。然而南韓的變節則與美國的動機不同，首爾政府擔心的是區域主義的作法會使南韓在全球市場的市場佔有

率重創。在此背景下，智利（Chile）成為南韓舉行 FTA 協商的第一個對象國，南韓 FTA 協商的動力自此持續維持迄今，並與更多的貿易伙伴簽署 FTA。南韓刻正與其主要貿易伙伴如美國、日本與歐洲聯盟（European Union）等進行 FTA 協商，擁有龐大市場的中國將會是南韓 FTA 政策的下一個目標，儘管這可能是項難度更高的挑戰。

南韓與智利簽署 FTA 對南韓貿易政策、國際貿易與國內的貿易政治而言有多項重大意義。其中最重要的意義莫過於意味著南韓改變其傳統的貿易政策，從多邊的世界貿易策略轉向雙邊的 FTA 策略。迄今韓智簽署自由貿易協定已逾三週年，本文主旨即在探討韓智 FTA 過去三年的經驗及其對未來南韓與中國 FTA 的意義。

# **An Analysis of the Korea-Chile FTA Performance: Implications for a Korea-China FTA<sup>1</sup>**

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## INTRODUCTION

The post-Cold War global trade regime underwent a dramatic progress with the launch of the World Trade Organization (WTO) in 1995. It was an achievement reached after almost a half-century effort for multilateralism in international trade. In reality, however, the multilateralism that WTO represents had to go still along with regionalism despite the general expectation that this will wane away soon. It was understood that regionalism had been active largely because the multilateral scheme was not in full strength. Yet it was finally revealed that regionalist approaches die hard even in the era of multilateralist institutionalization.<sup>2</sup>

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<sup>2</sup> Lester Thurow. *Head to Head: The Coming Economic Battle among Japan, Europe and America*. New York: William Morrow, 1992;

Korea must be an interesting case in that one-time staunch believer in multilateralism turned into an active pursuer of both bilateralism and regionalism. The United States also belongs to this category of converters. US turned to regionalist approach with a free trade agreement (FTA) with Israel and Canada in the 1980s, and then with Mexico in the early 1990s because it attempted to accelerate multilateral negotiations, Uruguay Round (UR) of the General Agreement on Tariff and Trade (GATT). But Korea joined this category not for the sake of such multi-regional interplay, but for the fear of losing its shares in world markets by regionalist discrimination. Korea negotiated its first FTA with Chile, and has maintained the momentum of FTA negotiations by concluding FTAs with more trade partners. While Korea has been negotiating FTAs with major economic powers including Japan, United States, and European Union, China as a huge market will be the next frontier for Korea's FTA policy while it seems to be an even more difficult challenge.

Korea's FTA with Chile, the first of its kind, was concerned with Korea's policy toward Latin America, a region distant in geography and in focus of foreign policymaking. Korea-Latin America relations had experienced ups and downs throughout the second half of the 20<sup>th</sup> Century by the major factors of international political arrangement and local economic situations. Formerly, Korean investments in Latin America were "pulled" by the economic boom and regional integration in Latin America and "pushed" by high Korean production costs, the

market-seeking behavior, and the corporate strategy that emphasized globalization; but in late 1990s, particularly on the wake of the financial crisis few of those pull and push factors remained. All of this implied negative fallout for Korean-Latin American economic relations. While Korean-Latin American relations enjoyed a “honeymoon” period during the first half of the 1990s, they now met serious setbacks in the wake of the Asian financial crisis of 1997-98, also partly due to South American intra-regional trade (Kim 1999). The region’s economic integration as well as financial fluctuations and economic recession, principally triggered by the Argentine crisis of 2001, worked to reduce the interest of Korean businesses in the region, shrinking trade and investment relations. The Korea’s FTA with Chile presented a new path for these relations. The fact that Korea would have a free trade relationship with a South American country entailed institutionalization of the trade relations between Korea and Latin America, strengthening Korea’s presence in the region.

The Korea-Chile FTA also carried several important implications for Korea’s trade policy, international trade, and the politics of trade in Korea. First of all, the Korea-Chile FTA project implied a significant change in Korea’s traditional trade policy, which took a multilateral approach to world trade. Once Korea embarks on the bilateral scheme, the momentum has reached Korea’s major trade partners and encouraged further initiatives for a regionalist scheme. Second, interestingly enough, the Korea-Chile FTA subsequently played a milestone role for trans-Pacific commercial relations as it was the first FTA between an East Asian country and a Latin American country. While countries expanded their trade and investments across the

Pacific, and several regional and inter-regional schemes attempted to further institutionalize and facilitate those commercial relations, the Korea-Chile FTA led neighboring traders to follow suit in accelerating the launch of a trans-Pacific trade community. Lastly but not the least, it led to politicization of trade, and finally to the bold adventure into a new trade policy.

