Australia - Republic of Korea Free Trade Agreement Feasibility Study

Executive Summary

Supporting an important bilateral trade and investment relationship

A free trade agreement between Australia and the Republic of Korea offers significant opportunities to further strengthen our highly complementary and growing bilateral trade and investment relationship, and deliver gains to both countries through closer economic integration.

A complementary relationship

Australia and the Republic of Korea (ROK) are medium-sized economies and stable democracies. Both have demonstrated periods of strong growth, underpinned by structural reforms and sound macroeconomic management: over the long term for Australia; and, for the ROK, following the 1997-98 Asian financial currency crisis.

Australia maintains a transparent trade policy regime, with relatively low tariffs, an open services sector and a liberalised foreign investment regime. The ROK has embarked on significant trade liberalisation since the 1980s, reducing average tariff rates substantially, and significantly liberalising the services and investment sectors, though tariffs in some sectors, particularly agriculture, remain high and restrictions apply across a range of service industries and on investment.

Two-way trade between Australia and the ROK was valued at over A $21 billion in 2006. The ROK is Australia's sixth largest trading partner by value, taking 7 per cent of all exports at a total value of nearly A$14 billion in 2006. Australia's energy and raw materials have underpinned ROK industrialisation. Our major merchandise exports to the ROK, by value, are coal, crude petroleum, iron ore and beef (2006). Education and tourism services have been particularly successful. Australia is the ROK's 14th largest export market, with ROK exports to Australia reaching US$4.7 billion in 2006. Major exports by value in 2006 were automobiles, electronic devices, mineral fuels, boilers and machinery and ships and steel. Services exports are dominated by transportation services.

Despite the dominance of primary commodities in the bilateral relationship, trade is also important across a range of industries, including automotive products, biotechnology, building and construction, dairy products, defence materiel, fruit and vegetables, information and communications technology, seafood, textiles and clothing and wine.

Bilateral investment flows are becoming increasingly important. Although relatively small compared to most of Australia's major trade partners (valued at A$6.9 billion in 2006), Australia's investment in the ROK is twice the size of that in China, and the ROK is the 12th largest destination for Australian investment abroad. Australia is the ROK's sixth largest recipient of FDI abroad, with total accumulated stock of investment as at end of 2006, valued at US$3.1 billion. The ROK has made substantial investments in Australia, particularly in the natural resources sector.

A growing relationship

The Australia-ROK trade relationship continues to grow and has done so significantly since the mid-1990s. There has been continued growth in the value of Australia's exports of both goods and services to the ROK - of more than 100 per cent since 1999, and 13 per cent between 2005 and 2006, surpassing that experienced in traditional Australian markets such as the US, Japan and New Zealand. ROK exports to Australia have also increased in recent years. ROK merchandise exports to Australia in 2006 showed an increase of more than 23 per cent over the previous year. Since 1999 they have increased by over 93 per cent.

Bilateral investment is also growing. Between 2001 and 2006, Australia's stock of investment in the ROK grew at an average of over three times the rate at which total Australian investment abroad grew over the same period. Investment has been concentrated in technology-intensive sectors, infrastructure and utilities, financial services, and education and training. The flow of direct investment from the ROK to Australia was US$51 million in 1996, reaching US$142 million in 2006. Australian energy and mineral resources, wholesale and retail, and manufacturing industries have been particularly important target sectors for ROK investment.

Advancing liberalisation of bilateral trade and investment

While the bilateral trade and investment relationship is significant and is expected to grow, barriers remain in some areas. A free trade agreement (FTA) which reduced or removed those barriers provides an opportunity to increase bilateral trade and investment flows. A liberalised trade and investment environment would also offer potential growth opportunities for mutually beneficial bilateral commercial relationships.

Modelling results reveal that bilateral liberalisation under an FTA would increase trade and investment flows between the two countries.Various simulation models show that there exist positive gains from an FTA between Australia and the ROK. Bilateral trade and investment liberalisation would also increase the total volume of both Australia and the ROK's trade with the Rest of the World.

Reducing regulatory discrimination in services

Services are becoming increasingly important in the bilateral relationship as their extent and importance expands rapidly in both economies. This is true even in the manufacturing sector, where the effects of services on value-added and job creation have become more significant and as trade in both goods and services are linked through global supply chains. Reduction or removal of regulatory barriers which restrict services will support improved trade flows across goods and services of interest to both economies.

