SUMMARY

1. Since its previous Trade Policy Review in 2012, the Republic of Korea's relatively strong fundamentals and solid buffers to external shocks have helped maintain macroeconomic stability and ensure the resilience of its export-led economy. During the review period, annual GDP growth ranged from 2.3% (2012) to 3.3% (2014), and its annual average rate for the period 2012-15 stood at 2.8%, a major slowdown compared to previous performance (averaging at 4.4% over 2001-11). Monetary and fiscal stimulus measures are being used to spur economic recovery. Major developments in Korea's position among the most competitive economies in the world involve lack of improvement in labour productivity growth and, in particular, total factor productivity (TFP) growth, but also weaknesses in several areas where reforms are under way. Whereas in 2015 headline inflation dropped progressively to 0.7% (a third of its 2012 level), the unemployment rate remained relatively stable (3.6%) and below target.

2. During the review period, trade and trade-related structural reforms (e.g. rice tariffication, taxation, and competition policy) were undertaken. Reforms aimed at spurring broad-based productivity growth, thereby improving Korea's international competitiveness. The enhancement of growth and domestic demand is under way in areas such as taxation, SME support, state enterprises, innovation, and labour market rigidities. Since July 2012, the Bank of Korea has progressively cut its policy rate from 3% to a record-low 1.5%, and fiscal surplus has been in decline to accommodate additional government spending to support consumption and investment.

3. The responsiveness of the floating exchange rate system to economic developments provided an important buffer against external shocks and facilitates adjustment toward domestic sources of growth. The nominal exchange rate has slightly depreciated (except in 2013 and 2014) while the effective exchange rates appreciated owing to external and internal factors, *inter alia*, involving global risk-on risk-off investment behaviour, changes in major advanced economies' monetary policies, and trends in the current account balance. The current account registered a substantially larger overall surplus, averaging 6% of GDP during 2012-15 compared to 1.9% over 2007-11, reflecting weak domestic demand and falling global oil prices. Foreign exchange reserves have increased steadily due to continuously increasing returns from the management of reserve assets. Gross external debt increased during the period 2012-14, and dropped in 2015.

4. The openness of the Korean economy to international trade, and its integration into the world economy continued to be reflected by the high ratio of its trade (exports plus imports) in goods and services to GDP that stood at 84.8% in 2015, though significantly lower than in 2012. International trade and foreign direct investment (FDI) trends reflect the continued importance of Asia-Pacific as Korea's main regional market and supplier, though China, the EU, and the United States remain its major individual trading and FDI partners; furthermore, trade under regional (free trade) agreements (RTAs/FTAs) has risen during the review period. Korea's FDI policy remains unchanged. FDI caps are in place in several sub-sectors, including: beef cattle farming, inshore and coastal fishing, transmission and distribution of electric power, air transport and supporting services, publishing activities, broadcasting and telecommunication services. Official approval is required for foreign investment in financial services, while prior notification by foreigners is needed in various other subsectors. Incentives to FDI are mainly in the form of tax exemptions/reductions, cash grants, and industrial site support. The cost effectiveness of these incentives remains questionable.

5. A 2013 government restructuring exercise affected a number of public institutions; for example, the Ministry of Trade, Industry and Energy (MOTIE), which formulates and implements trade and industrial policies, replaced the Ministry of Knowledge Economy (MKE). Korea, a global leader in e-government, has been implementing a Smart Government Strategy 2011-15.

6. As an original Member of the WTO, Korea grants at least MFN treatment to all its trading partners. The general trade policy objective remains to build a free and open economy based on market principles, and the Government has been rigorously pursuing market opening opportunities through not only multilateral, but also regional trade agreements. Six RTAs entered into force during the review period (with China, New Zealand, Viet Nam, Canada, Australia, and Turkey), adding to the existing RTA network with large economic blocs and newly emerging markets (with ASEAN, APTA, Chile, EFTA, the EU, India, Peru, Singapore, and the United States). Rice remains excluded from all the RTAs. Maintaining its developing country status, Korea has been eligible for trade preferences under the GSP schemes of Australia, Belarus, Kazakhstan, and the

Russian Federation. Korea has continued to provide duty-free treatment to most imports from LDCs.

