



22-10 Is South Korea Vulnerable to EU and US Carbon Border Restrictions?

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INTRODUCTION

South Korean exports, especially carbon-intensive products like steel, are increasingly vulnerable to new import restrictions in European countries and the United States as these countries implement more stringent climate policies to reduce greenhouse gas (GHG) emissions pursuant to their commitments at the November 2021 UN Climate Change Conference in Glasgow. The added costs of carbon pricing and regulatory policies borne by EU and US producers have made them more sensitive to import competition and more insistent that imported goods also incur comparable charges. Concerns that the cost of complying with new carbon policies in Europe would prompt companies to source from abroad rather than producing at home and paying for the carbon content of goods—often called carbon leakage—inspired the proposed introduction of the European Union’s carbon border adjustment mechanism (CBAM); similar competitiveness issues underpin new legislation in Congress to impose a US-style CBAM. Both could affect billions of dollars of Korean exports.

Korean exporters cannot count on the decade-old free trade agreements (FTAs) with the European Union and the United States, nor the multilateral trading rules of the World Trade Organization (WTO), to protect them from new carbon-based import barriers in key foreign markets. The WTO and the FTAs have broad and loosely defined exemptions for environmental protection. Nor is Korea likely to be shielded from the prospective EU CBAM because it maintains its own carbon cap-and-trade emissions trading system (the K-ETS). Under the K-ETS, Korean producers receive free allowances or permits to cover most of their carbon costs; the remaining allowances are auctioned at relatively low prices compared with the emissions certificates bought in the European Union Emissions Trading System (EU ETS).

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Proposals for a US CBAM are much less developed and more controversial. The Clean Competition Act, the most recent CBAM proposal, would impose both a new border adjustment mechanism and a domestic carbon tax. The bill faces substantial legislative obstacles given Republican opposition to climate policies of any shape or form and bipartisan aversion to domestic carbon taxes in advance of mid-term elections in November 2022.

In any event, US imports of Korean goods are subject to climate-related duties under US unfair trade statutes. The US Department of Commerce has ruled that free allowances issued under the K-ETS (and EU ETS) are implicit subsidies that can be offset by countervailing duties, so Korean exporters of steel and other carbon-intensive goods are still liable to import charges at the US border. Those charges are in addition to the harsh tariff-rate quotas on imported Korean steel applied under the “national security” authority of Section 232 of US trade law, which are more restrictive than measures imposed against European and other steel exporters. These US barriers should be relaxed, as they have been for shipments from Europe, in return for Korean participation in the nascent talks to establish a “Global Arrangement on Sustainable Steel and Aluminum.”

This Policy Brief first summarizes Korean steel exports to Europe and the United States and the progress to date in reducing emissions under the K-ETS. It then assesses the prospective imposition of CBAMs in Europe and the United States, the exposure of Korean exports to new climate-related import restrictions in those markets, and whether Korea’s carbon abatement policies—in particular, its ETS—can shield Korean trade from the CBAMs. Finally, it examines the new transatlantic initiative designed to link steel trade and climate policies and possible Korean participation as a channel to liberalize existing US Section 232 steel import barriers.

KOREAN STEEL TRADE AND THE K-ETS

South Korea launched its national emissions trading scheme, the Korea ETS, on January 1, 2015, the [first mandatory national cap-and-trade system](#) in operation in East Asia. At the time of its launch, the K-ETS was the world’s second-largest carbon market after the EU ETS was established in 2005. The K-ETS covers direct emissions, and indirect emissions from electricity consumption, of six GHGs from the building, transportation (freight, rail, passenger, and shipping), industry, heat and power, waste, and public sectors.¹ Overall, the K-ETS applies to almost 700 of the largest emitters that account for approximately [73.5 percent](#) of national GHG emissions.²

Cap-and-trade systems are a market-based approach to reducing GHG emissions by providing economic incentives. Under this system, a government determines the maximum level of total emissions permitted during a certain period—a “cap”—and issues a set number of permits (by free allocation or auction) that allow the owner to emit a certain amount of GHGs within a certain

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1 In phases 1 and 2 of the K-ETS (2015-2017 and 2018-2020), transportation was limited to domestic aviation. In phase 3 (2021-2025), the transport sector has been expanded to include freight, rail, passenger, and shipping. See <https://icapcarbonaction.com/en/ets/korea-emissions-trading-scheme>.

