

Promotion Strategy and Economic Effect of an Inter-Korean CEPA

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I. Introduction

This study examines the necessity and possibility of an inter-Korean FTA in order to expand inter-Korean economic cooperation and economic integration between the two Koreas. In the meantime, inter-Korean economic cooperation has been free of tariffs (zero tariffs) since 1992 in accordance with the principle of “domestic transaction,” and has been tolerated by the international community. However, as the scale of inter-Korean economic cooperation increases and economic integration is discussed in a fuller context, it is expected to become inevitable for the international community to raise the issue of trade practices. Also in the long run, if North Korea joins the WTO, there is the possibility of a complaint being lodged against South Korea, a member of the WTO, by WTO member countries. In this paper, we propose a Closer Economic Partnership Arrangement (CEPA) as a new development model of inter-Korean economic cooperation that will secure international legal legitimacy and contribute to economic change in North Korea. First, it reviews the necessity and possibility of conclusion of a CEPA for the two Koreas. Then it provides the key con-

tents that should be included in the CEPA and seeks a conclusion strategy. Finally, the economic effect of the inter-Korean CEPA will be analyzed.

II. The Necessity of an Inter-Korean CEPA

Currently, inter-Korean economic cooperation does not constitute international trade, but is treated as a “domestic transaction” in principle. In addition, since North Korea is a non-WTO member, various trade rules which are applied to trade between member countries are not applicable. In particular, there is the risk of violating the MFN, which is one of the basic obligations of South Korea as a member of the WTO under the GATT/WTO Agreement. In addition to the tariff-free system, some of the preferential measures provided by the inter-Korean economic cooperation policy could also be objected to as a violation of the WTO agreement on Subsidies and Countervailing Measures. In the agreement, a subsidy is deemed to exist if “government revenue that is otherwise due is foregone or not collected (e.g.

fiscal incentives such as tax credits.”¹ This means other WTO member countries can object to commodity transactions taking place with the DPRK without paying customs duties as a violation of the subsidy agreement. Even if the goods produced in the Kaesong Industrial Complex are exported to a third country, partners may file a complaint regarding the financial support measures in South Korea as “export subsidies.” Until now, the scale of inter-Korean economic cooperation has been so small that no WTO member country has raised any formal objections, but there is the possibility of a dispute if the amount of transactions increase in the future.

The best way to ensure the legal justification in the perspective of international trade law and prepare for the expansion of inter-Korean economic cooperation and further economic integration between the two Koreas is to conclude an inter-Korean FTA or regional trade agreement. Although it would be possible to utilize the waiver system of the WTO Agreement instead of an inter-Korean FTA, this is not practically possible because it requires securing the support of more than three-quarters of all WTO members,² including the United States, which is leading economic sanctions against North Korea. Citing the “National Security Exception” of the GATT / WTO Agreement is also unrealistic because there is no precedent for interpreting inter-Korean economic cooperation as a security exception.³

¹ Article 1. Agreement on Subsidies and Countervailing Measures.

² In exceptional circumstances, the Ministerial Conference may decide to waive an obligation imposed on a Member by this Agreement or any of the Multilateral Trade Agreements, provided that any such decision shall be taken by three fourths(4) of the Members unless otherwise provided for in this paragraph; GATT article 25 and WTO article 9

³ GATT article 21

On the other hand, there is the possibility of recognizing inter-Korean economic cooperation as an exception based on the “Enabling Clause.”⁴ But even in this case, it would be necessary to prove that South Korea, an advanced country, is pursuing economic cooperation with North Korea, a developing country, to support North Korea's economic development and trade. However, this is difficult as well because South Korea has not yet given up its status as a developing country, because it wishes to protect its agricultural sector under the WTO DDA negotiating strategy.

