



Facultad de Ciencias Económicas y empresariales

TRABAJO FIN DE GRADO

Grado Internacional en Administración y Dirección de Empresas

“International Trade Agreements Analysis”

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13 de Junio de 2014

ABSTRACT

The purpose of this study is to address the topic of international trade and interaction between nations. The considerable attention given to free trade is based on its relation with an increased national welfare and economic growth. The paper also discusses the trends towards multilateralism analyzing and comparing two 21st century deep free trade agreements characterized by “made everywhere sold there” goods and internationalization of production or Global Value Chains. The FTAs will be analyzed regarding their impact assessment and the challenges that negotiations faced, mainly focusing on the important and changing automotive industry, in terms of trade creation and trade diversion.

KEYWORDS

International Trade Agreements

Preferential trade agreements

Free trade Agreements

Foreign Direct Investment

Multilateralism

US, European Union, South Korea

Automotive industry

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1. INTRODUCTION

We are in a world that gets smaller day by day, frontiers are being reduced and relationships between countries are gaining more importance. With the increasing Globalization not only trade, but also flows of ideas and technology go beyond borders for which nations must adapt. International economic relations have become very important nowadays in this global world that we live in. In this paper the economics of international trade agreements is addressed with theoretical and empirical approaches, focusing on the following topics: the positions for and against free trade; the trends towards multilateralism of this 21st century, and a comparison between two actual free trade agreements, regarding trade creation, trade diversion and focusing on the automobile industry.

International trade is a very important field in International Economics, which studies the issues concerning special problems in the economic interaction between nations. It can be defined as the real transactions in the international economy; this is the movement of good, services or tangible assets between sovereign states. Among all the topics that can be analyzed in International Economics this paper makes a deep analysis into a theoretical and empirical approach to International Trade Agreements.

Since Adam Smith published in 1776 *The Wealth of Nations*, the majority of economists and researchers have accepted that free trade among nations benefits the overall economic welfare. Free trade is one of the most debated topics in economics in the last centuries and the arguments against and for it involve not only economical issues but also political, social and moral aspects. Free trade can be defined as the elimination of tariffs, quotas, or other governmental impediments to international trade. By doing so, countries specialize in the production of those goods they can produce at a lower cost and efficiently in comparison to other countries. Free trade is an ideal toward which trade policy should strive in order to avoid the losses associated with protectionism. Although this is the desirable situation only few countries approach complete free trade. Hong Kong can be proud of being the only modern economy with no tariffs and import quotes and it is one of those so called Asian miracles, this is developing countries that in the last 60 years have had spectacular rates of growth. It is proven that gains from free trade have been smaller for advanced economies as the US or Europe than those for developing economies.(Krugman and Obstfeld, 2012).

In this paper free trade will be analyzed from different perspectives. A special focus is made on the trends of this last century, the 21st century multilateralism, and also a comparison of two free trade agreements that the European Union signed with Korea in 2011 and is in process of negotiations with the US (TTIP).

Section two focuses on the analysis of the basic terms that have to be clear, about economic integration and preferential trading agreements, challenges that integration among different countries and economies have and different ways to classify trade agreements.

Section three makes a special emphasis on the positions and arguments for and against free trade. Beginning with several theories positioned for free trade and followed by some arguments against free trade like the domestic failure argument.

In the fourth section, a quick walk through the history and steps that have been done in International trade agreements during the 20th and 21st centuries, analyzing the regionalism and multilateralism of these two periods. A main focus will be made on the developments that are happening in this 21st century and the trends of globalization and internationalization of production.

In section fifth a comparison between two International Trade Agreements and a data comparison is made. First about the Transatlantic Trade and Investment Partnership (TTIP) between the EU and the United States, which is of special relevance since it is being negotiated nowadays and the last round discussions just took place in Virginia (US) on the 21st of May. Second, the EU-Korea Free Trade Agreement (FTA), which entered in force on July 2011.

In order to make the comparison more concrete and with real data, in section six a comparative between both agreements is done, focusing on the automotive industry, in which the three parts involved in the preferential trade agreements (EU, South Korea and USA) are very strong.

Section seven includes two hypothetical examples in terms of trade creation versus trade diversion for our trade agreements. Finally, in section eight, a closure of the work is done with some of the concluding remarks that can be taken away, and a critical point of view.

Following, the bibliography with the most important sources of information, among them papers, books and some official data website. An annex with the competences applied in the paper is also attached at the end.

2. ECONOMIC INTEGRATION AND PREFERENTIAL TRADING AGREEMENTS

International trade agreements are the order of the day, and it is normal to hear about them in the newspapers, television and in political matters. Nobody said that negotiations between countries were easy and all the challenges that entering foreign markets have must be taken into account when trying to approach free trade policies. Among them some obvious aspects such as: language barriers that different countries might face, cultural norms or the impact of social institutions. We also find some factors that contribute to the success in the establishment of a common market, those can be having a similar political system, social or cultural similarity and geography.

Economic integration among nations can be classified in four levels of Regional Economic Integration. The first one are preferential trading agreements where nations apply tariffs to each other's products at lower rates compared to the ones they apply to goods coming from other countries. Krugman and Obstfeld (2012) explain three types of preferential trading agreements to establish free trade, setting tariff rates at or near zero. The first one is a free trade area, which is an agreement between countries where free trade among members is allowed but each member set tariffs against other non member countries independently, also in this kind of agreements trade is easier but there is no free-flow of labor and capital. An example of a free trade area can be the North America Free Trade Agreement NAFTA, between Mexico, the US and Canada. The second one is a full customs union, an agreement where each country's goods are exchanged without tariffs but members must agree on a common external trade policy towards non member countries. An example of a customs union was the European Economic Community (ECC) created by the Treaty of Rome in 1957. A third one and less common type of preferential trading agreements are asymmetrical agreements, where preferences are not exactly the same on each side. A second level of economic integration is the establishment of a Common Market where there is free flow of labor and capital, tariff elimination, and a common external tariff, as well as common antitrust law and tax harmonization. Next level is an Economic Union where a common currency, monetary policy and fiscal policy are shared. It can be also defined as a combination between a common market and customs

union previously described. An example of this is the EU's concept of reciprocity, a reciprocal treatment in international trade activity. Finally, the last level of economical integration is a Political Union, as is the case of the Commonwealth of Nations, where member states have no legal obligation one to another and are united by language, culture, history and the shared values of democracy and human rights.

In this paper the focus will be made on preferential trading agreements (PTA's), but also taking into account the other different levels of economic integration. PTAs are not always necessarily good for the welfare of a nation, as this welfare is affected by trade creation and trade diversion, concepts that will be explained later on, with the arguments for and against free trade.

3. POSITIONS FOR AND AGAINST FREE TRADE

3.1 Arguments for Free Trade

There are many theories for and against free trade that economists have argued in the last century. It has been shown that free trade can generate welfare gains for a country, but some economists and scientists still argue the opposite.

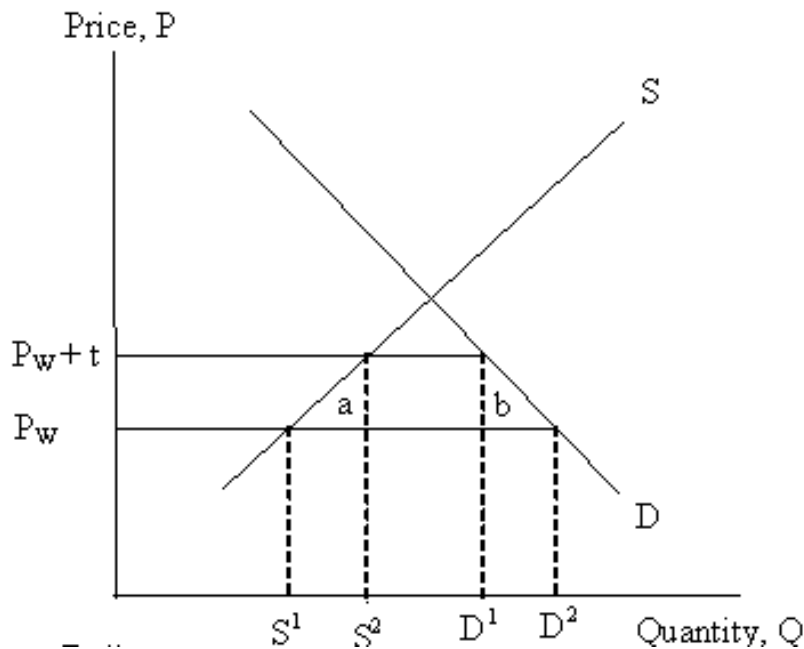
Among basic arguments for free trade, the theory that matches it with the concept of comparative advantage, which can be defined as the ability of a country to produce goods at a lower opportunity cost than others, selling also at a lower price. This is the efficiency argument, where there is an increase in world consumption and resources will be used in a better and more efficient manner. The increase in output level can also lead, although not in all cases, to specialization among countries, hence more variety and higher quality of products. Specialization and economies of scale, which is a cost advantage that comes from a reduction on average cost per unit as the quantity of production increases, leads to an increase in global production, and therefore increased productivity and efficiency. This can be an argument on favor of free trade, but this long run concept cannot be applied in all activities or sectors. Although it is of special importance on the automobile industry, sector that will be analyzed later on, as the mass production of vehicles is characterized by economies of scale and average cost diminishing as production increases.

Free trade is also supposed to increase competition, encouraging companies to innovate and develop better products and to bring more of their goods and services to market, lowering prices and increasing quality in order to retain or increase their market

share. Competition leads to an increase in innovation, because with free trade, along with goods and services also the flow of new ideas occurs. Since companies must compete with their overseas counterparts, they can observe all the successes as well as the failures that take place in the global marketplace. (Denise H. Froning, 2000) Giving entrepreneurs an incentive to find new ways to export or compete with imported products offers more opportunities for learning to improve and for innovation.

More arguments for free trade can be shown in this simple figure 1 below about the efficiency of free trade using a cost-benefit analysis of imposing a tariff:

Figure 1. The Efficiency Case for Free Trade



As shown in figure 1 with free trade, thus when there is no tariff added to the world price and when governments do not distort market prices through trade policies, producers and consumers allocate resources most efficiently. When trade is restricted through a tariff, the domestic price increase from P_w to $P_w + t$ and consumers pay higher prices (world price plus tariff), so consumption decrease from D^1 to D^2 , leading to a consumption distortion shown in area b. This increased or distorted price also cause overproduction either by existing firms producing more or by more firms entering the industry, and the consequent increase in supply, production will rise from S^1 to S^2 , resulting in production distortion that corresponds to the area a Trade restriction with the imposition of a tariff on

the price of goods leads to a production and consumption distortion, where the net loss is the sum of both consumption and production distort.