2 The GHGs are carbon dioxide, methane, nitrogen oxide, perfluorocarbons, hydrofluorocarbons, and sulfur hexafluoride.

period. Companies that increase their emissions must buy permits from other polluters willing to sell them. Over time, the government progressively lowers the cap, encouraging companies to reduce their emissions to avoid paying for higher-cost permits. South Korea's current annual caps are influenced by its two main GHG reduction targets: at least 35 percent reduction below 2018 emissions by 2030 and carbon neutrality by 2050. Both targets are enshrined in Korea's [Carbon Neutral Green Growth Framework Act to tackle the Climate Crisis](#), which entered into force in March 2022.

Korean Allowance Units (KAUs)—the name for emissions permits/allowances under the K-ETS—have been largely distributed for free during the first two phases of the K-ETS. In phase one (2015-2017), all KAUs were [allocated for free](#) to covered entities to both ensure the smooth introduction of the system and prevent excessive economic pressure on covered entities. The allocation of these KAUs was based on the historical emissions of each entity, meaning that heavy polluters were allocated more KAUs for free than lower-carbon companies. Despite being easy to implement, this approach rewarded polluters for past inefficiencies and punished carbon-efficient businesses for past low-carbon investments. To resolve this apparent unfairness, during phase one, three heavy-polluting sectors (aviation, oil refinery, and grey clinker) received allowances based on the carbon intensity of production, an approach called “benchmarking.”

In phase two (2018-2020), 97 percent of KAUs were allocated for free to covered entities while the remaining 3 percent were auctioned by the government to companies. The benchmarking approach used in phase one for aviation, oil refineries, and grey clinker was expanded to include five additional sectors: power generation, group energy, industrial complexes, petrochemicals, and waste. Special provisions were also applied for energy-intensive and trade-exposed (EITE) sectors.³ EITE sectors had 100 percent of their KAUs allocated for free, 3 percent more than non-EITE sectors. Currently, in phase three (2021-2025), less than 90 percent of KAUs will be distributed for free while the remainder will be auctioned by the government to companies.

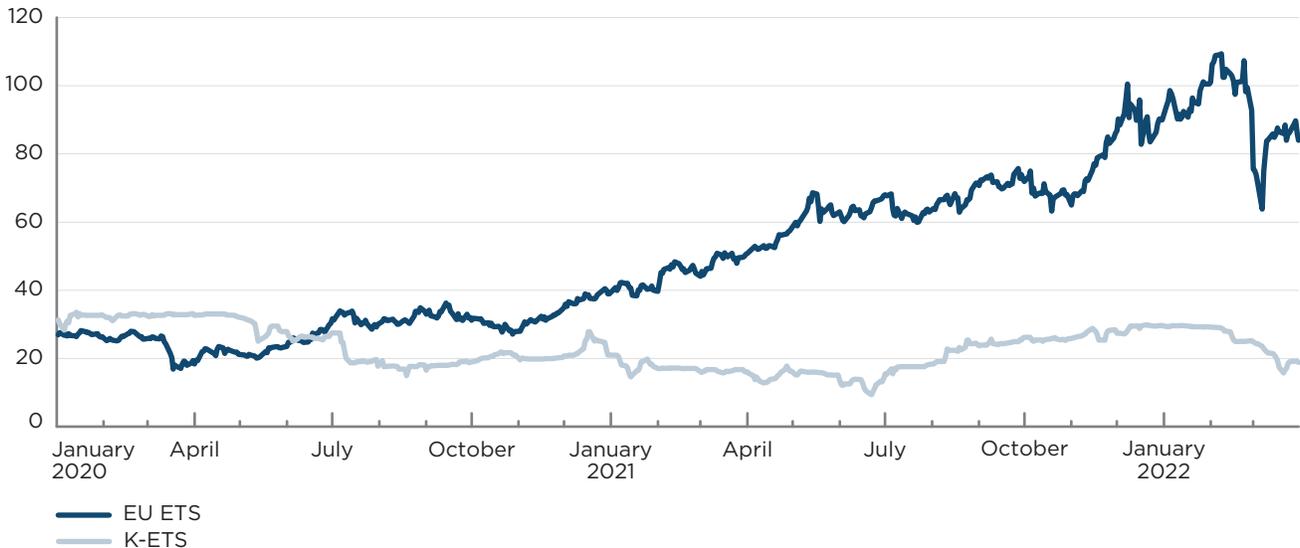
In comparison to the K-ETS, the EU ETS has required [substantially larger emissions reductions](#). In phase two (2008-2012), 10 percent of allowances were auctioned, and in phase three (2013-2020), 57 percent of allowances were auctioned. Korea's comparatively unambitious emissions reductions have contributed to [a sharp divergence in allowance prices](#) between the K-ETS and the EU ETS, starting in 2020. In the first quarter of 2022, the average allowance price per metric ton of carbon dioxide equivalent in Korea was US\$28. In the European Union, it was US\$87 (figure 1).