The purpose of this paper is to explore Korea's FTA experiences with Chile for the first three years, and implications for a Korea-China FTA. Particularly this paper will attempt to show what Korea-Chile FTA has brought to Korea's foreign economic policymakers, who once looked timid toward opening its doors. In doing this, this paper will first focus on the significance of Korea-Chile FTA, examine its general performance, and then analyze several major issues of Korea-Chile FTA at three years of age, and finally explore its implications for a Korea-China FTA.<sup>3</sup>

## SIGNIFICANCE OF KOREA-CHILE FTA

The Korean economy grew up fast for three decades, 1960s-1980s, fundamentally through export drive policies, starting with unskilled labor but ending up with skilled labor and high technology. As its manufacturing sector accounted for a major portion of exports, the Korean economy was the beneficiary from the multilateral trading system represented by GATT. That's why, until recently, Korea had been one of the

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<sup>3</sup> The Chilean perspective on the performance of the Korea-Chile FTA is beyond this paper's scope. Good sources for that purpose include *Informativo Chile-Corea*, monthly newsletter by Camara de Comercio Chileno Coreana.

few WTO member countries without any bilateral or regional FTAs, and adhered to multilateralism. There were several reasons for Korea to evade FTAs. First, a regional or bilateral approach was not attractive to Korea because its trade relations were quite diversified, encompassing practically all major regions of the world. By taking the bilateral route, Korea would have run the risk of discriminating against trade partners and ultimately distorting its trade structure. In the famous debate over the utility of bilateralism and regionalism for the ultimate goal of multilateralism—the building block vs. stumbling block debate—, Korea took the pessimistic position. Thus, Korea wished to strengthen the application of the Article XIV of GATT for exceptions to the most-favored nation principle. This position was reiterated at the first WTO Ministerial Conference in 1996, where Korea pointed out the negative effects of regionalism and demanded tighter regulations against its expansion. Second, the Korean agricultural sector was desperately resistant to liberalization, and bilateral or regional liberalization could provide additional ammunition to the political controversy already triggered by the process of multilateral liberalization in the wake of the end of the GATT UR negotiations. Thus, Korea largely depended on the multilateral approach. That is why the strong reluctance to join bilateralism was often interpreted as resistance to trade liberalization under the global boom of bilateral FTAs.

Such a traditional multilateral approach, however, lost steam in recent years due to the mushrooming of regional trade arrangements (RTAs) worldwide. According to the WTO, the number of reported regional trade agreements, including all kinds of preferential trading blocs such as FTAs, customs unions

and economic unions, reached 250 as of March 2002. Half of these were reported after the launch of the WTO. This was a trend contrary to the conventional understanding that countries anxiously formed RTAs as an insurance policy to the possible failure of the UR negotiations. Furthermore, the United States, the once-staunch defender of multilateralism, has continued to proceed with its regionalist strategy by embarking on negotiations for the Free Trade Area of the Americas (FTAA) since December 1994. While the U.S.-Israel FTA, the Canada-U.S. FTA and the North American Free Trade Agreement (NAFTA) could be seen as examples of the U.S. regional-multilateral interplay strategy to push forward with the UR multilateral negotiations, the FTAA went beyond such a scheme. At the same time, an increasing number of leading scholars began to promote RTAs as building blocks to multilateralism alongside international organizations such as WTO and the Organization of Economic Cooperation and Development (OECD). Korea, as outsider of this trend, became one of the nations most affected by trade diversion against non-RTA members. For countries excluded from such agreements, the practical way to ease the resulting damage to their national businesses and trade interests is to join the regionalist trend. Given that the future of the Korean economy would be critically dependent on how effectively its trade sector adjusts to external challenges, the greatest significance of the Korea-Chile FTA may be that it marks a shift in Korea's trade policy.

It was the financial crisis of 1997-98, however, that ultimately caused the Korean government to change its direction. Before the Asian financial crisis originating from Thailand and Hong Kong ultimately hit the Korean financial market, there had



been discussions in the Korean government, particularly within the former Ministry of Trade, Industry and Energy (MOTIE) in the mid-1990s, about the feasibility of FTAs with major trading partners. After Minister Lim Chang Yeol's visit to Chile in October 1997, MOTIE launched a study group for FTA policy without much progress. The subsequent financial crisis of November 1997, the introduction of a new government in February 1998, and the reorganization of ministries led to the new function of trade negotiation being given to the newly reorganized Ministry of Foreign Affairs and Trade (MOFAT).

The Office of the Minister for Trade took the FTA option seriously, and on November 5, 1998, the Inter-ministerial Committee on International Economic Policy finally announced a new policy of pursuing FTA negotiations, choosing Chile as its first FTA partner. In 1998, the Korean economy saw -6.7 percent growth, the second time since 1970 that the Korean GDP fell, and the annual unemployment rate reached 6.8 percent, the highest level since 1967. The Korean government actively and decisively restructured the financial sector and the corporate sector in 1998 according to the conditionality of the International Monetary Fund (IMF). What the Korean government needed most at the time was to influence foreign credit ratings through economic reform and an open-door policy. FTAs were considered to ultimately provide a better business environment for foreign direct investments and facilitate export promotion. In particular, once FTAs came to be widely seen as a channel for an open-trade policy, Korea needed to demonstrate its resolve to build an "open trading country" by opting for FTAs. While almost every trading nation in the world was involved in FTAs, non-participation in the trend might have appeared

representative of a passive position toward trade liberalization, doing nothing to mitigate the effects of trade diversion. Such FTA policy would reinforce Korea's ongoing trade liberalization programs, begun as early as the 1980s to eliminate trade barriers, mainly in the manufacturing sector, through unilateral measures, bilateral negotiations, UR negotiations and OECD accession negotiations. The liberalization programs were later accelerated by the IMF program, which emphasized eliminating trade-related subsidies, restrictive import licensing and the import diversification program, as well as improving the transparency of import certification procedures.