However, because tariff rates are already low in most of the countries, the benefits of moving from protectionist policies towards a freer trade are only a small fraction of total national income. Data from the Washington D.C Institute for International Economic about the benefits of a move to a worldwide free trade as a percentage of the country GDP show that the percentage for the US is the lowest with a 0.57% of GDP, in Europe is 0.61% and in Japan 0.85%. Whereas in developing countries the average benefits are 1.4% of GDP, this is considerable higher than for developed countries. Thus, the benefits of moving for a freer trade are bigger for developing nations (Cline, 2004). On the other hand for some countries in some time periods, the estimated cost of protection was substantial, being very low for the US but especially big for poorer countries such as Brazil or Philippines.

A clear example is explained by Krugman and Obstfeld (2012) about the creation of a unified European market after 1992 and the measures of the Single European Act. After this measures, no tariffs were set on the intra European trade but there were still some barriers at the time of crossing borders such as hours of wait, formalities, etc...According to them Europe should strived to agree even more on common standards and harmonize its regulations so that there will be a greater competition among firms, approaching the US model of a borderless country with a fully integrated market. Some argue that after these measures there was a consolidation of producers and many gains in productivity. Skeptics on the other hand see that the prediction of gain from 1992 was of a 7% of the GDP and indeed it was demonstrated in 2003 that the gain was only of a 1.8% of European Income. Seeing this as a disappointment and arguing that segmentation of markets has to do more with culture than with a concrete trade policy.

The US shows liberalization after the Second World War, and gradually removed tariffs and barriers between 1945 and 1980, and kept doing it in successive years. Through international negotiations they achieved mutual agreements helping mobilize support for freer trade and helping governments avoid starting destructive trade wars, as it is proven that trade wars will leave countries involved in it worse off.

Furthermore another relevant political arguments for free trade says that free trade is the best feasible political policy, as any policy that deviates from free trade would probably be

quickly manipulated by special interests, leading to a decrease in total national welfare. *“First that the conventionally measured costs of deviating from free trade are large, second there are other benefits from free trade that add to the costs of protectionist policies; and third any attempt to pursue sophisticated deviations from free trade will be subverted by the political process”* (Krugman and Obstfeld, 2012)

Finally, another argument for free trade is the one for trade creation with preferential trading agreements, which will lead to a replacement of high cost domestic production by low cost imports from other members, increasing consumer surplus, decreasing producer surplus and thus increasing national welfare. This concept is explained more carefully later on.

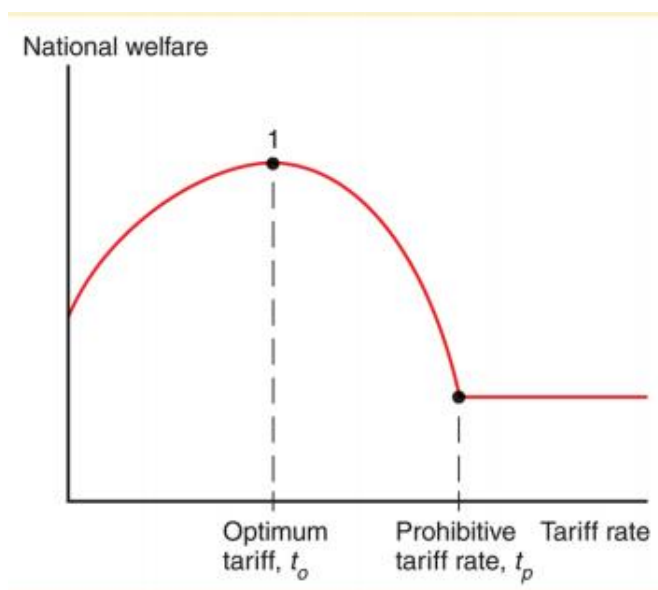
3.2 Arguments Against Free Trade

Nevertheless, despite all the evidence to the contrary explained above, it is common to constantly hear arguments for the protection of trade and the intervention of the public sector against free trade.

First argument for protectionist measures can be the optimal tariff imposition argument. Tariffs are taxes that aggravate imports; and there are circumstances in which a tariff can improve the terms of trade of the country. For a large country a tariff quota will decrease the price of imports in world markets and generate the so called term of trade gain, which benefit can exceed both production and consumption distortions. That is, by setting a tariff on a particular good, imports of these goods are reduced, reducing total demand and therefore the price. This falling on the price of imports increases the terms of trade of the importing country, improving national welfare.

Figure 2 below shows this graphically, where there is a small optimum tariff t_0 that maximizes national welfare, at the point which the marginal gain from terms of trade equals the marginal efficiency loss from consumption and production distortion. Nonetheless, at some tariff rate national welfare starts to decrease as the economic efficiency loss from production and consumption distortion exceeds the terms of trade gain, this is the case of a higher tariff rate that prohibits imports t_p . Therefore this optimum tariff argument does not hold in all cases, since it is just for the exception of a very small tariff rate in a large country, so only under that circumstance the terms of trade of the country improve.

Figure 2. The Optimum Tariff



Another argument against free trade is the argument for levying taxes. That is, the income that the country obtains through taxes on trade. This levying implies a little percentage of public revenues in developed countries, such as Spain, Germany or France. However, in developing countries such as the ones in the Middle East or Africa these levying taxes stand for high rates of the public revenues, as is the case of Cameroon 26.9%.and Egypt 18.9%

The argument of strategic trade policy, which conditions or alters the relationship between companies, occurs when a government adopts a policy that benefits local producers with trade protection. There are theories that show that these adaptations policies which give subsidies to their "picking winners" can in some cases benefit the country.

Furthermore, some economists argue that free trade and trade liberalization might lead to faster economic growth in the long run, but in the short run it is much related to poverty and does harm the poorest. Some studies done by A. Winters or Dollar D. Kraay suggest that developing countries trade liberalization has increased poverty and that there are many links that connect the two. For poverty purposes here, the so considered critical market factors are unskilled labor force. Poverty reduction is an important topic and is considered when analyzing trade liberalization by the World Trade Organization. The link between trade policy and poverty is very complex since "*tracing the links between trade and*

poverty is going to be detailed and frustrating task, for much of what one wishes to know is just unknown. It will also become obvious that most of the links are very case specific” (Winters, 2000 p.43). Some other theories, like the Heckscher and Ohlin trade theory also talk about the links between development and trade, arguing that “the poor” are not necessarily the ones losing from trade liberalization but the owners of the scarce endowments. This theory is based on the observations that countries differ from one another in the composition of their factor endowments and that productive activities are distinguished by the different intensities with which factors are required and since production patterns reflect different compositions of endowments so will patterns of trade. International trade encourages the specialization of production in those activities that require factors in similar proportions to the available endowment, and allows a country to import goods whose factor requirements are far from proportions found at home. Nonetheless, the Heckscher–Ohlin trade theory has frequently been criticized for its restriction to low dimensions as it is only represented by a model with two commodities, two factors and two countries. Another controversy in trade policy is the relationship between globalization and low wage labor, as with the rise of globalization and manufactured exports from developing countries, low wages are paid to these workers who also work under poor working conditions. Those opposed to globalization discuss this as a moral issue, nonetheless it has been proved that developing countries earn low wages comparing them to western standards but trade allows them to earn more than they would otherwise (Krugman and Obstfeld, 2012).

As mentioned above, those positioned against free trade defend that trade policies do sometimes increase the welfare of a nation as a whole. May be the case of some markets in a country where resources are not being allocated efficiently. The best example for this is the trade policy in developing countries. As a developing country it can be understand the so called newly industrialized nations that are having spectacular rates of growth in the last years, closing their income gap with advanced nations, examples of these are South Korea, Hong Kong, India or China. In this paper a special focus is made in these “Asian miracles” since South Korea will be part of the analysis of preferential trade agreements later on.

From the second world war till the seventies those countries tried to accelerate their economical growth by limiting the imports of manufacturing goods in order to foster on their own domestic market, this is applying an import substituting measure. Developing countries had in some cases a potential comparative advantage in manufacturing but they were not able to compete with already established and successful manufacturing in

developed countries. For this reason developing countries tried to temporarily protect their industries with what is known as the infant industry argument, either by encouraging the production of the good by a subsidy or protecting it from foreign competition with tariffs or import quotas until it gains experience.

Following two market failures why the infant industry protection position against free trade, may be a good idea. First of all the imperfect capital markets justification, where we see the case of developing countries that do not have strong banks or stock markets (such as financial institutions). In this situation the savings from traditional sectors are used to finance new sectors, so the growth of new industries is restricted to the ability of these firms to earn current profits. The second failure and more relevant one is the appropriability argument that has to do with externalities, this is, the social benefits that firms in a new industry generate and for which they are not compensated. Supposing that the production of a concrete good improves the technology of the economy as a whole but that the firms in this concrete sector cannot appropriate this benefit and so do not take it into account when it comes to decide how much they should produce. In this situation there is a marginal social benefit that we mentioned before to additional production which is not captured by the producer surplus measure. The marginal social benefit can be an argument against free trade, and a justification for tariffs or other trade policies.

This import substituting industrialization argument against free trade also has its problems. First of all it is not universally valid, and therefore it cannot be applied in all the countries in the same way. There are good examples in the case of Latin American countries that also applied import substitution policies in the fifties, sixties and seventies and unlike the case of the Asian miracle it did not work that well. The period of protecting the domestic industry (infant industry argument) will not create a competitive manufacturing industry if there are reasons why the country lacks of a comparative advantage as lack of skilled labor, entrepreneurs or managerial competence; problems that cannot be solved by a trade policy. And second, if imports are reduced by trying to protect the domestic industry, it is logical that exports will necessarily decrease too.

Another last argument against free trade is the case of trade diversion with preferential trading agreements, where low cost imports from non member countries are substituted for high cost imports from member nations, thus decreasing the total national welfare. This concept with trade creation will be explained more carefully in section five.

