

Talking point

German industry benefits from free trade

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Free trade stimulates economic activity in all the signatory countries. The free trade agreement between the EU and South Korea is a relatively recent example providing evidence of this fact. In H1 2015, German goods exports to South Korea were up by more than 50% on the level before the agreement came into force in July 2011; by contrast, total German exports increased by merely 13% in the same period. True, German imports from South Korea fell during this period. However, this was due to two sector-specific one-off effects. Stripping out these effects, the imports rose at an above-average pace. The positive economic stimuli should also be a strong argument in support of the current TTIP negotiations.

Controversy has raged over the past few months about the potential advantages and disadvantages of free trade in general and bilateral free trade agreements in particular. The proposed Transatlantic Trade and Investment Partnership (TTIP) currently being negotiated between the European Union and the United States has likely been a major catalyst for the debate in Europe. Critics of agreements such as TTIP mainly fear losses of sovereignty in the areas of consumer and environmental protection, data security, forced privatisations of public services and excessive power accruing to large companies. Furthermore, several interest groups that generally reject any trade pact being agreed whatsoever in fact even doubt the emergence of positive effects for trade volumes, economic output or the labour markets on either side of the Atlantic.

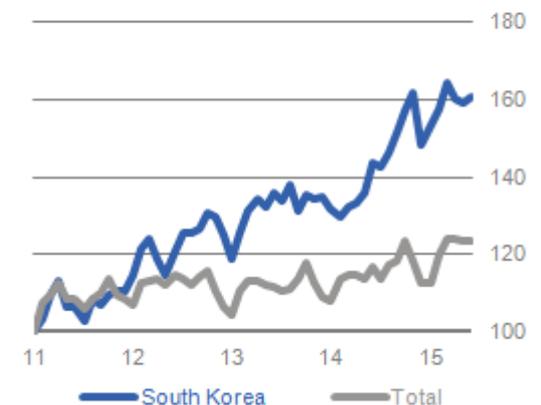
In the early 19th century, David Ricardo developed the theoretical basis for the notion that free trade between two nations benefits both countries because of different comparative advantages. Even today, the Ricardo model based on the example of cloth and wine trade between England and Portugal is still part of the standard economics programme at university.

Free trade agreement with South Korea buoys goods trade

Decades of experience with the liberalisation of trade relations show that this theory holds water also in practice. One relatively recent example is the free trade agreement between the EU and South Korea that came into force in July 2011. Among other things, it covers an extensive reduction of customs duties as well as non-tariff trade barriers. The dynamic growth of trade between Germany, for instance, and South Korea since the agreement took effect highlights its benefits for both sides. Despite not extraordinarily high GDP growth in South Korea, total German goods exports to that country were up by roughly 51% in nominal terms in H1 2015 on the H1 2011 figure (that is, the period immediately before the agreement came into force). The dynamics are remarkable, as total German exports only picked up by a bit less than 13% in the same period. Looking at Germany's major trading partners, only its exports to the US (+58%) increased at a faster pace than those to South Korea. The higher German exports to South Korea benefited from the euro's downtrend vis-à-vis the Korean won in the given period. However, the euro also depreciated against the currencies of other important trading partners to a similar degree without exports to those countries jumping by nearly as much.

German exports to South Korea growing dynamically

German nominal goods exports by target market, moving average, Jan 2011=100



Source: Federal Statistical Office

Nearly all of Germany's large industrial sectors have boosted their exports to South Korea since the free trade agreement was established. Among the major export sectors, the automotive industry recorded the biggest growth: in H1 2015 the sector's exports to South Korea exceeded the H1 2011 value by 159%. Traditionally,

German car makers (and suppliers) had always had difficulties penetrating the South Korean market. One of the reasons for this was non-tariff trade barriers. German corporate brands claimed only about 4.1% of the new passenger car market in South Korea in 2010. Since then, this share has climbed steadily, already reaching close to 12% in the first seven months of 2015. So far in 2015 the automotive industry has generated roughly 34% of total German exports to South Korea.

Other German sectors with a heavy export bias such as electrical engineering, chemicals, pharmaceuticals and metals have also been able to boost their exports to South Korea under the free trade agreement. Only mechanical engineering reported exports being 7.4% lower in nominal terms in H1 2015 than the level recorded in H1 2011. One reason for this decline could have been the competition from China's mechanical engineering industry, since the exports of capital goods from China to Korea increased during the given period. Moreover, investment activity proved moderate as a whole in Korea from 2011 to 2014, which was generally a drag on demand for machinery and equipment. On balance, though, German industry has benefited on the export side from the free trade agreement with South Korea.