In theory, the closer the FTA partners are geographically located and the larger their trade volumes are, the greater the benefits can be from forming an FTA between them. For Korea, the most favorable partners in this sense should be Japan and China. They would be highly strategic trade partners in any sense. Not only are China and Japan important and dynamic trade partners, but, if they joined forces with Korea to form a free trade region, their international negotiating leverage would be dramatically enhanced. Moreover, such a regional arrangement could ultimately expand to encompass the Association of Southeast Asian Nations (ASEAN), establishing a vast "ASEAN+3" free trade area. In the beginning, however, the three countries were independently involved in their own initial FTA efforts. Japan concluded an FTA with Singapore, Korea negotiated with Chile and China negotiated with ASEAN. All these efforts equipped the three countries with know-how, experience and an ultimate vision for regional cooperation. The slow, cautious approach to an ultimate three-way scheme taken by the three countries can also be explained by a historical

mistrust among them that would take time to be removed, even under the challenges of global competition, as well as by the uncertainty over the expected outcome for the respective economies.

When the Korean government decided on Chile as its first FTA partner, it took into account that in macroeconomic terms, Chile is the most stable country in the Southern Cone, and it was open to free trade with a major East Asian trade partner. The fact that Chile was linked to Brazil and Argentina through an FTA with the Southern Common Market (MERCOSUR) facilitated Korea to consider Chile as its strategic partner. In 1994, Chile joined APEC as the only South American country. Since then, Chile has energetically promoted its policy of serving as the bridge or gateway between the Asia-Pacific and South American regions. In this respect, Juan Salazar, the former head of Chile's international negotiation unit, emphasized the "Manifest Destiny" of Chile to reach across the Pacific and a deepening of Chilean political and cultural contacts with Asian nations.<sup>4</sup> But more than that, Chile's active FTA arrangements with multiple countries threatened the Korea-made goods to be less competitive and let Korea's business community eager to have an FTA with Chile to secure its market.

Subsequently, on November 17, 1998, President of Korea Kim Dae-Jung and President of Chile Eduardo Frei met in Kuala Lumpur at the APEC Summit to agree to undertake discussions on negotiating a formal FTA. High-level working group meetings were held through June 1999 to exchange

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<sup>4</sup> Juan Salazar Sparks, *Chile y la Comunidad del Pacifico*, Santiago: Editorial Universitaria, 1999.

information on respective economic institutions and trade policies, and to set up the technical arrangements for negotiation. In September 1999, the two presidents met again in Auckland at the APEC Summit to agree to officially embark on negotiations. Four rounds of negotiations were held, alternating between Santiago and Seoul, December 1999 through December 2000, without much progress in finding mutual concessions, followed by a 20-month deadlock in negotiations before the fifth round in Santiago in August 2002. The final (sixth) round was held in Geneva in October 2002. After highly politicized ratification negotiation in Korea, the treaty finally went into effect as of April 1, 2004.

#### PERFORMANCE OF KOREA-CHILE FTA

Although there were a lot of conflicting views over Korea-Chile FTA, which had taken four years and three months from beginning of negotiating to coming into effect, it sounds safe to say that the optimistic outlook on the FTA was correct. The Korea-Chile FTA has guaranteed a dynamically expanded presence of Korea in South America, and reciprocally Chile in Korea. The increase of exports with tariff reductions, increased investments, and Korean firms' participation in Chile's procurement market serve as major preliminary factors to pick up Korea's presence there.

The Korea-Chile FTA is a comprehensive FTA, including not only market access, but also investment, service, technology, sanitary inspection, procurement, intellectual property rights, etc. Under the schedule of concessions of the Korea-Chile FTA, the tariff-free rule would be applied by 2014

on 94.5% of the number of Korean items and 96.5% of Chilean items. Rice, fresh apple, and fresh pear were eliminated from the negotiations. Fresh grape was on the ten-year tariff reduction track but only for November through April, which would evade the shipment period of locally produced fresh grape. The Korea-Chile FTA's effects on Korean economy during the first three years are reviewed below.<sup>5</sup>

**Table 1. Korea's Trade with Chile**

Unit: US\$ million, %

	Exports (change)	Imports (change)	Balance
1997	655 ( 2.3)	1,162 ( 5.4)	-507
1998	567 (-13.5)	706 (-39.2)	-139
1999	455 (-19.7)	815 ( 15.4)	-360
2000	593 ( 30.2)	902 ( 10.6)	-309
2001	573 (-3.4)	696 (-22.8)	-124
2002	454 (-20.7)	754 ( 8.3)	-300
2003	517 ( 13.9)	1,058 ( 40.3)	-541
2004	708 ( 36.9)	1,934 ( 82.8)	-1,225
2005	1,151 ( 62.5)	2,279 ( 17.9)	-1,128
2006	1,566 ( 36.1)	3,813 ( 67.3)	-2,247

Source: KITA.