As a conclusion for this section it can be said that all those arguments by critics and defenders of free trade theories have their advantages and disadvantages. The majority of arguments cannot be applied under all circumstances and are subject to specific conditions that the country or industry must fulfill, like being a large country or having a competitive advantage for a concrete good. Some arguments contradict saying that the benefits of free trade are bigger for developing nations but the costs are also bigger for these countries, others are biased by morality and enter in a much complex and case specific approach relating poverty to free trade. Nonetheless, there is a critique that has been lately widely accepted by economists suggesting that developing countries that followed free trade had on average grown more rapidly than those countries with protectionist policies. Those nations that focused on exports orientation instead of import substitution had better economical outcomes in the long run. Empirical evidences also show that countries practicing free trade grow three times faster than countries that restricted their trade policies.

4. TRADE AGREEMENTS AND 21ST CENTURY MULTILATERALISM

After the World War II period, most of the nations tried to follow the objective of trade liberalization. In 1944 the International Monetary Fund (IMF) and World Bank created a meeting by the end of World War II with the purpose of developing a plan in order to rebuild the world economy. The General Agreement on Tariffs and Trade (GATT) was created some years later in 1947 as a multilateral agreement regulating international trade. On 1994 the Uruguay round took place, where a large group of countries got together to negotiate a set of tariff reductions and other measures to liberalize trade. A more formal international institution, the World Trade Organization, was then established in 1995, although GATT rules remained. The Uruguay Round was the largest trade negotiation ever setting out rules and principles to cover all global trade, from banking to consumer products. The WTO is a more developed organization which began with less than 50 member countries and now claims 159 members (World Trade Organization, 2 March 2013).

Since the birth of this organization there has been a growing involvement of the so called newly industrialized countries such as Brazil, India, and China. Also since the organization came into force there has been a tremendous reformation of regional trade agreements, numbers talk, and between 1995 and 2005 RTAs tripled from 58 to 188. Regional trade agreements are reciprocal trade agreements between two or more parts and

can be classified as deep when they focus on fostering international production sharing; or shallow when they focus on discriminatory tariffs, trying to reduce discrimination.

The WTO has become the most successful international organization in terms of dispute settlement and enforcement. Since the WTO commits all member nations to reduce trade barriers simultaneously, the agreements are sometimes referred to as a multilateral approach to trade liberalization, and also lately regional trade agreements tend to move towards multilateralism. These two concepts must be distinguished in this study of trade agreements. The first one is defined as behaving in a multilateral way; this is absence of discrimination and an approximation to free trade (Winters, 1996). Regionalism, on the other side is defined as *“a common sense of identity and purpose combined with the creation and implementation of institutions that express a particular identity and shape collective action within a geographical region”*. Also defined by L.Alan Winters as *“any policy designed to reduce trade barriers between a subset of two countries regardless of whether those countries are actually contiguous or even close to each other”*.(Winters, 1996)

In the study of free trade done by Baldwin two periods of history are distinguished, the 20th and 21st century, with different trends in international trade during these periods. First of all, during the 20th century we find shallow agreements focused on tariffs that were characterized by “made here sold there goods”, with rules on selling. Trade on the past century focused on goods crossing borders and regional trade agreements focused on tariff preferences; this is trade barriers at the border. On the other hand, 21st century trade agreements focus not only on reducing barriers but also on production-sharing agreements, facilitating internationalization of production. It is characterized in this century by “made everywhere sold there goods”, with rules not only on selling but also in making. This century trade is like past century but with the difference of adding complex cross-border flows, with trade not only in final goods but also in intermediate goods, services, ideas, know-how, capital and people. Those trade agreements are the ones we classified before as “deep”, including tariff preferences but also on international supply chains. What distinguishes the actual century international production sharing is the international coordination of the production facilities via continuous two way flow of goods, people, ideas and investments. Furthermore, the important phenomenon of producing abroad, named “off shoring”, this setting up production facilities in different countries and being exposed then to new international risks, to deal with this they include policies that reduce or try to eliminate risk. 21st century RTAs are not just regional trade agreements but

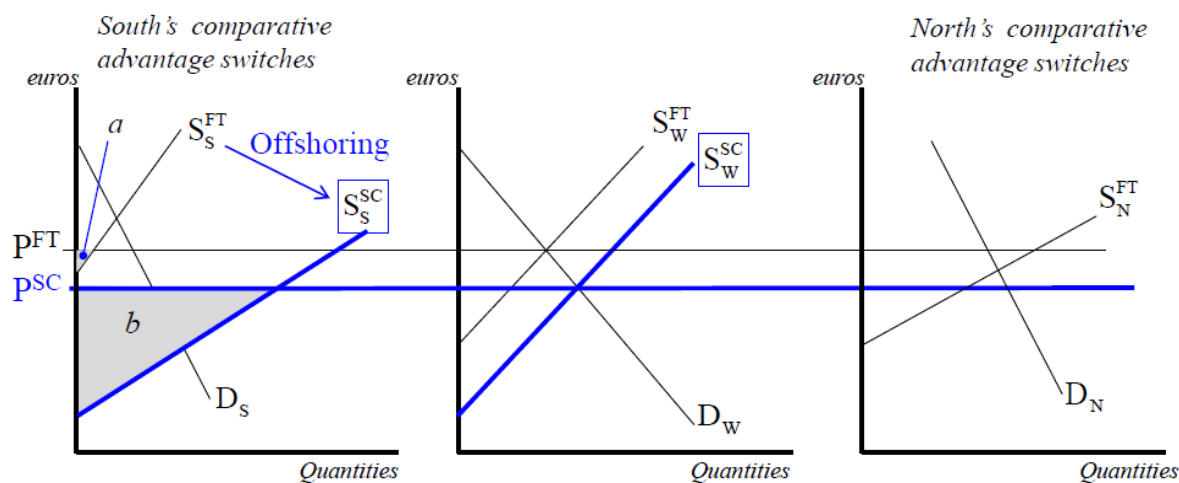
international supply chains, recombining technology and factors across high-tech and low wage countries. The demand is set by advanced highly technological nations trying to increase their competitiveness, while the supply is done by developing low wage nations trying to remove trade barriers, there is hence a mutual interest between both parts.

Globalization is characterized by transportation breakthrough, which allows consumption and production to be separated by big distances, and by transmission breakthrough of information and communications technology (ICT), allowing production stages to be unbundled and dispersed across international boundaries, increasing the ease with which ideas cross borders. 20th century is a traditional trade manner, where producing nations account for the majority of exports and the comparative advantage is a national concept. A comparative advantage as defined before is the ability of a firm to produce goods at a lower opportunity cost than other firms, selling for example at a lower price than competitors. In the 21st century with the trade of goods, services, ideas, and so on...comparative advantage has become a multinational concept.

Making a deeper analysis on 21st century trade and analyzing its basic economics a mix between northern technology and southern labor can be seen. This is high technology and high wage countries with low technology and low wage countries. In this century there is international mobility of technology, a gap in the technology labor ratio, and supply chain trade. A very different situation comparing to the 20th century trade, where all the resources of comparative advantage remain immobile and the goods trade was the only way of exploiting a comparative advantage. Supply chain trade is also used sometimes as a synonym for 21st century trade and traditional trade as 20th century trade. Twenty-first century globalization and supply chain involved technology and labor to move, with the outcome of offshoring (producing abroad), fragmentation, vertical specialization, production unbundling, production sharing, GVCs, etc,...(Baldwin 2014). Global value chains (GVC) characterize today's global economy, in which intermediate goods and services are traded in fragmented and internationally dispersed production processes. There is a positive correlation between participation in GVCs and country's growth rates of GDP per capita. GVCs have a direct economic impact on value added, jobs and income. They can also be important for developing countries to build productive capacity, including technology dissemination and skill building, thus opening up a wide range of opportunities for these countries. (World Investment Report, 2013)

On figure 3 below the impact of 21st century RTA, with the impact of the switch in comparative advantage is explained.

Figure 3. 21st Century RTAs: Switching comparative advantage



Source: Bladwin, 2014

For S^{FT} can be understand supply for free trade, and S^{SC} supply for supply chain trade, S for South, N for North and W for the world. Before the RTA is signed, South supply is S^{FT} and North is S^{FT} , D_s is South demand and D_N North demand. North produces in North and South in South, but North holds a comparative advantage as supply in North is bigger than in South, there are no tariffs or trade barriers and P^{FT} is the price for North and for South.

Once a RTA is signed the situation changes, and an international supply chain arises. Production in south is now going to involve the technology of the north combined with south labor. North supply curve is not going to change and remains S^{FT} , but south supply curve shifts down, because of offshoring, to S^{SC} . As explained before this offshoring phenomenon consists in the relocation of parts of the production chain abroad, vertical FDI and outsourcing together. North will move production facilities to the south since they can find cheaper raw materials and labor there. North countries stop production and start importing the good from the South, while South countries switch from importing to exporting to North countries. With this supply chain trade instead of the traditional trade, one can distinguish three groups of people: firms, workers and consumers that are going to be affected by the new situation. North firms and consumers are going to favor this supply

chain regime as it benefits them, with lower prices on the imported goods from the South. On the other hand northern workers will oppose this, as off shoring to south with their low wage, will not benefit them. Southern workers and consumers will support this new situation, while firms oppose it.

This switch on trade trends is very important as evidence shows that tariff preferences no longer dominate regionalism in this 21st century; we see that regional trade agreements are moving towards multilateralism. Some delicate aspects arise with multilateralism in 21st century RTAs, as is the example of competition policies. When production is established abroad foreign firms are often exposed to unfair competition and anti competitive practices such as domestic firms agreeing together against imports. To address this it is important for firms to adopt, maintain, and apply competition laws, immediately address forms of anti-competitive behavior, and settle fast disputes. When approaching competition policies, the European Union tends to be more prescriptive, and focuses on persuading partners embracing EU practices. On the other hand the US centers on co-ordination and co-operation between existing competition authorities.