In conclusion, it seems that the establishment of an FTA or regional trade agreement between the two Koreas is the best way to receive exceptional recognition of the obligations under the GATT / WTO Agreement. Currently North Korea is a non-WTO member but it is an independent custom area and can be a signatory to the RTA. Therefore, the CEPA, an FTA between two independent tariff zones in one country, has no procedural problems, reflecting the special relationship between the two Koreas. However, in order to conclude a customs union or FTA, two substantive requirements must be met. Trade barriers should not be increased externally and trade barriers between the contracting countries should be substantially eliminated (internal condition). In case of the Inter-Korean FTA, it is considered that it would not be difficult to fulfill the external condition as there will be no change in a zero tariff trade both before and after the CEPA. In order to fulfill the internal condition, it may not be easy to accomplish to lower the trade barrier due to

⁴ The Enabling Clause is the WTO legal basis for the Generalized System of Preferences (GSP). Under the Generalized System of Preferences, developed countries offer non-reciprocal preferential treatment (such as zero or low duties on imports) to products originating in developing countries.

the economic gap between two Koreas. Currently, trading items for inter-Korean economic cooperation are very limited, so there is no great difficulty in meeting the requirements. However, considering the scale of exchanges between North and South Korea and the level of economic development in North Korea, the most practical way to conclude an FTA would be in the form of a "tentative agreement" allowed by the WTO prior to concluding a full FTA.

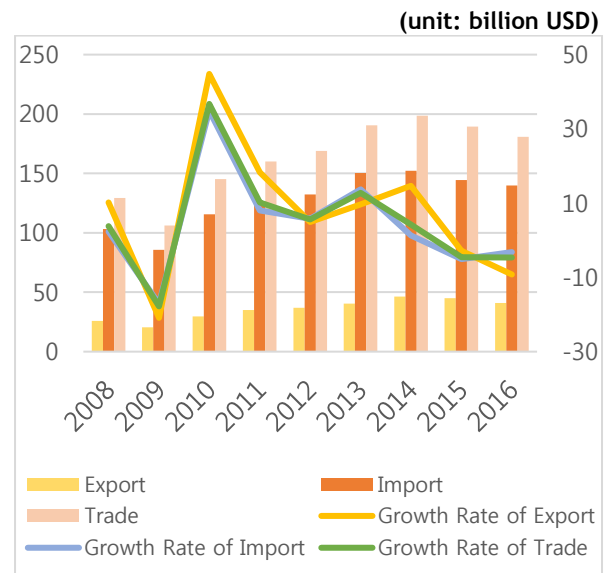
III. Promotion Strategy and Main Contents of the CEPA

The China-Hong Kong CEPA and the China-Taiwan ECFA are the only FTAs that can be referenced when accounting for the specificity and systematic heterogeneity of inter-Korean relations within an FTA between two independent tariff zones with different systems within the same country. The China-Hong Kong and China-Taiwan FTAs share certain aspects in terms of the basic strategy that defines the direction of opening and cooperation in each sector in the first round of negotiations, and then specifies the relevant regulations through follow-up negotiations. However, the China-Hong Kong CEPA systematically opened the market through supplementary agreements once a year, while the China-Taiwan ECFA is not able to specify goods and services trade negotiations in addition to the EHP (Early Harvest Program).⁵ As a result, the performance of the two FTAs shows a significant difference, mainly due to differences in China's political relations with Hong Kong

⁵ The China-Taiwan ECFA provided an "Early Harvest" list in the beginning of the ECFA. The program covered 539 Taiwanese products and 267 Mainland Chinese goods for tariffs reduction.

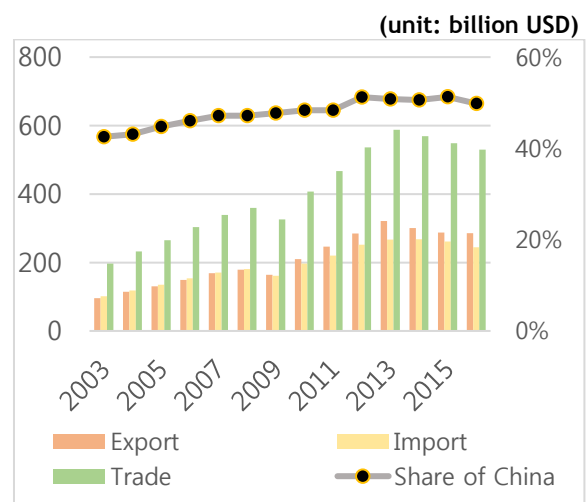
and that with Taiwan. This shows that it is desirable to separate economic problems and politics when concluding the CEPA.