The trade between Korea and Chile is typically characterized by inter-industrial trade. Korea's exports have

<sup>5</sup> Even although the year 2004 statistics might be imperfect because the FTA became effective in April 1, 2004, the whole year (January through December) data are used here for convenience sake.

concentrated on secondary products such as vehicles and cellular phones, and its imports on primary products such as copper and agro-livestock products. With such framework, since the Korea-Chile FTA went into effect, Korean exports' upward trend has maintained. The Korean exports increased by 36.9% in 2004, by 62.5% in 2005, and by 36.1% in 2006 as contrasted to the decrease by -20.7% in 2002, and the smaller increase rate of 13.9% in 2003. Consequently, the export volume of US\$517 million before the FTA reached US\$1,566 million in 2006. Particularly, the export's upward tendencies of vehicles, cellular phones and TV sets whose tariff were eliminated immediately with the treaty going into effect were remarkable. Meanwhile, the exports of steel and diesel have not increased conspicuously until three years after the treaty became effective.

In 2006, Korea's major exporting items were petrochemical products of US\$494,124 thousand (31.6%), vehicles of US\$481,892 thousand (30.8%), plastics of US\$ 137,666 thousand (8.8%) and cellular phones of US\$ 99,309 thousand (6.3%), etc. Korea's major importing items were copper products of US\$1,620,847 thousand (42.5%), copper mine of US\$1,369,192 thousand (35.9%), petrochemicals of US\$195,120 thousand (5.1%), paper materials of US\$129,184 thousand (3.4%) and flesh and meat of US\$83,985 thousand (2.2%), other metallic minerals of US\$82,182 thousand (2.2%), etc. As copper and its products occupy 78.4% of Chile's exports to Korea, Korea's trade deficit with Chile is largely determined by the imports of these traditional exporting items of Chile.

**Table 2. Korea-Chile Major Trading Items in 2006**

Unit: US\$ thousand, %

<b>Exports</b>			<b>Imports</b>		
Items	Amount	Rate	Items	Amount	Rate
Petrochemical product	494,124	31.6	Copper goods	1,620,847	42.5
Vehicle	481,892	30.8	Copper mine	1,369,192	35.9
Plastic	137,666	8.8	Other petrochemicals	195,120	5.1
Cellular	99,309	6.3	Paper material	129,184	3.4
TVs	36,065	2.3	Flesh and meat	83,985	2.2
Steel	33,732	2.2	Other metallic mineral	82,182	2.2
Vehicle parts	31,314	2.0	Zinc ore	73,722	1.9
Construction mining machinery	30,007	1.9	Steel	46,603	1.2
Rubber goods	22,944	1.5	Grain	42,616	1.1
Steel Pipe	15,845	1.0	Processed marine products	40,332	1.1
<b>Total</b>	<b>1,566,131</b>	<b>100.0</b>	<b>Total</b>	<b>3,812,945</b>	<b>100.0</b>

Source: KITA.

**Table 3. Shares in Chile's Import Market by Countries**

Unit: US\$ million, %

	2003		2004		2005		2006			Annual change for 3 years
	amount	Share (A)	amount	share	amount	share	amount	Share (B)	Change (B-A)	
US	2,464	14.5	3,377	15.1	4,708	15.8	5,570	16.0	1.5	31.2
Argentina	3,621	21.3	4,143	18.5	4,804	16.1	4,505	13.0	-8.4	7.6
Brazil	2,009	11.8	2,778	12.4	3,772	12.7	4,237	12.2	0.4	28.2
China	1,245	7.3	1,847	8.3	2,539	8.5	3,487	10.0	2.7	41.0
<b>Korea</b>	<b>506</b>	<b>3.0</b>	<b>696</b>	<b>3.1</b>	<b>1,076</b>	<b>3.6</b>	<b>1,641</b>	<b>4.7</b>	<b>1.7</b>	<b>48.0</b>
Peru	430	2.5	694	3.1	1,107	3.7	1,427	4.1	1.6	49.1
Angola	64	0.4	431	1.9	1,197	4.0	1,317	3.8	3.4	173.3
Germany	691	4.1	826	3.7	1,178	4.0	1,244	3.6	-0.5	21.7
Japan	612	3.6	797	3.6	1,017	3.4	1,147	3.3	-0.3	23.3
Mexico	489	2.9	619	2.8	762	2.6	1,000	2.9	-0.0	26.9
The World	16,969	100.0	22,339	100.0	29,788	100.0	34,750	100.0		27.0

Source: KITA.

In Chile's imports market, Korean products' market shares have augmented. It increased by 3.0% in 2003, by 3.1% in 2004, 3.6% in 2005, and 4.7% in 2006. With this, Korean products' market share in Chile, the 8<sup>th</sup> in 2003, has become the 5<sup>th</sup> in 2006. Especially before the FTA, Germany and Japan had taken higher rankings than Korea, but Korea took upper ranking in 2006. During the three years after the FTA, Chile's annual imports from Korea increased by 48.0% compared with the overall import increase rate of 27%, and are bigger than those from Germany, Japan, Mexico, and Brazil, which were Korea's



rivals in the Chilean market. Especially, the market shares of Korea's steel, vehicles, cellular phones, and TV sets were increased outstandingly. All in all, Korean exports to Chile advanced evidently thanks to the Korea-Chile FTA.

On the other hand, Korean imports from Chile have ascended largely after the FTA. It increased by 40.3% in 2003, by 82.8% in 2004, by 17.9% in 2005, and by 67.5% in 2006. It increased dramatically after the treaty, but slowed in 2005, and sped up again in 2006. The overall imports were US\$1,058 million in 2003 and US\$3,813 million in 2006. Also Chilean products' market share in Korea has climbed. It was 0.59% in 2003, 0.86% in 2004, 0.87% in 2005, and jumped to 1.23% in 2006. In short, both countries' exports have benefited from the Korea-Chile FTA, but in terms of the trade balance Chile has benefited more.