Other delicate issue that arises with the international flow of goods and services or trade becoming a multinational concept is investment and BITs or bilateral investment treaties. BITs are very common nowadays--about 2 800 exist -- and consist of international agreements establishing the conditions for private investment by nationals and companies of one nation into other nation. Developed countries are the biggest recipients of FDI and also the ones with most firms engaging in FDI outflows, but there is an increasingly importance of the role of big developing nations such as China, Brazil or India. Data from the World Investment Report gathers much information about Global foreign direct investment and trade trends. According to this source, global FDI fell by 18% to \$1.35 trillion in 2012, mainly due to policy uncertainty and economic fragility which increased caution and risk aversion among investors. Current trends show that developing economies are surpassing developed economies as recipients of FDI, as they accounted for a record 52% of global FDI inflows, exceeding flows to developed economies by \$142 billion. Developing economies' outflows reached \$426 billion in 2012, reflecting the changing patterns on investment since 9 of the 20 largest recipients were developing countries. On the other hand FDI inflows to developed economies declined by 32 % to \$561 billion in 2012; and outflows from developed economies fell by 23 % to \$909 billion. Top three investors of FDI in 2012 where the US, Japan and China, with investments of 329, 123 and

84 billions of dollars respectively. The first two developed economies and the third a developing economy, European countries that invest the most are the United Kingdom and Germany with \$71 and \$67 billion. Top three FDI host countries in the same year were the United States, China and Brazil with investments of \$168, \$121 and \$65 billion respectively. (World Investment Report, 2013)

All the major foreign direct investment (FDI) emitters (the United States, Japan, China, Europe, etc) have their own model agreements. FDI's protection is a core element of the package used by many developing nations to join international supply chains and its flows are protected by more than 2 800 bilateral investment agreements and 300 free-trade agreements with investment chapters (Berger, 2013). The rights that are provided include national treatment, fair and equitable treatment, and freedom to move capital. Again comparing the EU and US model it can be found that the European "admission model" protects investments after the FDI meets all the host country's domestic laws and regulations. While the North American "pre-establishment model" (used in Canada and Japan too), *"impinges to a much greater extent on host nation prerogatives by restricting their screening powers. This restriction thus leads to greater ex ante openness toward FDI."*(Baldwin 2014). To feel comfortable setting up supply chain operations in the nation, investors need to feel confident they can control capital flows. The global governance in this area is fragmented (Lupo Pasini, 2011). In order to address this fragmentation many North-South deep RTAs include provisions on capital flows.

4.1 Inverse relation between foreign direct investment and protectionism

An article of Holger Görg and Christiane Krieger – Boden, talks about how counterproductive a protectionist trade policy can be with regard to foreign direct investment (FDI), concludes that the more the protectionism, the less FDI is expected. The rationale for this is that if a company's products cannot enter a market because of protectionist barriers, the best option will be to settle it at home and avoiding crossing borders. It would be a horizontal FDI (for example looking to install the same type of production plant in another country), which is the case where multi-plant firms duplicate the same activities in multiple countries. It must be distinguished from vertical FDI, where firms locate different stages of production in different countries. Normally, the horizontal FDI is more representative of a pair of developed countries, whereas the vertical FDI is more likely in the context of a developed country and a developing host country

The problem of this inverse relationship points to vertical FDI, when a company wants to fragment its production, because of the costs, and develop intermediate components to various countries protectionism can inhibit the desire of investment. Protectionist measures would make the price of these intermediate components increase considerably, and in a world where fragmentation is increasing more and more, protectionism would discourage vertical FDI. Also the current crisis appears as a key argument when explaining the decline in FDI but, as is provided in this paper, protectionism and fragmentation of production may be accentuating this decline. *“Hence, at a first glance, there seems to be a negative association between the implementation of trade protection measures and changes in FDI. Of course, these relationships may be confounded by the influence of other bilateral characteristics”*. (Görg and Krieger-Boden, 2011).

An interesting and related concept here is the proximity-concentration hypothesis, or the fact that FDI occurs when the benefits of producing in a foreign market outweigh the loss of economies of scale that could be obtained if producing in the firm’s home country. FDI may exist to avoid not only actual trade costs but feared trade costs as well. FDI, such as by Japanese firms into the United States in autos, may be motivated more by fear of impending trade barriers than by any barriers in place at the time of the investments.

5. COMPARISON OF TWO TRADE AGREEMENTS

As concluded in the previous section, RTAs in 21st century are moving toward multilateralism, leading to trade creation and reversing trade diversion. In this section a discussion about two trade agreements of this century that have in common the European Union is made. This is done by comparing the two FTAs in terms of trade diversion and trade creation for the automobile industry, a very important sector that has and will have an important weight in both free trade agreements. Data will be analyzed from the European perspective and in order to simplify the study the period of study is mainly going to be 2012 the last year where complete data is available on the World Integrated Trade database, and also the period comprising 2008 and 2012 in order to see the evolution of flows in the last years.

5.1 Transatlantic Trade and Investment Partnership (TTIP).

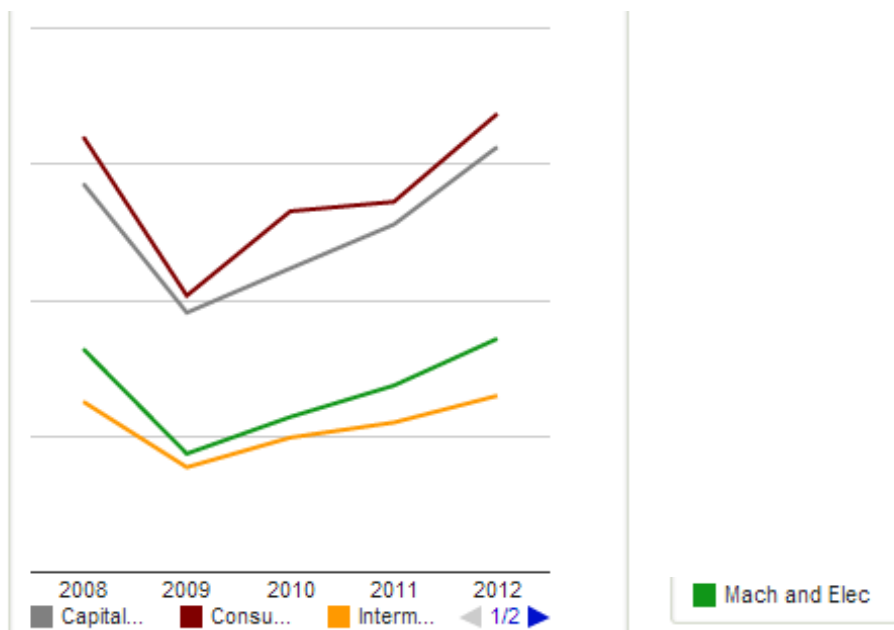
The Transatlantic Trade and Investment Partnership (TTIP) is a trade agreement proposed by U.S. President Obama, European Council President Herman Van Rompuy,

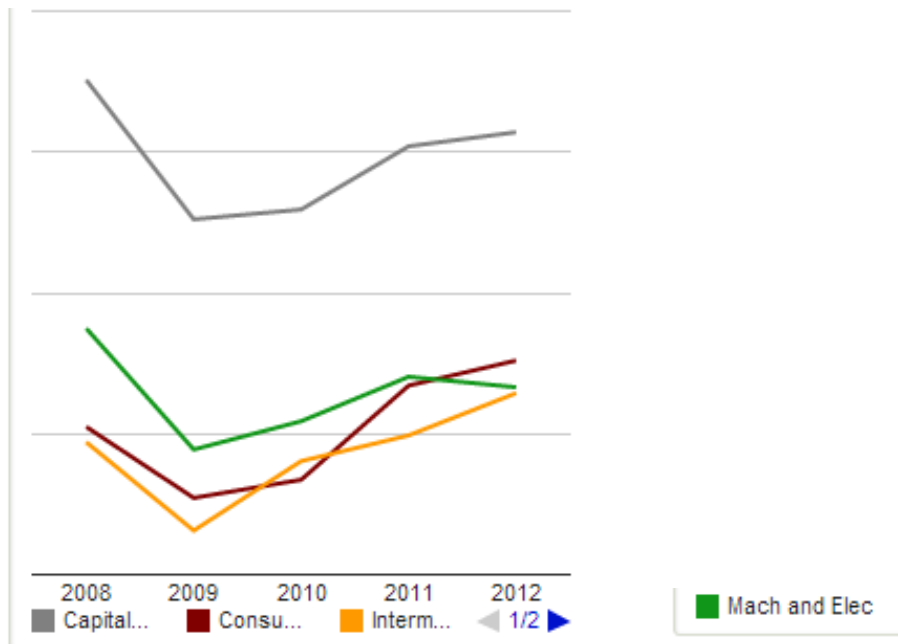
and European Commission President José Manuel Barroso in June 2013 that is currently being negotiated between the European Union and the United States. It is of important relevance because its fifth round of talks EU-US trade just took place in Virginia from 19 to 23 May 2014, so it is an issue that is currently in the news.

According to the European Community, its main objective is removing trade barriers (tariffs, restrictions on investment etc...) in order to make buying and selling goods and services between the EU and the US easier, as Europe and the US already have a strong trade relationship. Data from the World Integrated Trade Solution shows that the top European Union export partner in 2012 was the United States, with trade of goods with value of \$374,915 million, from a total value of goods imported of \$2,166,466 million; this is a 17.31% share of the total exports. Regarding imports the US holds a third position after China and Russia, with an import value of \$264,678 million, from a total of \$2,301,061 million imports in 2012, a share of 11.5%, these terms are in total trade value, regarding all products (capital goods, consumer goods...). Regarding stages of production Europe's trade value was higher in capital goods, followed by consumer goods, intermediate goods and finally raw materials.

The figure 4 below show European exports (first graph) and import(second graph) flow trends between 2008 and 2012 with the US.

Figure 4. EU- US Exports and Imports by product group 2008-2012(\$thousands)





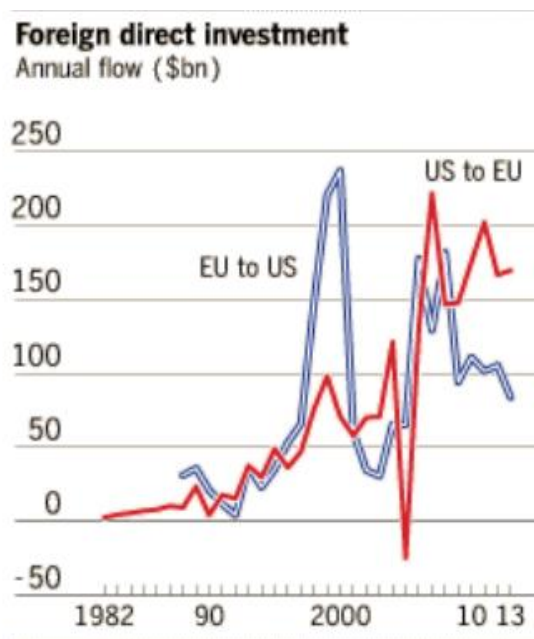
Source: WTTS (World Integrated Trade Solution)

In the first graph from figure 4 the relation of exports is shown. A drastic decrease in exports can be appreciated for all group of products during 2008, probably because of the economic crisis. A take off happens in year 2009, and the increase in export flows is still appreciable nowadays. As for import flows, in the second graph of figure 4, EU imports from the US follow a similar trend like exports, and showed a decrease between 2008 and 2009, that is slowly being recovered. The products that Europe exports the most are capital and consumer goods, and imports mainly capital goods and machinery and electronics from the US. With the TTIP agreement total exports are expected to increase 6% in the EU and even more in the US with an 8%.