7. The Government has continued to improve its regulatory framework to reduce the burden of doing business. In 2014, the Government launched the "cost-in, cost-out" approach to avoid introducing unnecessary new regulations. From January 2014 to January 2015, the number of economic regulations was cut by 10%. Korea has taken steps to fulfil its transparency obligations at the multilateral level by, *inter alia*, meeting its WTO notification requirements, though notifications in certain areas (e.g. government procurement, export subsidies, and domestic support in agriculture) have been subject to long submission gaps.

8. The tariff remains one of Korea's main trade policy instruments, and a significant, albeit declining, source of tax revenue. The 2016 customs tariff remains transparent but is relatively complex, involving a multiplicity of rates (85 *ad valorem* duties, 44 alternate duties, and 1 specific duty) often with small rate differences and some involving decimal points. As a result of changes relating to the insertion of 16 tariff lines at 513% (rice and rice products), the splitting of tariff lines with high rates and the merger of tariff lines with low rates, the average applied MFN tariff rate increased from 13.3% in 2012 to 14.1% in 2016. This remains high by OECD-country standards, thereby requiring tariff concessions or drawbacks to ensure that tariffs on intermediate inputs do not become taxes on exports, adding to the complexity of border taxation. Peak *ad valorem* rates also remained unchanged and concentrated in agricultural items (WTO definition); applied MFN tariff rates ranged from zero to 887.4% (for manioc). As was the case in 2012, 85% of rates were 10% or below in 2016. Tariff-rate quotas are in place under Korea's multilateral agricultural market access commitments, with in-quota rates ranging from zero to 50% (2016) compared with out-of-quota rates of up to 887.4%, and with a decreasing average fill rate of 59.5% (2015). Other measures (e.g. "autonomous" tariff quotas, usage tariffs, and duty concessions) selectively reduce tariffs on inputs. Korea has bound 90.1% of its tariff lines; that is, 99.6% of agricultural lines (excluding seaweeds and bait for fishing) and 88.6% of its non-agricultural lines (WTO definitions). The gap of 4.4 percentage points between the average bound and applied MFN tariff rates imparts a degree of unpredictability to the tariff regime and provides scope for the authorities to raise applied rates within the bindings. Korea has continued to use this gap to apply higher MFN duties (e.g. adjustment duties) termed "flexible tariffs", which the authorities maintain are within WTO bindings; product coverage under "flexible tariffs" fell from 216 (HS six-digit) items in 2012 to 145 in 2016.

9. During the review period, trade facilitation improvements included the ratification of the WTO Trade Facilitation Agreement (TFA) in 2015, the expansion of the authorized economic operator-related mutual recognition arrangements, and the introduction of a *de minimis* clearance process for consumer goods purchased online. Regarding customs valuation, legislation allowing for joint application of a unilateral advance pricing arrangement and an advance customs valuation arrangement were introduced. Activities to help companies utilize RTA/FTA trade preferences, *inter alia,* subject to diverse and complicated rules of origin were continued.

10. Rice import quotas were replaced as of 1 January 2015 by a tariff-rate quota of 5% and a virtually prohibitive 513% out-of-quota duty. Import licensing requirements cover numerous tariff items and prohibitions are maintained mostly for the protection of public morals, human health, hygiene and sanitation, animal and plant life, environmental conservation or essential security interests in compliance with domestic legislation requirements or international commitments. Korea intensified the use of anti-dumping provisions, mainly against imports of chemicals, plastics, and stainless steel; it initiated 20 anti-dumping investigations (2011-2015) and had 32 final measures in effect on imports from 11 countries, mostly in Asia. Price-based special safeguard provisions (SSG) have been imposed on ginseng and rice and related products, while volume-based SSGs were imposed for the first time since 2007 on ground-nuts, rice and related products, cereal flour and other worked grain.