**Table 4. Chilean Market Shares by Korea's Products**

Unit: US\$ million, %

	2003		2004		2005		2006			Annual change for 3 years
	amount	Share (A)	amount	share	amount	share	amount	Share (B)	Change (B-A)	
Automobile	107.5	16.1	179.6	19.8	280.8	23.3	366.5	26.2	10.1	50.5
Mobile phone	24.4	9.5	67.2	18.2	93.1	19.4	122.8	17.5	8.1	71.3
Color TV	7.3	7.3	13.2	9.5	20.8	11.0	35.9	12.4	5.1	70.3
Steel	7.8	10.2	11.7	10.1	13.9	14.9	37.0	23.0	12.9	68.0
Diesel	64.1	23.8	61.1	11.0	154.5	13.7	515.5	28.8	5.0	100.3
Polyester	57.7	8.2	71.7	7.6	139.7	11.7	170.8	13.0	4.8	43.5

Car parts	8.8	5.9	9.9	5.3	13.0	6.2	15.4	6.3	0.5	20.7
Tire	8.5	5.4	12.0	6.3	14.8	6.1	13.0	4.7	-0.7	15.1

Source: KITA.

Korea's trade deficit with Chile has widened from US\$541 million in 2003 to US\$2,247 million in 2006. Such widened trade deficit carried politically sensitive implications in Korea as the ratification of the Korea-Chile FTA was not an easy process due to protests particularly by the agricultural sectors. The agricultural imports always have been the main focus in these terms. For the first three years, the total agro-livestock imports increased by 183.8%, contributing partly to the widening of the trade deficit. Though agro-livestock products' occupancy is 3.88% out of overall import rate, the statistics have been often used as a reference to the damage of Korean agro-livestock industry. This was conspicuous particularly with grape and kiwi. Some analysts even predicted that the performance of Chilean grape and kiwi would ultimately work out apple, pear, and Korean orange by pressing down their local market demand and prices through the substitution effect of those imported agricultural goods and the long-term cultivation conversion behavior by local farmers.<sup>6</sup> This will be the focus of the next section.

Alternatively, the economic relations between Korea and Chile have been also facilitated and strengthened in the fields of investments and industrial cooperation over the first three years of the FTA. More Korean businesses seek investment

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<sup>6</sup> Sang-Ho Lee, "The Trend of the Agro-Livestock Trade and Prices since Korea-Chile FTA," *CEO Focus* No. 176, August 6, 2007.

opportunities in Chile. Korea has invested only US\$100 million in Chile while Chile has attracted the outstanding US\$60.3 billion foreign investments as of 2005. What is especially to watch further, however, is the opening of Chile's government procurement market in construction and infrastructures. In 2006, Korea's POSCO Construction earned the order of coal power plant project of US\$370 million.<sup>7</sup> Furthermore, the governments of the two countries founded the Korea-Chile Information Technology Cooperation Center in Santiago, Chile in 2004 which would promote joint research, exchange of human resources and technology, and bilateral trade in IT industry.<sup>8</sup> Additionally the industrial cooperation in the fields of mineral resources, energy, finance, and aviation has been undertaken for bear fruit in the medium term.

## THE CONTROVERSIAL TRADE DEFICIT

What pushed Korea's policymakers to the corner was the expanded trade deficit in its trade with Chile. If it were generally accepted that the Korea-Chile FTA simply resulted in the imports and trade deficit increase, the Korean government would hardly proceed with its ambitious FTA policies toward other trade partners. However, if the expanded trade deficit is examined in its causes and the Chilean products in its composition and competitiveness in the local market vis-à-vis

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<sup>7</sup> Won-Ho Kim, "Korea-Chile Industrial Cooperation," Paper presented to the International Conference on Korea-Chile FTA of Three Years, Seoul, COEX Conference Center, March 30, 2007.

<sup>8</sup> Jeong-Won Yoon, "Korea-Chile IT Cooperation," Paper presented to the International Conference on Korea-Chile FTA of Three Years, Seoul, COEX Conference Center, March 30, 2007.

their international rivals, the trade deficit can be understood as not so threatening Korea's local industries and long-term trade balances. This paper focuses on three factors in the increase of the trade deficits: the hike of international commodities prices, the trade diversion effect and the change of exchange rate.

Firstly, Korea's trade balance is the function of several items of imports from Chile as they are not diversified enough. In 2006, copper and its products from Chile occupied 78.4% of Korea's overall imports, amounting to US\$2,989 million. One should note that the international copper prices increased sharply in recent years. Copper cost almost US\$6,731 per a ton in 2006 as compared with the US\$3,677 per ton in 2005. With this, copper imports increased up to 95.7% in monetary terms in one year. This is the reason why Korea's imports from Chile showed sharp increase although copper import volume has not changed a lot.