Both countries also aim to make it easier for their companies to invest in each other, since North America is the most important destination for EU outward FDI and in the year 2012, the US accounted inflows by Europe ascending to \$105 181 million. However, a decrease in the inflows to the US by Europe is seen, since in the previous two years inflows were \$151 039 million in 2010 and \$127 791 million in 2011 as data from the Organization for Economic co-operation and development (OECD-statistics) database show. In figure 5 below it can be seen this important decrease in FDI, it can be observed that EU FDI to the US shows a decrease from 2008 till 2009, slightly increases in 2010, but falls again till 2013. It can be appreciated that flows are now half what they were in 2007 and 2008. A big difference can be noticed between the amounts of US FDI to Europe and Europe's FDI to the US between 2008 and 2012. US FDI also shows a decrease in 2008, increases in a

bigger manner till 2011 and the decreases during 2011 till 2012, when it starts to raise again. Nowadays US FDI to Europe shows an increasing trend while Europe's FDI to the US shows a decreasing trend. The TTIP agreement will help foster investment between parts, making it easier for companies to invest on the other side of the Atlantic.

Figure 5. Foreign Direct Investment EU-US



Source: Thomson Reuters Datastream; Haver Analytics; IMF

After some impact assessment of the potential effects of the agreement and examining the possible economic, social and environmental impact, the overall outcome for the EU was positive, and the more liberalization the better the result was. Data from the European Commission suggested the EU's economy could benefit by 119 billion Euros and the US economy could gain an extra 95 billion dollars a year. The best part is that all these gains would have small cost, because they would come from removing tariffs and erasing some unnecessary rules and bureaucratic hurdles that difficult the exchanges between the two parties. Furthermore this expected economic growth from the agreement will benefit everyone. The TTIP will be a cheap stimulus package, boosting the economies and increasing demand and supply without increasing public spending or borrowing, decreasing prices and creating jobs. It is clear that both sides will gain a win-win situation from opening up their markets to trade and investment. Removing these unnecessary rules and regulations, also called Non-Tariff Barriers (NTBs) which are the result of differences in

regulations and standards, can be very difficult because both countries often adopt different approaches to achieve one same goal.

Even in the current situation of economic crisis, making this agreement with Europe brings a lot of possibilities to US partners. Due to the importance and attractiveness of the North American region for EU investors and of the EU market for US investors any policy that aims to remove regulatory barriers to transatlantic investments is expected to have a very large positive impact. The EU is the largest economy in the world, the biggest market in the world, the largest importer of manufactured goods and services, it has the largest stock of investments abroad and it is the world's largest host of investments by foreign firms. But it is not just trade between the EU and the US which is expected to expand: as a result of increased demand for raw materials and other inputs, EU exports to other countries are also expected to grow. This means that it would not be the end of multilateralism, the fact that there is a bilateral negotiation does not mean there is no longer commitment for multilateral approach involving other countries, and increasing global income by almost €100 billion. (Joseph Francois, 2013)

5.1.1 What is slowing down negotiations?

The Trans-Atlantic Trade and Investment Partnership has already been under negotiations for nearly a year with talks about harmonizing regulations and standards, which analysts say would be the biggest source of gains from this pact. This is an opportunity for both sides to boost their economies, particularly as they work hard in order to recover from the global financial crisis. The ongoing crisis in Ukraine, and resulting cooling in the relations with Russia, have been highlighted as reasons for the US and Europe to deepen their economic ties.

The agreement is currently facing a various range of different problems, and since the two markets are gigantic, the differences are sometimes magnified. Within the European Union serious disagreements on several issues which are slowing down the negotiations are found. Some examples of these disagreements are the “cultural exception”, as France wants a cultural exception and almost 50 countries have ministers of culture who see a need to protect their culture from homogenization under U.S. influences, this is “*subsidize Renoir but then let him compete with Spielberg*”. There is a traditional rejection of the French authorities to TV programs and movies from the US.

Another important aspect are genetically modified foods, where the main difference of opinion is that “many Americans see the technology as solving problems while Europeans tend to see it as creating problems”. Despite the World Health Organization conclusion about these foods not having any adverse effect on human health (WHO, 2010), some still see them as a threat to agricultural productivity enhancement.

Furthermore, the problem of the Tobin tax, a currency transaction tax that was proposed by the winning economist Nobel Prize James Tobin to address the volatility of capital flows. While France is deeply committed to it, the United Kingdom and the United States have historically positioned against it. So it can hardly be expected that the TTIP will reconcile quickly the different arguments of each country for and against this tax.

Last round discussions, which took place on the 23rd of May 2014 in the city of Arlington (Virginia), addressed three areas of market access; this is tariffs, services, and government procurement. Last discussions primarily regarded government procurement, with negotiators looking into the potential rules but also on what elements might be involved in future exchange of offers. Four of the negotiating areas within TTIP are now at the level of “consolidated text-based discussions”; these are: technical barriers to trade, competition, state-to-state dispute settlement, and small and medium enterprises. Negotiators about sustainable development, labor and the environment will be discussed in the next round.

Another delicate topic of the last round was energy trade, and the possibility of having a separate energy chapter within the TTIP agreement. Both sides have to find here a common understanding on whether to have or not a dedicated energy chapter.

Whether to include financial services remains unresolved, with two opposite positions. The EU wants financial services to be featured in the TTIP, and states that establishing a framework for regulatory cooperation is key in order to work together and prevent future financial crises. The US position, on the other side, remains unchanged in this area and has maintained that this may be better addressed in other international forums.

Furthermore, the last European Parliament elections had the outcome of a massive shift in the EU legislative body and over a quarter of the seats going to “anti-establishment” parties. Even when the majority of the European Parliament that will have the task to ratify a deal remains pro-trade, there are fears now that this trend will infect the national politics of EU member states. With the rise of right-leaning parties and a growth in euro-skepticism across the continent because of the slow economic recovery, fears of deflation,

and high unemployment levels, the proposed TTIP agreement might be in danger. The president of France's far-right National Front, Marine Le Pen, has been one of the biggest opponents of the agreement and has said that she will work with similar-minded parties from other states trying to stymie the talks. But this does not only come from right leaning parties, since questions regarding TTIP have also come from left-leaning parties mainly regarding what impact the pact could have in environmental protection. The reality is that politics had an impact on the TTIP negotiations even before the elections.

In the other side of the Atlantic, the US also approaches its congressional "mid-term" elections, where lawmakers are considering whether to renew the "fast track" legislation known as Trade Promotion Authority (TPA). This legislation "*defines U.S. negotiating objectives and priorities for trade agreements and establishes consultation and notification requirements for the President to follow throughout the negotiation process. At the end of this process, Congress gives the agreement an up or down vote, without amendment*". (Office of the United States Trade Representative)

Meanwhile, both parties' officials have suggested that they expect to finish their trade and investment negotiations by 2015, before the US' presidential elections in 2016 complicates it more.

5.2 EU- South Korea Free Trade Agreement

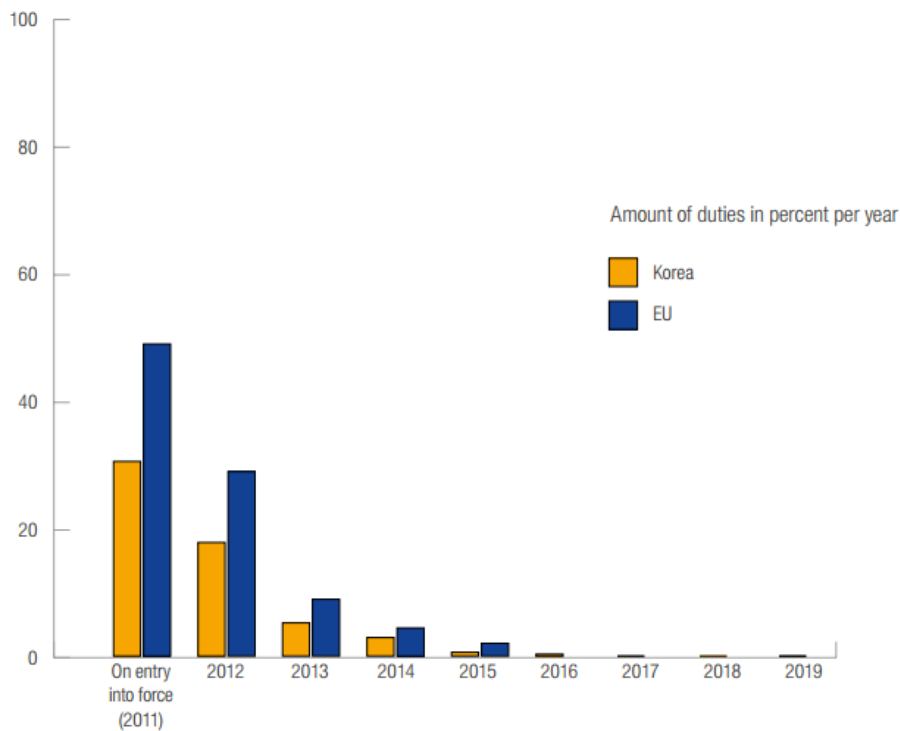
The EU-Korea FTA is the first free trade agreement ever negotiated by the EU with a partner country in Asia; as opposed to the previous agreement it already came into force on the 1st of July of 2011. It has the objective of enhancing market access for European companies in the highly dynamic and competitive markets of Asia, the so called developing countries. This agreement is of important relevance since Korea is currently the 11th largest economy of the world, the 3rd in Asia and has experienced an incredible economic growth in the last 60 years. It has developed a strong light industry, consumer goods (IT and technology) but also heavy industry. It stands out in the textile, steel, car manufacture and electronics industry. This FTA represents new opportunities for the Asiatic country to deepen and expand trade relationships with Europe.