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3 EITE sectors are defined as having additional production costs of more than 5 percent and trade intensity of more than 10 percent or additional production costs of more than 30 percent or trade intensity of more than 30 percent. For more, see the Korea Emissions Trading Scheme [factsheet](#) from the International Carbon Action Partnership.

Figure 1
K-ETS and EU ETS allowance prices, January 2020-March 2022

US dollars per metric ton of CO₂ equivalent



EU ETS = European Union Emissions Trading System; K-ETS = Korea Emissions Trading Scheme

Source: ICAP Allowance Price Explorer.

In the past, Korea expected to be exempt from EU CBAM levies because its own ETS was comparable to the EU system. Indeed, at a meeting in Seoul on July 6, 2021, the EU Green Deal chief Frans Timmermans told Korean trade minister Yoo Myung-hee that the CBAM would not target South Korean exporters and the [mechanism will be designed not to affect countries like South Korea](#) that have managed their carbon emissions by measures such as emissions trading. Timmermans was quoted in the Korean press reassuring that “The European Union is adopting the carbon border tax in order to prevent European companies from relocating to China, Russia, Turkey and the like for the purpose of carbon regulation avoidance,” adding “European companies are unlikely to relocate to South Korea, which means the CBAM is unlikely to target South Korea.”

A year later, Korean firms should not be sanguine about being exempted from the EU CBAM. The extensive use of free allowances under the K-ETS and large differences between EU and Korean carbon prices increase Korean exports’ vulnerability to EU import charges. Korean exports also will be harmed if the EU CBAM covers both “direct emissions” related to the production processes of goods and “indirect emissions” related to the generation of electricity consumed during the production processes of goods, as currently covered by the European Parliament proposal (see section below). Korean energy generation emits roughly [twice the amount of carbon dioxide](#) per kilowatt-hour of energy than EU energy production.

As steel production is inherently carbon-intensive, Korean steel is likely to be targeted by prospective EU and US CBAMs from the start. Korea exports significant amounts of steel to both the European Union and the United States; between 2019 and 2021, Korea [exported](#) 7.9 million metric tons of steel to the European Union and 6.7 million metric tons to the United States, valued at \$7.8 billion and \$6.7 billion, respectively (table 1).

Table 1
Korean steel exports to the European Union and the United States, 2019-21

Year	Total world		European Union		United States	
	Value (billions of US dollars)	Volume (million metric tons)	Value (billions of US dollars)	Volume (million metric tons)	Value (billions of US dollars)	Volume (million metric tons)
2019	24.2	29.7	2.6	2.8	2.3	2.3
2020	20.7	28.3	2.3	2.7	1.5	1.8
2021	28.7	26.6	2.9	2.4	2.9	2.6

Source: International Trade Administration, www.trade.gov/data-visualization/global-steel-trade-monitor.