Secondly, Chile enjoyed the diversion effect in Korea's copper market. Korea has imported copper annually about 1,400,000 tons, and the tariff on Chilean copper which was 1.0% before the FTA was eliminated after the FTA. Even though Indonesian and Australian copper's prices have increased irregularly, Korea's copper imports from the two countries have decreased because of the Chile's tariff advantage. Such diversion effect appeared most strikingly in Korea's wine market. Chilean wine has been one of the most popular and growing items among other Chilean products in Korea. Indeed, most Korean consumers became knowledgeable of the presence of Chilean products ironically due to the lengthy period of negotiations and parliamentary ratification process in Korea. Tariff on the Chilean

wine in 2005 was 15%, but in 2007 went down to 5.0%. Under the schedule of FTA concessions, no tariffs on Chilean wine will be imposed in 2009. Since the FTA became effective, Chilean wine's occupancy in the Korean market has been remarkably growing up to 16.9%, taking No.2 position after the French wine with 37.1% market share. The Chilean wine's occupancy in Korean market before FTA was only 6% as compared with 50.0% by the French wine. It is a remarkable surge item among Chilean products and also is the successful import diversion effect.

This also happened to grape and kiwi markets too. Korean tariffs on the Chilean kiwi will be reduced for 10 years from 45.0%, and in 2007 it was 28.9%. Thanks to the reduced tariffs, Chilean kiwi has enjoyed a remarkable growth in the Korean market in early years of the Korea-Chile FTA, taking No. 2 place in the Korean market after New Zealand's. In 2003 Chilean Kiwi's occupancy in Korean market was 12%, but in 2006 it reached 26.8%. On the other hand, American and New Zealander kiwi's market share has diminished.

Korean tariffs on the Chilean fresh grape will be gradually reduced for ten years from the original level of 45.0%. Tariff on this went down to 16.7% in 2007. This applies only during the non-producing season in Korea, or November through April. Particularly in 2006, Korea's imports of the Chilean grape have remarkably expanded due to its increased popularity among Korean consumers. The Chilean grape's occupancy in the Korean market before the FTA was 81% in 2003, and it increased to 88% in 2006. It is safe to say that even though such preferential tariff is applied only during the non-producing

season in Korea, the existence of preferential tariff and the strong presence of the Chilean grape contributed to the better recognition and consumption habit among Korean consumers regardless of the preferential season.

**Table 5. Imports of Chilean Agro-Livestock Products**

Unit: Ton, US\$ thousand

	2003		2004		2005		2006		Change in amount (%) 2006/2003
	volume	Amount (A)	volume	amount	volume	amount	volume	Amount (B)	
Total	43,242	52,355	41,938	81,507	59,677	125,179	67,688	148,557	183.8%
- kiwi	1,536	1,758	2,131	2,885	5,932	7,996	8,595	12,255	597.1%
- grape	9,138	13,656	8,317	13,133	11,173	19,158	15,221	27,835	103.8%
- pork	15,385	30,237	23,257	54,725	32,425	80,627	32,428	83,557	176.3%

Source: Korean Ministry of Agriculture and Forestry.

Korean tariffs on the Chilean pork meat will be gradually reduced from 25% for ten years under the reduction schedule, and in 2007 tariffs on this was by 16.7%. The Chilean pork meat has enjoyed the growing popularity in the Korean market. Chile's supplies of pork meat actually did not meet the Korean market demand due to its limited pork meat production capacity and some sanitary problems in processing facilities in Chile. When the Korea-US FTA will come into force in the near future, Chilean pork meat producers will certainly face a steep competition from the American pork meat producers in the Korean market.

Thirdly, the change of exchange rate cannot be neglected in the change of trade balance. Korean currency *won* appreciated by 4% in 2004, by 10.5% in 2005, and by 2.2% in 2006 against the US dollar, and this determined the relative cheaper prices of Chilean agro-livestock products. Considering the annual tariff reduction rate was only 3%, import prices of Chilean agro-livestock were more influenced by exchange rate change than by tariffs change. Also, in the case of pork whose amount of import has increased, it is noteworthy that imports of pork from other countries than Chile have also increased while Korea's local pork price has kept expensive.

It will be fair enough to mention here Korea's trade adjustment regime and its actual practices applied to the cases of the Korea-Chile FTA. During the internal political process for the ratification of the Korea-Chile FTA in 2002-2004, the compensation for any possible impact on the domestic farming was the key issue. As a result, the Korean government enacted the Special Law to Support Farmers and Fishermen after Free Trade Agreements in March 2004. This Law would create the fund of 1,200 billion won (about US\$1,200 million) through 2010 and compensate damages to grape, kiwi and peach farm households and help increase their competitiveness. It was composed of Damage Compensation and Closure Subsidies. Actually the Damage Compensation was hardly claimed, and the Closure Subsidies were invoked ironically by the farmers of peach, which had not been imported due to sanitary regulation (See Table 6). As the result of such unilateral closures before the real competition, the peach cultivation area reduced from 15,558 ha in 2004 to 13,440 ha in 2006.

**Table 6. Closure Subsidies by Items**

(Unit: ha)

	2004	2005	2006
Facility grape	69	105	146
Peach	490	1,202	1,517
Kiwi	14	32	36

Source: Korean Ministry of Agriculture and Forestry.

**Table 7. Domestic Grape and Kiwi Production**

	2002	2003	2004	2005	2006
Fresh grape area (thousand ha)	26.0	24.8	22.9	22.1	19.2
Facility grape area (thousand ha)	-	1,412	1,516	1,720	1,699
Total grape production (thousand ton)	422	376	368	381	330
Kiwi area (ha)	-	873	997	970	998
Kiwi production (thousand ton)	12.7	11.0	12.8	14.8	15.3

Source: National Agricultural Products Quality Management Service.