According to the European Commission for trade the agreement would reduce and eliminate tariffs and trade barriers in many goods, agricultural products, services; including also provisions on investment, government procurement, the protection of intellectual property and environmental issues. This agreement is supposed to benefit both economies,

since EU is the largest investor in Korea and Korea is one of the biggest importers in Europe, gaining more and more importance in the present. Studies done on the potential impact of this agreement show a small but positive effect on EU and Korean economies, it is estimated that the FTA will create new trade in goods and services with a value of € 19.1 billion for the EU and € 12.8 billion for Korea. (Publications Office of the European Union, 2011)

All this benefits will come from the path to elimination of tariffs, preventing non tariff barriers to trade, prohibiting and penalizing practices that distort competition, or removing custom duties achieving lower prices for customers and strong competitiveness for exporters. In figure 6 below we can see the schedule forecasted on reduction and the goal to eliminate tariffs.

Figure 6. Tariff reduction and elimination schedule



Source: European Commission, 2011.

Figure 6 shows how the tariffs are forecasted to be reduced since the agreement entered into force in 2011, when duties were very high, 30% in Korea and almost 50% in the EU, until 2019 when duties are almost nonexistent. There is a drastic reduction of almost half of

the duties percentage in both Korea and the EU sides during the first year, and the forecast tends to a total elimination in tariffs in both sides.

A largest relative impact on South Korea's economy is expected as agricultural producers, manufacturers of cars, ships, equipment, or pharmaceutical products among others are expected to increase their exports to EU markets. But also EU exporters benefit from tariff elimination, and the machinery represent the largest sector for duty saving, with gains close to € 450 million.

There is an important aspect in this RTA about "product originate" saying that goods must have been wholly obtained or sufficiently processed in the EU or Korea. Rules of origin as the following must be fulfilled: *"the different processing procedures normally have to be carried out either in the EU or in Korea, though EU producers can also use inputs originating in Korea (or vice versa) to help them comply with the rules. Additional conditions such as an "origin declaration" of an approved exporter must accompany the products; the processing which took place in either the EU or Korea has to go beyond minimal operations and goods have to be transported directly from the EU to Korea."*(European Commission Trade, 2011)

As mentioned in when talking about the TIPPA agreement, this one is neither the case of end of multilateralism since this new era relationship will not only benefit both sides economies but also have an impact in all Asia, as the EU has committed to trade with third countries and free trade.

An important part of international trade and the global economy is Government procurement, or the acquisition of goods and services by a public authority or agency. It counts for an important percentage of the GDP of every country and even more in developing or emerging countries. With the FTA UE and Korea have mutual commitments on government procurement and agree on apply transparent and non discriminatory rules. An important point is made on the commitment in several infrastructural projects such as highways construction where Europe is leader. The agreement secures for EU companies to participate in tenderly opportunities in Korea. Finally for intellectual property both parties agreed on fostering exchange and cooperation in the issue, for protection of authors, registering trademarks or n geographical indications (GIs). Cooperation against infringement of the protection of intellectual property is also regarded on the FTA.

Figure. 7 UE-South Korea Exports and imports by product group



Source: WTTS (World Integrated Trade Solution)

Figure 7 shows European exports and imports flow trends between 2008 and 2012 to and from South Korea. Firstly exports to Korea in the graph above show the same trend as the US, decreasing in 2008 and slowly recovering till 2012, with the biggest increase in capital goods. Imports in the graph below show a very different trend, capital goods and

machinery and electronics are falling in 2008, recovering in 2009 and again falling drastically from 2010 till 2012. Consumer and intermediary goods imports also decreased in 2008 but on the other hand, slowly grew since 2008 till 2011, showing a constant flow in 2011 till 2012. In the trade Europe-Korea the main flow of products imported and exported coincide and are capital goods and machinery and electronics. The product which is the less exported and imported is intermediary goods, closely followed by consumer goods.

6. THE AUTOMOBILE INDUSTRY AND FTAS

Three sectors are of considerable relevance with these two FTAs: pharmaceutical products, agricultural products and industrial products (electronic devices, vehicles). In this section a deep analysis is made in one of the most affected industrial sectors with both of the trade agreements, these are the motor vehicles and parts industry.

The car industry and car culture has spread intensely over the entire globe in the last century. The car industry has shaped the global economy and has seen constant change, mostly regarding the increasing environmental requirements, and the rise of new countries such as the “Asian miracle” of China or India. Companies in the automotive industry are aware of all the changes and challenges going on, and in order to be successful in the long run must take the right strategic decisions.

In a general picture, the industry is recovering from the economical crisis, since the industry profits were much higher in 2012(54billion €) than in 2007(41€ billion). Forecasts predict that by 2020 profits will reach 79€ billion, this benefits will not be distributed equally, since some regions and segments are expected to do better than others. Actually the following next seven years will be profitable with emerging markets obtaining the majority of gains, mainly China. (McKinsey & Company, 2013)

The three parts involved in the trade agreements, the EU, US and Korea are well known as some of the major car manufacturers in the world, and are also named the original equipment manufacturers that are already established markets. They are headquarters for some of the most important car brands in the world such as Ford (US), Volkswagen (EU-Germany) or Kya and Hyundai (Korea), and hence hold the biggest shares of car imports and exports in the world. Figure 8 below shows this with numbers, Germany holds the first position on light vehicle exports, followed in third position by the United States and fifth

position Korea. Japan holds a second position on the rank, and is the actual Asiatic leader in the industry, for this reason it will be mentioned in the analysis too.

Figure 8. Top 10 Light Vehicle Exporting countries (million of dollars)

Germany	151,096
Japan	99,952
United States	60,962
Canada	46,917
Korea	43,550
Mexico	39,774
United Kingdom	35,022
Spain	28,813
Belgium	28,066
France	21,334

Source: United States Department of Commerce, Bureau of the Census, Foreign Trade Division as of June 21, 2013.
HS Codes: 870322, 870323, 870324, 870331, 870332, 870333, 870390, 870421, 870431

Excluding parts and only taking into account motor vehicles it can be seen that North America was and remains nowadays the leader in the industry. Furthermore, Asia shows the biggest increase in exports in the last years, in 2009 Europe and Asia were close in number of exports, but by 2012 Asia has taken off and gets closer to North American numbers, with Japan and Korea as the leading countries.

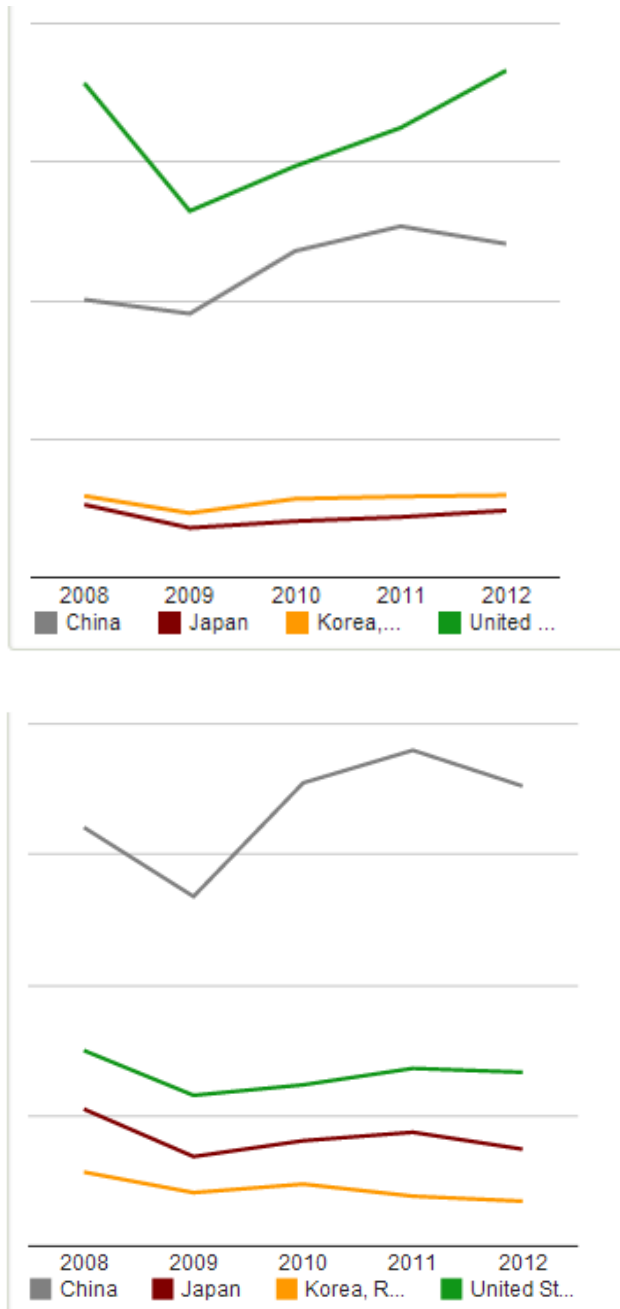
It is of importance relevance the case of South Korea, as one of the so called Asian miracles. In order to move a step forward and develop the automobile industry, the Korean government started in 1962 the "Automobile Industry Promotion Policy", with the Automobile Industry Protection Act and the objective of protecting the infant industry. With this, auto makers from other countries were prohibited from operating in Korea. The government's efforts led to companies that were established in other businesses to enter the industry and also the formation of new startups.

The automotive industry is also central in the prosperity of Europe. First, it creates many jobs and is a huge employer of skilled workforce in many countries, accounting for roughly 12 million jobs. Furthermore it is a key driver of knowledge and innovation representing Europe's largest private investor in research and development. It also makes a major contribution to EU's Gross Domestic Product (GDP) and exports more than it imports. European cars are well known for being leading in technology and considered clean, fuel efficient, quite and safe. Finally in the US, the automobile industry has been one

of the largest employers in the US, employing currently more than 8 million people in the country. (Center for Automobile research, 2010).

Figure 9 below shows the trends in car export (first graph) and import flows(second graph) between 2008 and 2012, from Europe’s perspective to China, Japan, the US and South Korea.