Figure 1. Trend of China's Trade to Taiwan



Source: KITA

Figure 2. Trend of China's Trade to Hong Kong



Source: UN Comtrade

In fact, even though an FTA is yet to be signed between the two Koreas, more economic cooperation agreements have already been signed between the two Koreas than between China-Hong Kong or China-Taiwan. Therefore, it is desirable to promote the CEPA

in the direction of accepting and developing existing economic cooperation agreements. In addition, since the inter-Korean relationship is not an inter-state relationship but a “potentially special relationship aimed at unification,” it would be appropriate to conclude an FTA in the form of an inter-agency “arrangement” instead of an inter-state “agreement.” The details of the CEPA for South and North Korea include step-by-step implementation of free trade in goods and services, liberalization of trade in services, and facilitation of trade and investment. Considering the current system and economic realities of North Korea, it will be necessary to approach the FTA by starting from a low-level or provisional FTA and gradually adjusting its level according to system changes in North Korea and its economic development. In other words, the CEPA of the two Koreas corresponds to the lowest level of economic integration between the two Koreas. Commodity trade should be maintained in a way that preserves the current tariff-free regulations between the two Koreas, but employs non-tariff barriers appropriately in order to minimize potential damage to industries in North and South Korea following the conclusion of the FTA. Since non-tariff barriers are the only devices that can mitigate industrial damage on both sides in advance, they should be abolished gradually in accordance with the long-term economic interests of the two sides and considering the extent of promoting change in the North Korean economy. This is because the CEPA is designed to facilitate North Korea's reform and opening in order for the inter-Korean CEPA to receive domestic and foreign support. At present, there are non-tariff barriers in North and South Korea, such as the conditional approval system, quota, safeguard, subsidy, and import authority (qualification) restriction system. On the other hand, since North and South Korean rules of origin

are lacking in specificity, it will be necessary to operate a "Country of Origin Confirmation Consultation Meeting" between the two Koreas to prepare detailed rules on origin and adopt them as CEPA attached documents. The basic principles relating to trade in services and investment between the two Koreas are included within the annexes of the “Inter-Korean Basic Agreement.” However, there is no consensus on a specific timetable for opening or investment methods (direct investment, joint investment, joint venture). In order to promote North Korea's reform and openness, South Korean companies should be guaranteed direct investment and joint venture investment in North Korea. Meanwhile, many agreements have already been reached between the two Koreas concerning the trade and investment facilitation measures. However, since the three agreements (traffic, customs, and communications) are confined to the Kaesong Industrial Complex and the Mt. Kumgang area, it will be necessary to expand the regional scope of related agreements. In addition, these should be able to substantially guarantee the business activities of South Korean companies that have entered North Korea, as well as the right to manage personnel and labor relations within Korean companies in regard to North Korean workers.

IV. Economic Effects of an Inter-Korean CEPA

The economic effects of a CEPA between the two Koreas are analyzed in terms of GDP change and production inducement effect in the two Koreas.⁶ First, if a CEPA is concluded

⁶ Growth Accounting model is used for analyzing GDP change. Input-Output Table and Production Inducement Coefficients are used for analyzing production inducement effect.

ed, South Korea's GDP will increase from 1,822.8 trillion won in 2020 to 3,067.5 trillion won in 2039, and North Korea's GDP will increase from 38.0 trillion won in 2020 to 308.3 trillion won in 2039. As a result, the income gap between North and South Korea will decrease from 21.4 times in 2020 to 5.2 times in 2039. Trade between South and North Korea will also rise to 2.32 billion dollars in 2020 (0.15% of South Korea's GDP, 7.2% of North Korea's GDP) and to 4.93 billion dollars in 2039 (0.18% of South Korea's GDP, 11.0% of North Korea's GDP)