Paradoxically, however, the domestic facility grape area and production, and kiwi production rather have increased although the fresh grape production has decreased before the steeper competition (See Table 7). All this took place despite the fact that the price differences between Korean grape and kiwi and their Chilean counterparts were enlarged (See Table 8). The Korean grape was 3.27 times more expensive in 2007 than the Chilean grape while it was only 37% more expensive in 2002. In the case of kiwi, the change was from 2.12 times to 2.84 times. This means that local consumers' demands for locally produced fruits were not influenced so much by their price difference from the imported ones, and rather have expanded and many of them still prefer local flavor.

**Table 8. Comparison of Korean and Chilean Grape and Kiwi Prices**

(Unit: won/kg)

	2002	2003	2004	2005	2006	2007*
Korean grape (A)	2,685	3,400	4,132	3,464	3,732	6,100
Chilean grape (B)	1,963	1,782	1,800	1,754	1,742	1,864
A/B	1.37	1.91	2.30	1.97	2.14	3.27
Korean kiwi (C)	2,972	3,390	3,606	4,434	3,769	4,104
Chilean kiwi (D)	1,404	1,365	1,543	1,379	1,358	1,444
C/D	2.12	2.48	2.34	3.21	2.78	2.84

\*As of June 2007.

Source: Korea Agro-Fisheries Trade Corporation.

## **CONCLUSION: IMPLICATIONS FOR A KOREA-CHINA FTA**

The Korea-Chile FTA has special significance for Korea's trade policy approach. Its multiple trade strategy is differentiated from its traditional, multilateral approach and represents attempts to free itself from marginalization in view of the global regionalist trend. At the same time, as an FTA with a South American country, it brought about Korea's renewed focus on South American markets in particular, and Latin America in general. As the first FTA between an East Asian country and a Western Hemisphere country, it has contributed to intensifying interregional cooperation and interdependency between East Asia and Latin America. The following interregional FTAs included the Taiwan-Panama FTA and the Japan-Mexico Economic Partnership Agreement in 2004, the Singapore-Chile-Brunei-New Zealand Strategic Trade Partnership Agreement and the Singapore-Panama FTA in 2005, and the China-Chile FTA and the Japan-Chile FTA in 2006. In particular, as the FTA is between Korea and Chile with highest trade interest in the respective regions regarding the other, it will also test the dynamics of inter-regional trade and investment.<sup>9</sup>

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<sup>9</sup> Korea's exports to Latin America accounts for more than 6% of its total exports in recent years, which is the highest in Asia while Chile's exports to Asia for more than 35%, the highest in Latin America.

The Korea-Chile FTA contributed to the expansion of bilateral trade and advance of Korean products' competitiveness in the Chilean market. Especially in 2006, Korea has become Chile's 5<sup>th</sup> largest trading partner, both in exports and imports. The Korea's trade deficit with Chile came from Korea's imports of Chile's traditional exporting items, copper and its products which occupy 78.4% of total Chile's exports to Korea while imports in monetary terms increased by 88% in 2006. The increased imports of grape and other fruits whose tariff will be eliminated in 2014, were explained by both tariff reduction and the exchange rate change while understood as having not affected local producers as anticipated earlier. Besides, the increased imports in consumer products like pork and wine rather have contributed to Korean consumers' welfare. It will be interesting enough, however, the recently concluded China-Chile and Japan-Chile FTAs may affect Korea's exports to Chile which have increased faster than China's and Japan's during the past years.<sup>10</sup>

Nevertheless, the Korea-Chile FTA importantly brought confidence among Korea's FTA policymakers. The cases of peach, grape and kiwi production performance for the first three years of the Korea-Chile FTA implied that there was no real damage to the Korean farm households. It rather worked to expand local demand for those items. If there was any increase of imports, it was to be interpreted as demand creation and trade

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<sup>10</sup> The China-Chile FTA went into effect in July 2006. Although it is beyond the coverage of this paper, its impact on the performance of the Korea-Chile FTA must be significant. Korea and China have some items competing with each other in Chilean market, and the concessions and tariff reduction schedules they concluded with Chile are different.

creation. It might be too complacent attitude to anticipate the real long-term effect of the full tariff elimination,<sup>11</sup> but such evaluation overwhelmed the policymakers' understanding of the circumstances.

This observation on the part of Korean policymakers was significant for Korea's FTA policy toward China. Their bottom was that an FTA is an economic treaty but that it should be regarded as a highly comprehensive instrument binding many aspects of nations to lay ground to securing overseas markets and strengthening Korean industries' international competitiveness. Once Korea launched its first FTA with Chile, Korea has actively initiated more FTAs with major trading partners in the world. Korea concluded FTAs with Singapore, the European Free Trade Association (EFTA), ASEAN, and US. At this writing, FTA negotiations with Japan, Canada, India, the European Union (EU), and Mexico are yet to be completed. The FTA with the US is on the parliamentary agenda for ratification in both countries. For now, only China has been out of the straightforward negotiation tables as Korea's major trade partner.