Figure 9. UE Exports and Imports flows 2008-2012 Automotive industry



Source: WITS (World Integrated Trade Solution)

The majority of exports goes to the United States, closely followed by China, and farther followed by Japan and South Korea, that show a similar trend. Exports to the US decreased during 2008, and show a constant growth since then till the present. Exports to China are more irregular and also decreased in 2008, slowly increased till 2011 and decreased till 2012. Japan and South Korea exports decrease during 2008 and slightly increase since then, but do not show a big increase as their flat lines show, their flow levels in 2012 are the same as in 2008. On the other hand, the vast majority of imports to Europe come from China, followed by the US, Japan and South Korea. As in the case of exports, import flows decrease during 2008 and slightly recovered between 2009 and 2011 in Japan, Korea and the US. A decrease is seen between 2011 and 2012. The case of China is quite different, as imports decreased dramatically during 2008, increase again reaching 2007 levels during 2009, kept growing but less heavily in 2010 and started decreasing again till 2012, going back to 2010 levels.

The three countries face several challenges mainly regarding increasing complexity and cost pressures. It is the case of the respect to the environment or the expensive “greening tendency”, as companies must invest high amounts of money in developing alternative technologies for low emission vehicles and electric or hybrid cars. Emerging markets also present a big challenge, for example the Chinese industry which is gaining more and more importance, forecasts say that emerging markets’ share of global sales will rise from 50% in 2012 to 60% by 2020. Also the growing role of digital trends, as most of the buyers nowadays use digital channels as the main source of information. This trend can be an opportunity for the developed countries but also a challenge as a threat from competition from online retailers.

Following a discussion about how both free trade agreements will affect the automobile industry, the impact they will have and the issues concerning this important sector for all the countries involved.

6.1 Automotive industry and the TTIP

Beginning with the first FTA, the Transatlantic Trade and Investment Partnership, as mentioned before Europe is the biggest investor in the US, the second largest destination for US exports of goods and biggest market for US exports of services. With the RTA exports from all parts of the economy are expected to rise, but some sectors will increase their exports more than others. This is the case of EU exports of motor vehicles to the US,

for example predicted to grow by 149%. This reflects the importance of trade in parts and components first and the later predicted integration of the two industries. (Grant Eyster, 2013)

The EU and the US are well known for having high car safety standards. The agreement between both parts could make it possible for the EU and US to recognize each other's standards, by doing so the cars that are proven safe on one side of the Atlantic would also be proven safe on the other side, avoiding the realization of further tests or adaptations in order to meet extra specifications. This means enormous savings in time and costs in the long run. Regarding regulatory issues from the EU position on motor vehicles, a high level of success in the automobile sector is expected by the gains and cost savings that would come from addressing regulatory differences and from eliminating tariffs. All this is planned to be done without lowering safety or environmental standards.

Furthermore, an international leadership on motor vehicle regulations would be created, through the reinforcement of the UNECE framework (United Nations Economic Commission for Europe). The two ultimate goal pursued in the TTIP negotiations are the following. Firstly, the *“recognition of motor vehicles manufactured in compliance with the technical requirements of one party as complying with the technical requirements of the other”* Secondly, *“a significant strengthening of EU-US cooperation also in the framework of UNECE 1998 Agreement, especially on new technologies”* (European Commission).

There is only little doubt that the levels of safety required by both sides would be broadly comparable, there are some motor vehicles manufactured according to the US specifications that can already be driven legally in the EU, such as Ford vehicles. In addition, for future convergence regarding other future regulations it will be provided that whenever either side thinks that a new regulation is required, it has to consult the other part and commit to work together trying to establish common rules.

6.2 Automotive industry and the EU-Korea FTA

Following with the second FTA, the EU-Korea FTA, for the EU automotive industry the agreement contains provisions to address what is perceived as the most significant obstacles to export to Korea by EU industry, the so called non-tariff barriers. For the most sensitive industrial products, such as the case of passenger cars, EU customs duties will have five-year liberalization for small engine cars and three-year liberalization period for cars with large or medium-sized engines after the entry into force of the

agreement. The figure 10 below shows a comparison between South Korea, the EU and the US in automobile tariff reductions due to the EU- Korea FTA (KOREU FTA) and another agreement that exist between the US and Korea, KOREU FTA. In the table the current existing tariff and the time frame for its elimination under both agreements is showed.

Figure 10. Comparison of Automobile Tariff Reductions

	South Korea		European Union		United States	
	Current Base Tariff Rate	Time Frame	Current Base Tariff Rate	Time Frame	Current Base Tariff Rate	Time Frame
Passenger Cars	8%	KORUS FTA: Reduce tariff from 8% to 4% immediately and fully eliminate the tariff in year 5. KOREU FTA: Eliminated over 3 or 5 years depending on engine size.	10%	KOREU FTA: Eliminated over 3 or 5 years depending on engine size. ²	2.5%	KORUS FTA: Eliminated in year 5 (no linear phase-out).

Source: CRS, compiled from South Korean, EU and US. Tariff schedules.

Non-tariff barriers in the motor vehicles sector are the most significant obstacles when it comes to exporting to Korea from the EU industry. To address those problems, the EU-Korea FTA contains ambitious provisions under which Korea accepts the equivalence of EU standards (UN-ECE) for its major technical regulations. This is a big step, as EU manufacturers will not have to modify motor vehicles produced following EU specifications in order to export to Korea. In practice, the FTA eliminates the need to produce specific cars for the Korean market or make expensive tests in Korea to show adequacy with different safety standards, such as resistance to crash or effectiveness of braking. Tests that are conducted in the EU will now be recognized in Korea.

This RTA benefits in a big manner EU producers since UN-ECE standards are equivalent to Korean standards, this standards will be aligned in a five year period, and are set also on future requirements. Equivalence with European standards on OBDs also represents a major cost saving, since Korean standards for gasoline cars are based on US Californian standards. With the FTA Korea will also accept the EU on board diagnostic (OBD) for emissions to Euro 6 standards, accepting Euro 5 standards as a transitional quota. With the agreement Korea accepts products that incorporate new technologies on its market, unless

they put in risk health, safety or the environment. And finally with the most-favored nation (MFN) clause, if Korea decides to give more favorable treatment on any regulations to third country products, it will extend this favorable treatment to EU products.

Figure 11. Korea Automotive Exports by Region

(Unit: 1,000 units, %)

Items	2010		2011		2012		2013
		% Change		% Change		% Change	
Total	2,772	29.0	3,152	13.7	3,171	0.6	2,799
North America	678	11.4	771	13.7	905	17.4	859
US	511	13.7	588	15.1	694	17.9	681
EU	298	-1.3	426	42.8	398	-6.5	374

Source: Korea Automobiles Manufacturers Association and Korea Automobile Importers and Distributors Association (2013)

Figure 11 above shows some numbers that seem to contradict what in principle was expected with this treaty. Exports to EU have decreased after the signature of the agreement that was done in 2011. We see a decrease of -6.5% in exports between the years 2011 and 2012, bigger than the decrease by 1.3% between the previous two years 2010 and 2011. As mentioned before, South Korea auto exports have raised but numbers say that it hit record high on demand for high priced models, with \$48.7 billion in 2013, an increase by 3.1% from 2012. But concerning volume there is a decline of 2.7% from 2012. It is the first fall in four years and may be due to global economic uncertainties, or the weak trend of Japanese yen, South Korea's biggest competitor for overseas car market. On the other hand exports to the US rose by 17.9% from 2012.

It is expected that the FTA present new opportunities to deepen and expand trade relationships with Europe, but this will be more appreciable in the long run, as the treaty is very recent (2001).

6.2.1 The Safeguard clause and more

In the negotiations with Korea, the European Commission considers the interests of the EU car industry. In order to protect the EU industry, including the automotive sector, the agreement incorporates a general safeguard clause, which will be applied from the entry into force of the FTA. This safeguard clause *guarantees "special treatment for the automotive industry according to their specific characteristics"* and will be activated in the event of an increase of imports in absolute or relative terms, which cause or threaten serious injury, and would reintroduce custom duties for up to four years. The Commission has indicated its commitment to closely monitor the market in sensitive sectors and to activate the bilateral safeguard clause if the conditions are met. (European Parliament, 2009) *"The clause provides for the possibility of imposing safeguard measures if, as a result of concessions under the free trade agreement, Korean merchandise is imported into the EU in such increased quantities and under such conditions as to cause serious injury or threat of serious injury to EU producers. Safeguard measures include suspension of further reduction of the rate of customs duty or re-imposing the most-favored-nation rate on the product concerned."* (Council of the European Union, 2011)

As regards the rules of origin for the automotive industry, the FTA provides only a limited increase of permissible foreign content level from the EU standard rule of 40% to 45. Finally, the Agreement includes also an accelerated dispute settlement mechanism exclusively negotiated for the automotive sector and mediation mechanism to ensure that adequate and speedy procedures will be available to handle new barriers to trade that could they emerge in the future.

7. TRADE CREATION AND TRADE DIVERSION WITH FTAS

In this section, two hypothetical models of trade creation and trade diversion for both trade agreements (TTIP and EU-Korea FTA) are made from the European Union's point of view.

7.1 Trade creation with the TTIP

Firstly, a situation where trade creation occurs for the TTIP between EU and the US, adding to our model a third country, for example Japan. Let us set the production costs for a medium class, small size unit car in the EU at 22000€ in the US at 20000€ and Japan 18000€. There is a specific tariff of 5000€ per unit imported.

In an initial scenario where there is no FTA, imports from the US will cost 25000€ as we add the specific tariff to the cost. Imports from Japan will have a cost of 23000€. The decision that the EU will make in this scenario is to buy domestic goods as the cost is lower: 22000€. In a second scenario, where a free trade agreement, the TTIP between the US and Europe is settled with tariffs between both parties set to zero, imports from the US will have a cost of 20000€. Imports from Japan will still have an increase in the cost due to the specific tariff of 5000€, and remain 23000€.