Next, we analyze the change in the vertical integration structure of the two Koreas and the change in the final demand ripple effect by using the production inducement coefficient of the inter-Korean industry linkage table. The degree of vertical integration between the two countries after signing the CEPA shows that the proportion of intermediate goods input to South Korea in the light and heavy industries increases in the case of North Korea whereas the proportion of intermediate goods input to North Korea increases in the mining and light industries in the case of South Korea. In addition, the intra-regional effect and inter-regional effect listed in the inter-Korean industrial relations table also increased in the post-CEPA analysis. The intra-regional effect of North Korea was 14.8 at the general exchange and cooperation stage, but increased to 16.4 after the signing of the inter-Korean CEPA, and 19.86 from 18.77 in South Korea. In the case of inter-regional effects, the effect of final demand (export) on South Korea rose from 0.2289 to 0.6394, and the effect of final demand (import) on North Korea increased from 0.0243 to 0.0585. Lastly, we analyzed the production inducement effect of final demand items by applying GDP and trade scale estimation results before and after the signing of CEPA between South and North Korea. The ef-

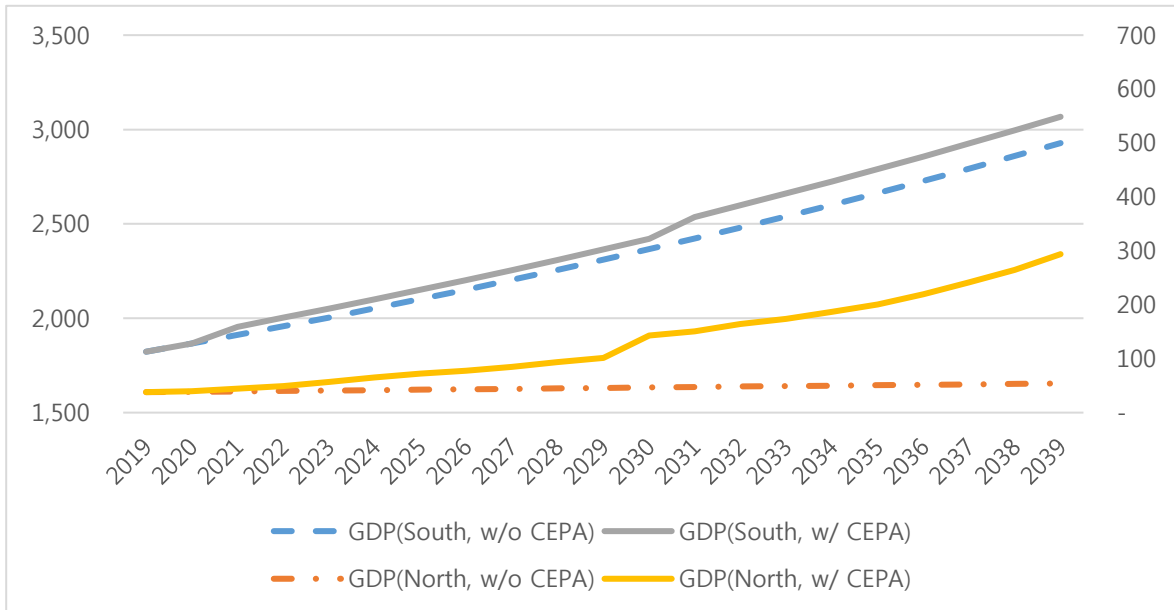
fect of the increase in South Korea's final demand (imports) in North Korea increased from 2.44 to 2.90 before and after the signing of the CEPA between South and North Korea, and North Korea's dependency on South Korean production inducement increased from 2.9% to 7.4%. On the other hand, the signing of the CEPA between the two Koreas will create various effects in addition to the international approval of non-tariff transactions between the two Koreas. By integrating the inter-Korean economic cooperation system, the institutional framework of the economic integration of the two Koreas will be established, and this will contribute to securing the support of the international community for the economic integration of the two Koreas by utilizing it as an opportunity to reform and open up the North Korean economy. It is also expected that the expansion of inter-Korean trade will provide economic benefits to both North and South Koreans and virtually create economic integration effects through industrial reorganization of the two Koreas.