11. Korea continued to maintain the option to restrict or monitor exports of certain products to ensure adequate domestic supplies, thereby possibly assisting downstream processing of these products. Quantitative export restrictions (recommendations) on rice were removed in March 2015 although, in practice, there has been no trade-restrictive effect; no quantitative export restrictions for any other agricultural products are in place. Export prohibitions are aimed at protecting animal rights and endangered species, and conserving natural resources. Direct export subsidies are maintained to reduce marketing costs for certain agricultural products. In addition to the tariff

drawback scheme, excises and VAT are rebated at the border. Furthermore, income tax relief is accorded to enterprises located in free trade zones. Exporters continue to benefit from export credit insurance, finance, and the promotional activities provided by state-owned institutions.

12. Several measures, involving grants, tax concessions or low-interest loans, continue to support the production and trade of a range of products and to encourage SMEs, R&D, and environmental-protection activities. Although tax incentives were to terminate automatically in accordance with "sunset" clauses, many were extended. SMEs remain among the major beneficiaries of these measures, which are especially generous for information technology activities, although a new 2015 policy direction was aimed at reducing guarantees to mature SMEs and focusing on start-ups and early-stage SMEs; those facing problems of access to raw materials are supported by a fund. Agriculture continues to receive substantial domestic financial support in line with the relevant WTO provisions. Compensation or adjustment support for farmers and manufacturers adversely affected by a bilateral free trade agreement remains in place.

13. Korean industrial standards have been reduced over the review period and those adopted in mandatory technical regulations decreased by 39%; the share of those harmonized with international standards increased. During the review period, a mandatory organic certification programme was introduced and changes were made, *inter alia*, in the areas of reporting, declaration of conformity, testing and environmental impact review as well as maximum residue limits, food additives, and genetically engineered animals. A traceability system for infant/baby food and health functional foods, and labelling requirements for tobacco health warnings and biotech crops and food were introduced.

14. Despite the lack of domestic price preferences, Korea has continued to use government procurement as an instrument of economic policy for promoting SMEs, companies in a disadvantageous position (firms owned by women and disabled people), regional development, and green purchasing. Although no substantial changes were made to the main government procurement legislation, since 14 January 2016, additional market opening commitments in the form of a reduction of threshold values and a slight expansion of entities' coverage have been undertaken as a result of the implementation of the revised WTO Agreement on Government Procurement (GPA); nevertheless, the already small share of foreign supplies continued to fall during the review period. Consequently, foreign suppliers accounted for only 0.9% of the Public Procurement Service's total purchase operations in 2015. Procurement remains decentralized as more than 70% of the market involves direct purchases by public institutions.

15. State involvement in the economy (e.g. agriculture, mining and energy, financial services, broadcasting and media, and transport) persists, as the limited privatization efforts during the review period were widely opposed; however, action *inter alia* involving increased transparency, reduction of the debt level, and improved management efficiency of public institutions was undertaken. One government agency remains responsible for imports of all rice within the tariff quota and another state entity for those of some other agricultural items; their operations allow for important price mark-ups.

16. During the review period, several legislative changes, necessary for the realization of economic democratization intended to narrow the wealth divide, as well as to reflect the actual market situation and improve regulations, were undertaken in the competition policy framework; its sectoral coverage exemptions and price controls remain unchanged. A prohibition on new cross-shareholding (i.e. circular-shareholding) between subsidiaries under large business groups, many of which are family-controlled, was introduced. Nonetheless, market concentration remains relatively high. Large corporations and SMEs continue to be encouraged to voluntarily sign an agreement on fair trade and shared growth. Consumer protection has been reinforced by strengthening law enforcement with respect to products and areas that closely affect consumers, such as daily necessities and e-commerce.