Figure 12. Trade creation example

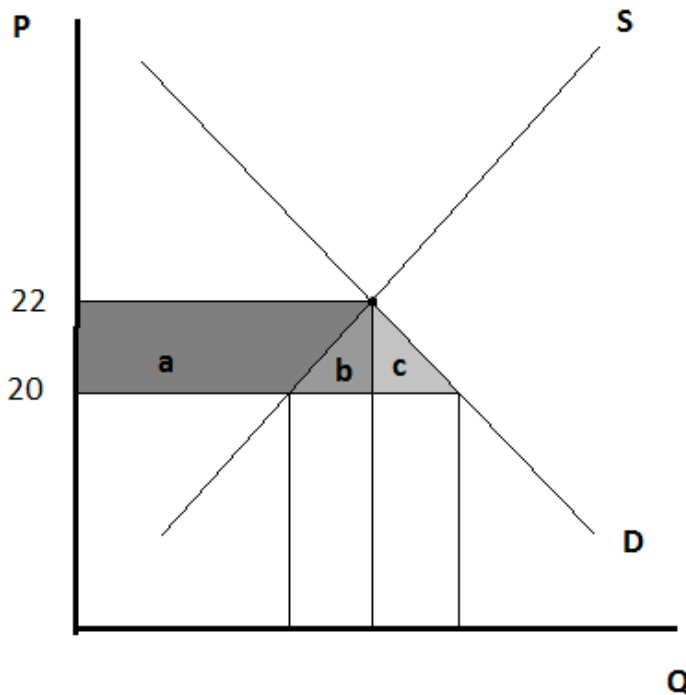


Figure 12 above shows this situation of trade creation, where high cost domestic cars (22000 €) are going to be substituted by low cost car imports from the US (20000 €). Consumer surplus increases by the areas denoted by a b and c in the graph, as consumers are willing to buy more since the price they used to pay has decreased to

20000€. Consumers of the product in the EU benefit from the free trade area with the reduction in the domestic price of both imported goods and the domestic substitutes raises consumer surplus. On the other hand producer surplus is going to decrease by the area denoted by a, as manufacturers are willing to sell less cars, since the price has decreased. Producers in the EU suffer losses as a result of the free trade area, the decrease in the price of their product in the domestic market reduces producer surplus in the industry. Since initial tariffs were prohibitive and cars were not originally imported there was no initial tariff revenue, so there is no loss of revenue for the government. The total welfare effect for the country is found by adding the gains and losses of consumers and producers; this is areas b and c. The net sum consists of two positive components: first, a positive production efficiency gain (b) and second a positive consumption efficiency gain (c).

The same situation could be set substituting the US for Korea with the EU-Korea FTA; then a situation of trade creation due to the agreement between parties will also be found (if we use the same costs and tariffs).

7.2 Trade diversion with the EU-Korean FTA

Following, a scenario where trade diversion occurs using the EU-Korean FTA. Maintaining the costs of car production for the EU at 22000€, Korea 20000€ and Japan 18000€. The difference now resides in the specific tariff which is going to be lower, 3000€.

Before the FTA between Korea and the EU entered into force, EU will have a cost of imports from Korea of 23000€ and from Japan of 21000€. Therefore, the decision will be to buy Japanese cars as they have the lower cost, 21000€. When the agreement entered into force, the situation changes, as imports from Korea cost 20000€ and from the non member country Japan 21000€. The decision undertaken by the EU is going to be buy Korean cars at 20000€ as there is no tariff in the import.

Figure 13. Trade diversion example

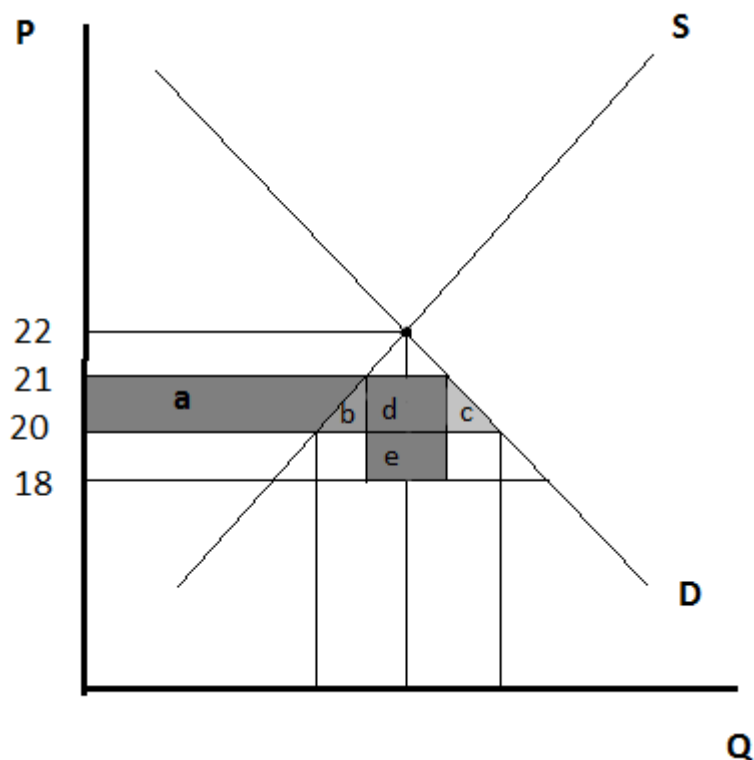


Figure 13 above shows this situation of trade diversion, where low cost imports (21000€ or even 18000€ if there was no tariff) from a non member of the agreement as it is Japan are going to be substituted by high cost imports from a member of the agreement, Korea (20000€).

Again, consumer surplus increases considerably as the price per car decreases to 20000€, denoted by the areas a b c and d. Therefore, consumers of the automobiles in Europe benefit from this free trade area. The reduction in the domestic price of both imported goods increase consumer surplus, and producers in the EU suffer losses as a result of the free trade area, with the decrease in the price of their product on the domestic market producer surplus in the industry is reduced by the area a. Price decrease will also induce a decrease in output produced in existing firms and may cause some firms to close, a decrease in employment, and a decrease in profit. Furthermore, the government loses all of the tariff revenue, areas d and e in the graph. Those revenues which were collected on imports of the product make reduce government revenue which may in turn reduce

government spending or raise government debt. In conclusion national welfare in this case decreases by areas b and c minus e. The aggregate welfare effect for the country is calculated by summing the gains and losses of consumers, producers and the government. The net effect consists of three components: a positive production efficiency gain (b), a positive consumption efficiency gain (d) and a negative tariff revenue loss (e). It is remarkable that not all of the tariff revenue loss (c + e) is represented in the loss to the nation, because some of the total losses (area c) are transferred to consumers. Generally, the larger the difference between the no distorted prices in a FTA partner country and the rest of the world, the more likely it is that trade diversion will cause a decrease in national welfare.

8. CONCLUSION

In this paper free trade agreements have been analyzed theoretically, and with some real data and empirical evidence, mainly focusing on preferential trading agreements, and free trade agreements. Free trade agreements have been argued not to necessarily be good for the welfare of a nation. After analyzing some of the positions for free trade it can be concluded that most of these positions have their weak points. This is the example of the efficiency theory which argues that the benefits of free trade are bigger for developing nations as a fraction of GDP, but the cost protection at some periods for these countries is also higher. The success of trade liberalization and economical union is set by the European Union example, and the consolidation of production and increased productivity, although skeptics argue that the gain from this union have been lower than expected. On the other hand opposite arguments, positioned against free trade present some inconsistencies too, for example the optimal tariff argument is only applicable to large countries and for a very small tariff. It was also discussed that import substitution works in some exceptions and that protecting an industry does not necessarily make it strong if the country lacks of a comparative advantage. Those problems cannot be solved with a trade policy. In spite of this, there is a critique that has been lately widely accepted by economists, suggesting that developing countries that followed free trade and focused on exports orientation instead of import substitution had on average grown more rapidly and had better economical outcomes in the long run.

The tendency of the two last centuries in terms of free trade and the trend of multilateralizing 21st century regionalism is also discussed in the paper. The change from shallow trade agreements in the 20th century towards 21st century deep agreements

characterized by supply chain flows, internationalization of production and offshoring. Global value chains have been proved to have a positive correlation with GDP growth, and this is of special importance for developing countries as it offers many opportunities as technology dissemination. Data showed that developed countries are the biggest recipients of FDI, but there is an increasingly importance of the role of big developing nations. FDI also has an inverse relation with protectionism, the more the protectionism the lower the vertical FDI.

A main part of the study was the comparison of two trade agreements, the first one, the TTIP being negotiated nowadays between Europe and the US and the second between Europe and South Korea which already came into force. Most of the studies done so far have demonstrated that an EU-US trade agreement would have a very positive effect on the economy cutting businesses' costs and generating enough growth and jobs to boost up the EU economy. Exports and imports showed a drastic decrease during 2008 due to the economic crisis, and although the flows are slowly increasing an agreement like this will boost both economies and increase demand and supply of goods in both sides of the Atlantic. One main fear with both FTAs was concerning the end of multilateralism, but economists argue that there will also be an increase in global income as a result of increased demand for raw materials and other inputs.

To fully develop the analysis, this study focused on the automotive industry, and the impact that both FTAs have or will have in the industry for the countries involved. Finally, a hypothetical model for the automotive industry from Europe's perspective was developed setting the examples of trade creation and trade diversion under both preferential trade agreements. The three parts involved have important automobile sectors employing many people and contributing to the country's GDP. The car industry is in constant change, recovering now from the economical crisis, facing many challenges mostly regarding the increasing environmental requirements, and rise of new developing countries. Companies in the automotive industry must be aware of all the challenges, and take the right strategic decisions in order to be successful in the long run. Overall, evidence suggests that future opportunities outweigh the challenges, and countries that anticipate to future challenges and opportunities will be better positioned and have more success in this complex industry.

After discussing all the data concerning both FTA and relating it to the trends in a specific sector as it is the case of the automotive industry it can be concluded that both 21st century

FTAs analyzed will have positive outcomes for the countries' economic welfare in the long run. By signing these two free trade agreements and following positions closer to free trade, trying to eliminate tariffs and non tariff barriers, and fostering trade creation the three parts involved in the FTAs will grow more rapidly and present better economical results and increased national welfare in comparison to those countries with protectionist policies.

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10. ANNEX

10.1 Generic competences:

CB4	In the whole work
CG03	Paper wrote in English
CG06	Different readings and sources of information, in the whole work.
CG17	The work was done while studying abroad in Germany, more autonomy.
CG19	Creativity with new ideas, automobile industry comparison in section 6.
CB2	As an International Business Administration major, I choose this topic as it perfectly fits with my professional aspirations, regarding International relations between countries and International trade.
CB3	Data concerning the TTIP and EU-Korea FTAs. Sections 5, 6 and 7.
CG01	In the whole paper. Mainly sections 5, 6, 7 and 8.
CG02	In the Introduction and Index.
CG04	The whole paper, presentation video and discussion
CG14	In the conclusion.
CG15	Declaration of integrity.
CG16	Deadlines and meetings with the tutor.

10.2 Specific competences

CE02	Bibliography
CE13	In the whole paper, when addressing Global Value Chains and when talking about the automotive industry.