VI. Policy Implications

As seen in the previous sections, conclusion of an inter-Korean CEPA is an economically and legally valid measure to ensure the expanding of inter-Korean economic cooperation. It would be desirable to conclude the CEPA between the two Koreas in the form of an inter-agency arrangement rather than an inter-governmental agreement. This is because if the CEPA is implemented in the form of an intergovernmental agreement, the sovereignty of the two Koreas may come into conflict and negotiations

Figure 4-1 GDP trend of North and South Korea before and after the CEPA

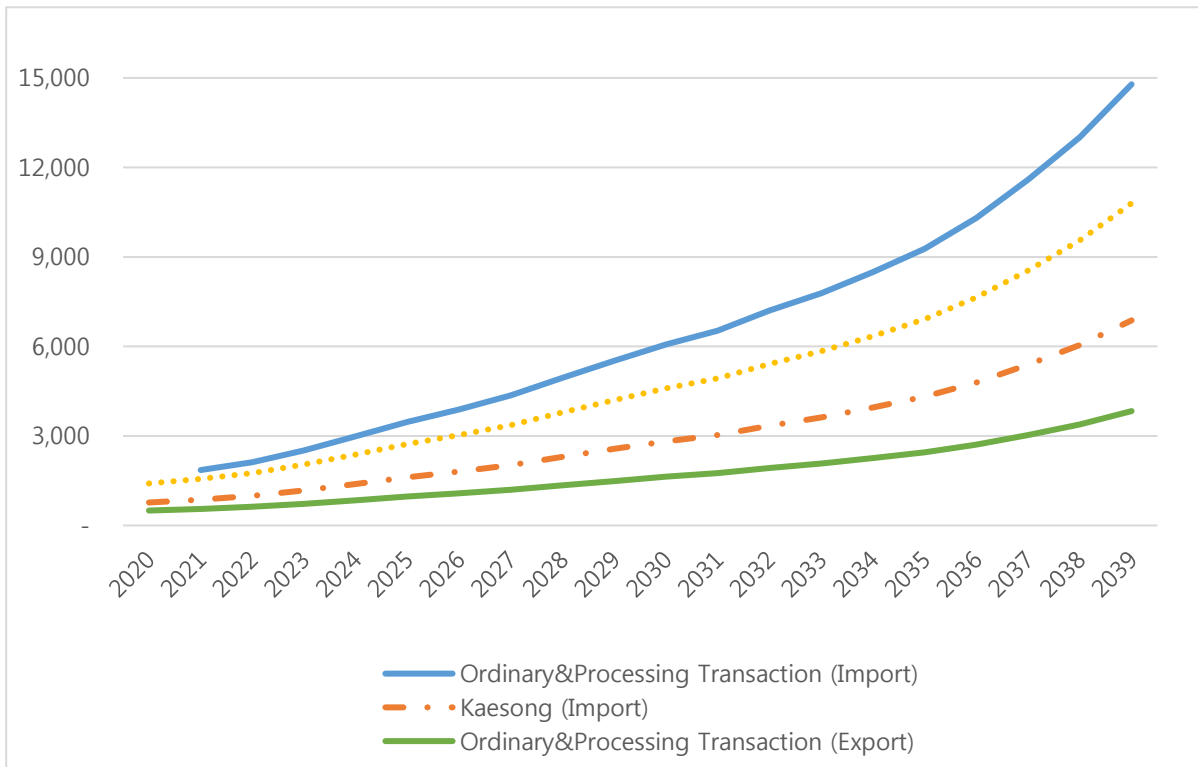
(Unit: trillion won)



Source: Lim (2016), p.103

Figure 4-2 Inter-Korean trade trend after CEPA

(Unit million USD)



Source: Lim (2016), p.107

may fall into the rut of a zero-sum game. In particular, given the dynamics of the relationship between North and South Korea, it is important for the two Koreas to secure the “irreversibility” of agreements reached by defining as much detail as possible during the initial negotiations. At the same time, the CEPA needs to be designed to minimize any potential negative effects and ensure positive effects for economically weak sectors for a certain period of time after the conclusion of the CEPA. Lastly, it will be necessary to focus on long-term economic integration effects rather than short-term economic effects when proceeding with the CEPA. **KIEP**

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