Free allowances under the K-ETS also have implications for Korean exports to the United States. In its December 23, 2021 decision memorandum on Certain Cut-to-Length Carbon-Quality Steel Plate from the Republic of Korea, the US Commerce Department ruled that the provision of additional KAUs under the K-ETS to EITE industries should be treated as a countervailable subsidy because the free allowances constitute a financial contribution to those sectors that is not generally available to all Korean industries.⁴ The decision is very similar to the Commerce Department's December 7, 2020 final determination in Forged Steel Fluid End Blocks from Germany, where it ruled that certain free allowances under the EU ETS would be considered countervailable subsidies.⁵ Like Korea, the European Union permits a higher rate of free allowances to selected enterprises in its ETS, foregoing revenue that Commerce deems is "otherwise due." The Commerce Department assesses this practice as an implicit subsidy, regardless of the fact that there is not an equivalent tax or requirement on US firms, because of the nonuniformity of the distribution of free allowances under both the K-ETS and the EU ETS. The Commerce ruling provides a forceful legal argument for accelerating the phase out of free allowances to carbon-intensive industries covered by the K-ETS.

THE EU CBAM WILL HIT KOREAN EXPORTS

In essence, the EU CBAM [applies the functioning of the EU ETS](#) to imported goods, requiring certain carbon-intensive imports to purchase ETS permits to cover their embedded carbon emissions. If importers can prove that embedded emissions have been paid for in the country of origin of the imported goods, required CBAM permits [can be reduced](#) accordingly to account for the emissions price already paid. Other exemptions include generous offsets for free allowances provided to EU firms.

4 See United States Department of Commerce, "Decision Memorandum for the Final Results of the Countervailing Duty Administrative Review, 2019: Certain Cut-To-Length Carbon-Quality Steel Plate from the Republic of Korea," C-580-837 Investigation, December 23, 2021.

5 See United States Department of Commerce, "Issues and Decision Memorandum for the Final Affirmative Determination of the Countervailing Duty Investigation of Forged Steel Fluid End Blocks from the Federal Republic of Germany," C-428-848 Investigation, December 7, 2020.

Under phase three of the EU ETS (2013-2020), the allocation of free allowances in the industry sector was based on product benchmarks set at the average emissions intensity of the 10 percent most efficient installations within a (sub)sector, using 2007-2008 activity levels. Sectors deemed at-risk of carbon leakage received [free allocation at 100 percent](#) of the relevant benchmark while subsectors deemed not at risk had free allocation reduced gradually from 80 percent of the relevant benchmark in 2013 to 30 percent by 2020.⁶ 82 percent of allowances were allocated to the aviation sector for free, and 5 percent of the total allowances for phase three were reserved to assist new installations entering the EU ETS (or to cover installations that underwent a significant increase in production volume since the level of their free allowances had been set).

EU policymakers have been developing a plan to phase out free allowances over time in conjunction with the phasing in of the CBAM. The energy crisis of the past year, exacerbated by the Russian invasion of Ukraine, has complicated the task but increased the urgency of reducing fossil fuel consumption in Europe.

On June 14, 2022, the European Parliament's three biggest political groups—the center-right European People's Party, the centrist Renew Europe, and the Socialists and Democrats—along with the Greens, approved by [substantial majorities](#) a compromise deal on EU ETS reform. The European Parliament is now negotiating with the European Council and Commission to fine-tune the details and implementation schedule.