Australian service exporters could benefit from greater liberalisation of and access to, the ROK services market through the removal of specific barriers, while ROK consumers could benefit from better access to more sophisticated and competitive services. This would result in benefits for both economies. An FTA with Australia could also help the ROK services sector become more flexible and innovative, to meet the growing challenge from China and India, amongst others. Although deregulation and reform of ROK service industries has continued since the Asian currency crisis, foreign business continues to face restrictive regulations in some service areas, such as financial services, legal and accounting. Econometric modelling estimates that liberalising trade in services under a comprehensive FTA would increase the present value of the stream of deviations from baseline in Australia's real GDP by US$9.8 billion and ROK real GDP by US$14.1 billion over the period 2007 to 2020.

Encouraging investment

There is significant potential for liberalisation of investment to enhance bilateral investment flows, in particular, greater ROK investment in Australia, including in the resources sector, which would enhance ROK's energy and resource security.
An FTA also provides a means to strengthen institutional arrangements in each country and provide a strong base for building flexible commercial relationships supportive of further investment. Greater investment opportunities could be expected to flow through to growth areas such as financial services, IT, automotive and leisure. Econometric analysis estimates that investment facilitation under a comprehensive FTA could add US$5.2 billion to Australia's GDP and US$6.3 billion to Korea's GDP by 2020.

Improving market access for goods

ROK exporters could be expected to gain from reductions in Australia's tariff on textiles and garments, as well as automobiles and automotive parts where ROK exports are globally competitive. The ROK could also be expected to gain from reducing its own levels of tariff protection against imports from Australia that serve as important inputs for local production. This also offers obvious benefits for ROK consumers. Likewise, reductions in Australia's tariffs would not only aid ROK exporters, but also benefit Australian consumers in terms of greater variety and lower prices.

For Australia obvious gains would arise from reductions in ROK agricultural trade barriers, where Australia is a globally competitive exporter. The Australian agricultural sector would benefit from improved market access to the ROK market in meat, dairy, grains, and sugar. Gains could also be expected to arise from tariff reductions in areas where ROK tariffs are more modest, but the bilateral trade is growing and important, such as medicines, chemicals and wine.

The removal or reduction of the non-tariff barriers affecting bilateral trade in goods could offer significant gains for parties, in particular reduced transactions costs and efficiency improvements. Gains would arise from improving the transparency and administration of regulatory procedures affecting trade in goods, such as improved transparency in quarantine and anti-dumping procedures or better coordination and harmonisation of labelling requirements and inspection standards. Greater transparency and improved administration of the tariff quotas could also be important commercially.

Addressing many of these barriers often requires more than simply removing trade barriers and implies some form of regulatory reform in each country or harmonisation of regulations between them. FTAs can assist this process to some extent by setting up regulatory frameworks in which these issues can be addressed or progressed over the longer term.

Delivering economic benefits

Bilateral liberalisation of trade and investment between Australia and the ROK has generally positive economic welfare and efficiency effects for both economies.

Modelling results support the conclusion that a bilateral FTA which is comprehensive in scope and coverage has the potential to deliver welfare gains for both countries. These gains are likely to be well underestimated. Quantitative gains from reducing barriers to trade and investment that are estimated by econometric modelling techniques do not generally capture the full extent of all the efficiency gains that are derived from liberalisation. For example, they cannot fully account for the consumer benefits from the increased choice of goods and services that flow from a reduction in trade and investment barriers. These gains are generally expected to be much larger.

Enhancing economic welfare

Modelling results reveal that comprehensive bilateral liberalisation of trade and investment would generate increased output and trade, and will be welfare enhancing for both Australia and the ROK.

Real GDP increases in both countries could be expected due to increased capital accumulation, improved productivity and a better utilisation of resources. A key factor underlying real GNP increases is improved terms of trade. Liberalisation will enhance the economic partnership between Australia and the ROK by increasing bilateral trade and investment flows between them. On balance, it is also trade creating for the world as a whole, with the volume of world imports increasing from its baseline level as a result of bilateral liberalisation between the two countries.

Deriving efficiency gains

Liberalisation delivered through an FTA can improve the allocative efficiency of the economy by allowing for increased specialisation. Both Australia and the ROK are expected to gain from trade liberalisation as resources are reallocated to those sectors in which each country has a comparative advantage. As a result some industries will contract, while others will expand.

At the sectoral level, the Australian industries which contribute most to increases in Australian output are meat, dairy products, sugar and non-ferrous metals. For ROK the manufacturing industries contributing most to the overall expansion in production include in particular, textiles, metal products, machinery, and motor vehicles and parts industries. The services sectors in both countries will both gain from liberalisation.

Typically the static allocative efficiency gains arising from tariff reductions, particularly in a low tariff environment, are relatively modest compared to the gains that flow from reducing non-tariff barriers including those in services and investment. These are generally much more damaging to economic efficiency than tariffs. Consumer benefits from the increased choice that can flow from a reduction in such barriers can be large, particularly as they can prevent products from even entering the domestic market.

