

The Components of Free Trade Agreements and Their Effects on Trade

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I. Introduction

The recent spread of protectionism is posing a threat to the multilateral trading system represented by the WTO. Under these circumstances, free trade agreements (FTAs) have been expanding worldwide over the past few years. Also, while the FTAs in the past focused on tariff cuts, recent FTAs contain various provisions on areas such as services, investment, and intellectual property rights. This study investigates current situations in global and Korea's FTAs based on the World Bank database (2017) and analyzes the effects that contents of FTAs have on trade.

First, the components of FTAs are categorized into 14 elements (WTO+) legally enforceable under the WTO's mandate and 38 elements outside the WTO's authority (WTO-X). For the 261 FTAs that took effect between 1958 and 2015, we determine the depth of the agreements based on whether the agreement includes these 52 components and whether the components are legally enforceable.

Over time since the mid-1990s, FTAs have come to contain more and more WTO+ and WTO-X components, in particular FTAs

including WTO+ elements such as SPS, TBT, TRIPs, and GATS have increased significantly. However, the number of legally enforceable components has not increased significantly. The depth of FTAs has turned out to depend on the level of economic development of the party or the region to which it belongs. Both FTAs between developed countries and those between developed countries and developing countries show a similar number of components, but FTAs between developed countries have more legally enforceable components. FTAs in Europe and East Asia included relatively many components, but agreements in North America, Europe, and Oceania included more legally binding components.

II. The Effects of Depth of FTAs on Trade

This study analyzed the effect of the depth of free trade agreements on trade with 196 countries between 1995 and 2015. According to the results, the more free trade agreements contain WTO+ and WTO-X components and the more legally binding components are, the more bilat-

eral trade increases. In particular, the more legally binding WTO-X components are included, the FTAs expand trade significantly. These positive trade effects are more pronounced in FTAs where developing countries are involved, and legally enforceable WTO-X components were shown to be particularly im-

portant in the promotion of exports of developing countries. In addition, the more legally binding WTO+ and WTO-X components FTAs contain, the longer the significantly positive trade effects of the FTAs were shown to persist. We find that the most important factor supporting this persistency is the inclusion of WTO-X components.

Table 1. The Effects of Depth of FTAs on Trade

Dependent Variable	1995–2007 & 2011–15			
	(1)	(2)	(3)	
Import Values	Import Values			
Explanatory Variables	Degree of legally binding components (Min:0, Max:1)	Degree of legally binding components (Min:0, Max:1)	Degree of legally binding WTO+ components (Min:0, Max:1)	Degree of legally binding WTO-X components (Min:0, Max:1)
Importer-Exporter ↓				
Total	0.221*** (0.045)			
Advanced-Advanced		0.098 (0.085)	-0.487*** (0.118)	0.736*** (0.151)
Advanced-Developing		0.287*** (0.064)	-0.081 (0.065)	0.523*** (0.101)
Developing-Advanced		0.201*** (0.071)	0.115 (0.113)	0.071 (0.141)
Developing-Developing		0.550*** (0.166)	0.069 (0.200)	0.686* (0.381)
No. of Observations	527,982	527,982	527,982	
Country Pairs	30,297	30,297	30,297	
Estimation Method	PPML	PPML	PPML	
Year Dummy	Yes	Yes	Yes	
Country Pair Dummy	Yes	Yes	Yes	
Control for ln(GDP)	Yes	Yes	Yes	

Note: Numbers in parentheses are standard errors (*** P < 0.01, ** P < 0.05, * P < 0.1).

Source: Author's estimation.

III. The Effects of Components of FTAs on Trade

In order to investigate the effects of FTA components on trade, 52 disaggregated components of the World Bank (2017) database are reclassified into 9 aggregated component indicators using principal component analysis (PCA).