The prospective EU ETS and CBAM reforms are substantial. [For CBAM](#), the Parliament broadened the mechanism's scope and accelerated its implementation. In addition to the products covered by the initial European Commission proposal—iron and steel, cement, electricity, fertilizers, and aluminum—the CBAM will now cover organic chemicals, polymers, hydrogen, ammonia, and indirect emissions. The inclusion of organic chemicals and plastics, however, will depend on a [“Commission assessment of their technical specificities.”](#) The CBAM will begin on January 1, 2023 with a transitional period until the end of 2026 during which EU importers of Korean goods will have to provide information on embedded emissions; starting in 2026, importers would have to purchase emissions certificates. Assuming export rebates are WTO compliant, the Parliament also plans to allocate free allowances to the most efficient EU installations in the EU ETS for the emissions linked to products exported to non-EU countries that lack carbon pricing mechanisms.

As the fifth largest iron and steel exporter to the European Union in 2020—the most affected of the five sectors initially covered by the EU CBAM—Korea is among the top ten countries [estimated to be hardest](#) hit by the EU CBAM. The K-ETS will likely provide some relief, as Korean exporters to the European Union will have their required CBAM certificates reduced to account for the carbon prices they already paid in Korea. But a full exemption from the CBAM

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6 A sector was deemed at risk of carbon leakage if its direct and indirect cost increased by 30 percent or more, or if its non-EU trade intensity was 30 percent or more, or if its direct and indirect costs increased by 5 percent or more and its trade intensity was 10 percent or more. Cost intensity was determined by the following formula: $[\text{carbon price} \times (\text{direct emissions} \times \text{auctioning factor} + \text{electricity consumption} \times \text{electricity emission factor})] / \text{gross value added}$. Trade intensity was determined by the following formula: $(\text{imports} + \text{exports}) / (\text{imports} + \text{production})$. For more, see the EU Emissions Trading System (EU ETS) [factsheet](#) from the International Carbon Action Partnership.

is unlikely given large carbon price differences between the K-ETS and EU ETS. How hard Korea will be hit by the EU CBAM depends, in part, on the scope of the CBAM itself.

Under the initial proposal, the EU CBAM will be applied to direct emissions of five sectors: aluminum, cement, fertilizers, iron and steel, and electricity. These five sectors accounted for **\$3.6 billion** of 2021 Korean exports to the European Union, or 5.6 percent of total 2021 Korean exports to the European Union. If, however, CBAM coverage is expanded beyond the five categories in the original proposal to include organic chemicals, hydrogen, ammonia, polymers, and indirect emissions released during the production of electricity used in the production of CBAM-covered goods or upstream products (as approved by the European Parliament in June 2022 noted above), these additional four sectors affect as much as **\$6.4 billion** of 2021 Korean exports to the European Union, or 9.9 percent of total 2021 exports to the European Union. Indirect emissions coverage would be especially burdensome for Korea, as Korean energy installations are considerably less efficient than EU energy installations. Though the European Commission, Council, and Parliament still need to iron out differences in coverage, the phaseout of free allowances, and export rebates, the CBAM is set to begin on January 1, 2023 in both the Commission and Parliament proposals. The threat the EU CBAM poses to Korean exports is imminent.

WILL THE UNITED STATES LEGISLATE A CBAM?

On June 9, 2022, four Democratic senators—Sheldon Whitehouse (RI), Chris Coons (DE), Brian Schatz (HI), and Martin Heinrich (NM)—introduced the Clean Competition Act (CCA), which includes a [proposal](#) for a carbon border adjustment mechanism. The CCA pairs a border adjustment mechanism with a domestic carbon tax on certain high-emissions goods, including fossil fuels, petroleum products, fertilizer, cement, ethanol, iron and steel, pulp and paper, petrochemicals, aluminum, and glass, [among others](#). In 2026, the scope of covered imports would expand to include finished goods “containing at least 500 pounds of covered energy intensive primary goods,” and in 2028, that threshold would lower to 100 pounds.