Goods imports from South Korea distorted by one-off effects

External trade is, of course, not a one-way street. For this reason, one would expect German goods imports from South Korea to have risen since the free trade agreement came into force, too. However, this is not the case: in H1 2015 German imports from South Korea were down roughly 34% nominally on the corresponding period of 2011. During the same period, however, total German imports increased by over 5%. The surprisingly negative development of imports from South Korea at first glance can be largely explained by two one-off effects, though:

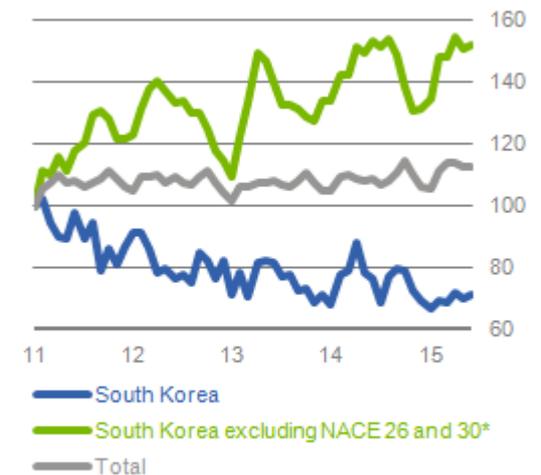
- First, German imports in the other transport equipment sector (in this case mainly ships) virtually collapsed in this period, by more than 96% in fact. This was attributable to the persistently high excess capacities in the global maritime shipping sector. In light of this crisis German shipping lines refrained from ordering new ships, which is why the respective imports from South Korea – one of the three biggest shipbuilding nations in the world – fell accordingly. In H1 2011, other transport equipment still accounted for 29% of total German goods imports from South Korea. So far in 2015 the reading has been only 1.5%.
- Second, during the relevant period German imports of IT equipment, electrical goods and optical products (mainly consumer electronics) from South Korea shrank by approximately 30%. Probably the driving force was that South Korean firms from this sector had shifted production to China or Southeast Asia (e.g. ASEAN countries) where wage costs are lower than in South Korea; all in all, the competition from these countries also increased. German imports of the respective products increased not only from important ASEAN members and China but also in some cases from eastern Europe, which obviously displaced imports from South Korea. Nevertheless, the consumer electronics segment, which currently generates 35% of total German imports from South Korea, is still the most important product group on the import side.

The two examples show that free trade agreements naturally do not make bilateral trade relations immune to broader cyclical or structural developments. However, the generally positive effects of free trade do emerge on a look at German imports from South Korea with the two given categories of goods stripped out. In nominal terms these were up by about 34% on the H1 2011 level in H1 2015 (in contrast to the already mentioned growth of total German imports of merely 5%). Among Germany's major trading partners only imports from Poland grew at an even faster clip than those from South Korea.

In the period under review here, imports from South Korea increased at sector level mainly in the areas of electrical equipment (+65.9%), rubber and plastics (+47.1%), automotives (46.5%) and chemical products (+43.1%). The growth performance was below average in mechanical engineering at 15.9%.

German imports from KR: Important one-off effects

German nominal goods imports by market of origin, moving average, Jan 2011=100



* NACE codes 26 and 30 cover the goods categories IT equipment, electrical goods and optical products as well as other transport equipment

Source: Federal Statistical Office

The increased trade volumes between Germany and South Korea suggest that the competition in the sectors concerned has increased. Ultimately, though, commercial users and private end-consumers may benefit in the shape of lower prices and/or a greater choice of products, for instance.

Bilateral free trade agreements only second best

Based on an empirical example, the figures discussed confirm that free trade can lend positive economic impetus to all the signatories of the agreement. This should also be a strong argument for the TTIP negotiations, especially since the European Commission transparently takes up arguments critical of TTIP and seeks to defuse them in a credible manner. Of course, given the far-reaching scope of such an agreement it will never be possible to please all interest groups. Undisputedly, extensive free trade agreements at WTO level would be superior to the growing spread of bilateral agreements. German industry in particular would benefit from increased free trade on account of its global orientation. However, since advances in the WTO framework are making only marginal progress, bilateral agreements may be regarded at least as a second-best solution. With TTIP, the world's two biggest economic regions would become even more closely integrated in the area of trade. Other countries could look to them for orientation in future, even though it will probably take some time yet before an agreement is finalised.

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