According to the empirical results, market access is found to have a positive effect on trade. On the other hand, services provisions are analyzed to have a negative effect on overall trade. Investment, as an aggregated component index,

also has a negative impact on trade, especially for exports of developed countries. Intellectual property rights provisions negatively affect trade between developing countries. Competition has been shown to increase imports of advanced countries. However, when it comes to disaggregated components, provisions regarding state-owned enterprises have a negative impact while state subsidy provisions positively affect trade. Standards provisions reduce exports of developing countries to advanced countries, but expands trade among developing countries. Trade remedy provisions negatively affected trade among developed countries and developing countries.

Table 2. Summary of the Effects of Contents of FTAs on Trade

Contents	Theoretical/Intuitive effects	Aggregated Contents	Disaggregated Contents
Market Access	(+) preferential market access	most cases (+) in particular, between DCs	Tariff liberalization in manufacturing, agriculture (+)
Services	(+) utilizing service intermediates (-) change in trade structure	between ACs (+) between DCs (-)	
Investment	(+) vertical investment (-) horizontal investment	export of AC (-)	Investment (WTO-X) (-)
IPR	(+) secure trust of patent holders (-) demand for technology imitation $\uparrow\downarrow$, price of imported goods \uparrow , quantity control of exporters	trade between DCs (-)	TRIPs (+) Intellectual property rights (WTO-X) (-)
Public Procurement	(+) transparency \uparrow (-) forced use of local products, home bias	import of DC (+)	
Competition	(+) withdraw marginal firms, price of imported goods due to competition \downarrow (-) import substitution due to # of firms and competitiveness \uparrow	import of AC (+)	State-owned enterprise (-) state subsidy (+)
Standards	(+) trust of consumer \uparrow searching cost \downarrow (-) compliance cost of firms \uparrow	export of DC to AC (-), trade between DCs (+)	TBT (+)
Trade Remedy	(+) procedural preference (-) abuse \uparrow when import increases	trade between ACs (-) trade between DCs (-)	Anti-dumping (+) Countervailing (-)
Non-Trade Issues		most cases (+)	

Notes: AC and DC indicate advanced countries and developing countries respectively.

Source: Author's estimation.

IV. Policy Implications

Based on the analysis above, we make some policy suggestions. First, we should establish a new roadmap for future trade agreements focusing on emerging/developing countries with reference to the FTA roadmap in 2003. While the FTAs in the past have focused on securing markets and expanding exports, the new FTA roadmap should focus on the effective use of the global value chain and components in terms of inclusive trade policy. As an economic policy, the important goals of trade policy are economic growth and job creation, and these goals are determined not by total output but by value added in exports. Therefore, the contents of the FTA agreement should be structured so that the global value chain can be efficiently utilized to create high added value. From an inclusive trade policy perspective, it is necessary to include components such as investment, intellectual property right, and standards, as well as improving market access in order to promote SMEs' overseas market entry.

Second, a targeted negotiation strategy should be established in consideration of the degree of economic development and interests of FTA partner countries. Korea is already classified as an advanced country in terms of its economic system as well as industrial and trade structure. Therefore, we should study the negotiation strategies used by developed countries in FTA negotiations with developing countries and make strategies accordingly. In particular, many developing countries are interested in investments from Korea, meaning we should consider the possibility of investments replacing exports.

Third, we need to prepare a proactive response to international discussions on newly emerging trade issues which include e-commerce, intellectual property rights, state-owned enterprises and

labor, and the environment. In addition, as the global value chain expands, global standards are being pursued to harmonize regulations. Our empirical results show that the more FTAs contain legally binding WTO-X components, the more trade significantly increases. As new technologies, industries, and trade issues emerge, countries discuss WTO-X components actively and Korea should pay attention to this discussion.

Fourth, it is important for firms to utilize FTAs successfully in the end. For this, it is necessary to understand what kinds of obstacles firms face from their point of view and make an effort to resolve them through an implementation committee. The Korean government provides various programs to increase utilization of market access. However, the public support for other components remains insufficient. In addition, the effectiveness of trade policy depends on how well firms are taking advantage of the opportunities brought by FTAs. Major countries, such as the United States, make policy effective by actively engaging stake holders in all processes of negotiation and implementation. In this regard, we should review and reorganize existing consultative bodies to support effective opinion gathering and policy establishment. **KIEP**