Improving productivity growth

Liberalisation of bilateral trade and investment under an FTA can contribute to faster productivity growth resulting from lower barriers to trade and investment which facilitate access to technologies that are not available from the domestic market and which increase competition in the domestic market.

Dynamic gains in efficiency are achieved as successful innovation generates increased investment in the domestic economy which in turn attracts further foreign technological developments and know how. The gains are more difficult to quantify than the gains in static allocative efficiency but they are generally considered to be potentially much larger.

Theoretically an FTA could operate to increase the competitive pressure on the ROK services sector. Development of the service industry in the ROK has been relatively slow with labour productivity in most industries lagging well behind that in developed countries, including Australia. Greater competition from Australian service providers could serve to assist the ROK develop a more advanced service industry; increase competitiveness of manufacturing and other industries and result in higher productivity and efficiency in the whole economy, with resulting gains in welfare and growth. Australian companies operating in Korea would gain from improved functioning and efficiency of the services sector overall.

Creating trade consistent with multilateral liberalisation

Addressing competitive disadvantages

Recent years have seen a dramatic rise in the negotiation of bilateral FTAs and proposed regional initiatives in the Asia-Pacific region, many involving Australia and the ROK and their major trading partners. At the same time, negotiations for liberalisation at the multilateral level through the WTO Doha Round have increasingly stalled. Both Australia and the ROK have sought deeper and wider economic integration with countries in the Asia-Pacific region through the negotiations of FTAs, pursued simultaneously with the WTO Doha Round.

While FTAs with third parties have opened further trade liberalisation opportunities, the extension of preferential treatment to enterprises in third countries has introduced discrimination against Australian and ROK enterprises in one another's market vis-à-vis their competitors from those countries. Preferential access to the ROK market that would be granted to US producers under the KORUS for example, has the potential to adversely impact on trade in agricultural products between Australia and the ROK. Similarly, competitive disadvantages suffered by ROK exporters of manufactures as a result of preferential treatment accorded to third parties under Australia's FTAs, have adversely impacted on bilateral trade.

A strong case can be made for an Australia–ROK FTA which grants at least equivalent terms of market access, or treatment, to either party in each country to that granted to third countries in other FTAs.

Trade creating, not diverting

Bilateral liberalisation of trade carries a significant risk of diverting trade from third parties and replacing them with imports from the other party to the liberalisation. If the third party countries are lower cost suppliers, then the trade diversion would be welfare-reducing. At the same time, however, bilateral liberalisation will create new trade between the two parties. The key question is, therefore, whether the gains from trade creation outweigh the losses from trade diversion; the answer depends upon the circumstances of each case.

For this reason, recent developments in trade policy underline the need for bilateral trade agreements to create more trade than they divert. The analyses undertaken for this report indicate that, provided the bilateral trade barriers between Australia and the ROK are reduced comprehensively, there will be significant net trade creation. Moreover, they conclude that any trade diversion from such a liberalisation would be minimal.

These results reflect the fact that comprehensive liberalisation heavily favours trade by each country in its areas of comparative advantage. Liberalisation that lowers trade barriers in the ROK in areas where Australia is globally competitive — particularly agriculture and minerals – and lowers them in Australia where the ROK is globally competitive — namely electronics and automobiles — would achieve this end.

FTAs which complement and reinforce the multilateral trading system and which support the elimination of tariffs and non-tariff barriers on imports from all countries, are the simplest and most desirable way to remove the scope for trade diversion arising from FTAs with and among third parties. This consideration underscores the importance of each FTA partner achieving the comprehensive elimination of all its tariffs if it is to derive maximum economic gains from FTAs.

Driving deeper economic integration

A bilateral FTA also offers significant opportunities to strengthen and build on the bilateral relationship to reap mutually beneficial outcomes through closer economic integration, especially in the areas of IT, automotive, communication, education, tourism and financial services.

There is scope for benefits to be derived from cooperation in areas traditionally considered to be 'beyond the border' which are related to trade in services. This includes addressing matters such as mobility of business personnel and recognition of regulatory standards. Consultations with industry suggest there is scope for benefit from an FTA in all these areas in the financial services industry in particular.

The ROK is a key economy in the North Asian region critical to the success of some Australian industries in accessing global supply chains. Strategic alliances between Australian and ROK industry groups could be further strengthened through can FTA so as to maximise the opportunities for global integration.

Greater levels of FDI can also drive further benefits arising from stronger commercial relationships. An FTA can provide a platform for Australian and ROK firms to build stronger, mutually beneficial partnerships, such as those for the development and application of technology across industries. Both ROK and Australian industries will benefit from a synergy effect created by competitive ventures involving cutting-edge technologies. ROK firms are increasingly seeking strategic technological alliances with Australian companies for the development its automotive technological capacity.