17. Korea's extensive intellectual property rights legislation has been further strengthened with wide-ranging amendments, including the expansion of copyright protection to the duration of the author's life plus 70 years, *inter alia,* to facilitate the implementation of the Government's "creative economy" vision. Protection was further enhanced with the expansion of international commitments, and other enforcement improvements. Parallel imports of genuine products compliant with certain requirements remain allowed, in the interest of competition and thus consumers.

18. The agriculture sector remains heavily protected; its contribution to GDP (2.3%) was little more than its support (1.8%). In 2015, Korea replaced its import quota regime on rice with a tariff quota system, and abolished its rice export quota regime. Other agricultural policies have remained largely unchanged since the previous Review in 2012. At the border, tariffs continue to be the main instrument supporting domestic prices, particularly on rice. The average applied MFN tariff for agricultural goods reached 60% in 2016, up from 55% in 2012, and is more than nine times the average for non-agricultural goods (6.6%). Tariff quotas are utilized, administered or allocated by state-trading entities or industry associations. Domestic support continued to affect agricultural production and trade, and Korean consumers had to pay much higher prices than the world levels (1.9 times). Domestic support for fishing has fallen significantly. The Government introduced more severe sanctions in recent years to fight against illegal, unreported and unregulated fishing.

19. The energy sector has not seen any significant reforms since 2012. Korea relies heavily on imported energy and its per capita energy consumption is three times the world average. The Government has adopted various measures including financial and technical support and tax credits, for energy saving and to promote renewable energy. It has been encouraging diversification of crude oil supply through subsidizing up to 100% of the additional transport cost of importing crude oil from non-Middle East countries. State-owned companies continue to play a major role, and prices are often regulated (for natural gas and electricity). In addition, agriculture consumers benefit from lower energy prices, reflecting cross-subsidies between consumer groups.

20. Manufacturing contributed to about 30% of GDP, 17% of total employment and around 85% of total merchandise exports. Manufacturing activities are dominated by large conglomerates, with a large labour productivity gap between large firms and SMEs. The simple average applied MFN tariff rate was 11.3% (ISIC 3) on imports of manufacturing products, and the rate was 6.3% on manufacturing excluding food processing products; both are much lower than the rates for agricultural products. Sector-specific support included incentives to upgrade the steel industry, and the financing arrangement of the shipbuilding industry.

21. The share of services to GDP and total employment increased slightly to 59.7% and 69.8% in 2015; the same year they represented 17.8% of total exports. Labour productivity of the services sector is only half that of the manufacturing sector, reflecting policies favouring the manufacturing sector (including tax incentives and sector-specific supports). Foreign equity restrictions apply to several services sectors, notably facilities-based basic telecommunications, air transport and maritime services. The Government has been encouraging banks, which had a traditionally close relationship with large conglomerates and their subsidiaries, to shift lending to consumers and SMEs, and to invest overseas. None of the major players in both fixed-line and mobile phone market are state owned. Restrictions are also applied on the access of large retailers (super supermarkets) to traditional markets. Korea has made commitments beyond GATS in the context of some RTAs, although its GATS commitments remain unchanged.

22. Korea's economic growth is expected to gradually gain momentum in 2017. Despite Korea's mainly solid economic fundamentals, downside risks to the economic outlook remain. Notwithstanding the considerable success of its existing buffers, the economy remains vulnerable to exogenous shocks such as a delayed rebound in international trade, particularly due to its heavy reliance on exports of manufactures produced mostly by a few large business conglomerates, and global financial linkages. Future prosperity and sustainable growth depend on the Government implementing TFP-enhancing structural reforms, especially those aimed at closing productivity gaps in the non-traded sector as well as addressing issues relating to unviable SMEs, the rapid ageing of the population and the associated decline in the labour force. These and related reforms, including tax, privatization and continued regulatory reforms, would increase the flexibility of the Korean economy and its ability to respond to growing external competition, thus enabling it to continue meeting its broad-based economic and welfare objectives including inclusive growth and narrower wealth divide.