Now what implications does the experience of the Korea-Chile FTA have for Korea's future FTA negotiations with China? As it is the only FTA with several years of implementation on the part of Korea, one should rely on it to draw any implications for a future FTA including one with China. China became Korea's largest export destination as of 2003, and its largest trade partner as of 2004. Korea is one of the

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<sup>11</sup> In 2007 and 2008, the kinds of Chilean grape imported to Korea were further diversified, and their market penetration has been more consolidated.

major three foreign investors in China. Since early 1990s, when Korea established diplomatic relations with China, about 30,000 Korean companies have relocated their facilities into China due to rising labor costs and weakening competitiveness at home (*Korea Insight* 2007). These days, however, that picture faces a certain change as the number of Korean companies closing their business in China is growing rapidly due to soaring costs stemming not only from inflationary pressure but from several local factors such as the new labor contract law and decreasing tax benefits for foreign business and most significantly the appreciation of the Chinese *yuan*.

The first three Korea-China FTA Joint Study meeting were held in Beijing, Seoul and then Weihai through 2007. The fourth was scheduled for early 2008. This would cover government procurement, international property rights, and SPS/TBT while more controversial agricultural and fishery issues pending. With several assessments available on the impact of a Korea-China FTA on exports, imports, investments, government procurements, small and medium-sized enterprises, etc., sanitary standards and other regulations would be major issues among others. As Korea's FTA with Chile entailed more than two years' social disturbance of resistance particularly among agricultural sectors, and also Korea's FTA with US did the same, Korea's FTA with China undoubtedly will bring about another round of hot national debate and conflict in Korea.

The assessment of the impact of a Korea-China FTA available is quite similar to that of the Korea-Chile FTA before its launch in 2004. It is fundamentally negative particularly in terms of its impact on the agricultural trade as shown in Table 9.

As far as the Korean civil society is concerned, its major concerns when it comes to an FTA with China are the possible influx of cheap Chinese manufactured goods and hygiene-wise unsecured agricultural products to affect Korea's industrial bases and public hygiene. It would severely devastate Korean small and medium-sized firms and agricultural and fisheries sectors. More technological innovation and productivity gains as the long-term benefits from an FTA would be gained by China rather by Korea.<sup>12</sup> According to FKI's Survey,<sup>13</sup> 71.3% out of the respondents' support an FTA with China with expectations for more export opportunities and Chinese local market share expansion through customs process acceleration and tariff reduction and relieved unilateral protectionist measures. Some 52.9 percent out of the opposing respondents worried about loss of their domestic market shares and weakening of local industrial bases.<sup>14</sup>

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<sup>12</sup> Ho-Chul Lee, "Background and Prospects of Korea-China FTA," *Situation and Policy* (Sejong Institute), pp. 13-15, May 2007.

<sup>13</sup> Federation of Korean Industries, "Survey of Entrepreneurs' Views on Korea-China FTA," Issue paper, November 2006.

<sup>14</sup> A comprehensive assessment of a Korea-China FTA is available in KIEP (2007). This paper does not cover the Chinese perspective on the Korea-China FTA. Some other papers would be helpful for that purpose among others: Jianping Zhang, *Analysis on the Issues of and Prospects for a China-Korea FTA*. Korea Institute for International Economic Policy, 2006; Won-Ki Choi, "China's FTA Policy and the Prospects of Korea-China FTA," Paper presented to Korea Institute for Future Strategy, Oct. 24, 2006; Korea Trade and Investment Promotion Agency, "Chinese Firms' Views on a Korea-China FTA and Its Prospects," *Global Business Report* 07-015, 2007; and Shen Jia, "An Analysis of China's FTA Policy Background and Strategy," *LG Weekly Economy*, May 16, 2007, pp. 26-31.

**Table 9. Assessment of the Impact of a Korea-China FTA**

	Before FTA (as of 2004)	After FTA	
		Amount	Change
GDP	778,400 billion won	796,300 billion won	+17,900 billion won (2.3%)
Per capita GDP	US\$14,162	US\$14,488	+ US\$326
Trade balance in manufacturing	US\$22.3 billion	US\$24.9 billion	+US\$2.6 billion (11.7%)
Trade balance in agriculture, forestry and fisheries	- US\$2.1 billion	-US\$12.3 billion	-US\$10.2 billion (486%)

Sources: KIEP (2004).

But the wisdom acquired from the Korea-Chile FTA implementation suggests that the real outcome may vary according to the local consumers' preference, Korean government's sanitary control, and exchange rate fluctuation. It would not only affect Korea's trade balance with China, but also change Korea's importation structure while Chinese goods substitute more imports from other sources. This will be particularly true with fresh vegetables, fruits and fishes because China's geographic proximity should shorten their storing period and strengthen competitiveness of its products vis-à-vis those coming from other countries as well as local products. Trade diversion as well as creation effects would occur at the same time as it did with the case of the Korea-Chile FTA. The rising inflationary pressure worldwide and particularly in China, and the appreciation of the *yuan* would possibly decelerate the

possible influx of the otherwise farther cheaper Chinese goods. The sanitary control reflecting the local consumers' concerns to be imposed on the Chinese products would further affect their competitiveness and chances to get more access.

Above all, however, such a neighbor-to-neighbor FTA should promise more positive effect while deepening the sub-regional division of labor already underway, and enhancing Korea-China economic relations in the time of regional cooperation for a broader scope beyond economic realms. This will be particularly true when the Korea-China FTA may accelerate the process of the deadlocked Korea-Japan FTA negotiations and further the possibility of a Korea-China-Japan FTA shaping out as the largest trading area of the world.

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