Starting in 2024, US manufacturers would be taxed for emissions that exceed sector-specific baselines initially set at the industry’s average emissions intensity. Those baselines would decline by 2.5 percentage points annually for a four-year period beginning in 2025 and then by 5 percentage points annually starting in 2029. Importers’ emissions would be determined either by the carbon intensity of the relevant industry in the country of origin or by the carbon intensity of the country’s general economy, depending on data availability. Those determinations, in turn, would be made by the Treasury secretary in coordination with the administrator of the Environmental Protection Agency, the Energy and Commerce secretaries, the US Trade Representative, and the chair and vice chair of the US International Trade Commission. US importers of products from countries with reliable data, such as Korea, would have the option to petition Treasury to assess a charge based on the manufacturer’s emissions levels. Exporters, on the other hand, would receive rebates for taxes paid for covered primary goods that are exported from the United States. Carbon prices would start at \$55 per ton in 2024 and increase annually by 5 percent above inflation.

Passage of the CCA faces major obstacles. Bitter partisan differences over the imposition of carbon taxes suggests that the US political impasse over how to reduce GHG emissions is likely to continue.

The CCA covers a broader initial range of products than the EU ETS, including fossil fuels (coal, petroleum and products, and natural gas). Korea, however, is unlikely to face significantly higher costs under the CCA than under the EU ETS, and the impact would primarily be on Korean steel exports to the United States; it also would affect Korean exports of refined petroleum, which totaled about **\$2.3 billion** in 2020. Importantly, the sponsors of the legislation do not consider Korea a prime target of the prospective import charges. In a [June 22, 2022 floor speech](#) on CBAMs, Senator Whitehouse said that one goal of the CCA was to create a situation in which “the EU, the UK, Canada, Mexico, Japan, [and] perhaps South Korea, all [have] common carbon border adjustments, creating a common carbon pricing platform across all those major economies so that we move toward decarbonization.”

Several border adjustment measures have been floated in recent years, such as the [Coons-Peters bill](#) and the [Save Our Future Act](#), but failed to receive enough Republican support to secure passage. Passage of the CCA also faces major obstacles; in particular, disagreement over whether carbon taxes should apply to both domestic and imported products likely will stall legislative action in Congress this year and possibly until after the next presidential election in 2024. Ironically, the recent decision of the Supreme Court in [West Virginia v. Environmental Protection Agency](#) narrows the scope for regulatory measures that constrain GHG emissions from major power plants and thus increases the salience of adopting new legislation like the CCA to advance US decarbonization objectives. But bitter partisan differences over the imposition of carbon taxes suggests that the US political impasse over how to reduce GHG emissions is likely to continue. While bipartisan interest in developing a carbon border adjustment tax [is growing in the Senate](#), it is bound to fail if linked to new domestic taxes.

Indeed, the odds of CCA passage are slim and none if the Republicans regain either the House or the Senate in the November mid-term elections. Though Korean steel exports may not soon face new US carbon border tariffs, the United States will likely continue to apply special tariff-rate quotas on Korean steel exports under the dubious “national security” rationale of the Trump administration.

ADDRESSING TRADE AND CLIMATE RULES FOR GLOBAL STEEL TRADE

The Biden administration has been hard pressed to revoke the punishing [steel import restrictions](#)—both quotas and tariffs—introduced by former President Donald Trump in 2018 under the rationale that steel shipments from US allies such as Canada, the European Union, Mexico, and South Korea, among others, were undercutting US national security. To date, quotas applied to Korean steel exports have been maintained, limiting the volume of shipments to the US market by about 30 percent.

In October 2021, US and EU officials agreed to modify the US tariffs on EU steel and eliminate the EU retaliatory tariffs on specific US exports as of January 1, 2022. US tariffs have been replaced by quotas that allow the free flow of goods up to “historical levels” during a representative period before the Trump era; these quotas do not accommodate growth in trade and thus continue to restrict domestic US supplies, which in turn support higher prices for US steelmakers.

As part of the October 2021 agreement, the transatlantic partners launched talks on a “Global Arrangement on Sustainable Steel and Aluminum,” which

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seeks to mitigate global oversupply, address unfair trade practices, and reduce carbon emissions in the steel and aluminum sectors. The prospective pact would aspire to build a fair steel trade and climate club of countries that follow market-oriented policies toward each other and require stringent carbon-reduction standards by their industries. Presumably, this club would not include China. But it should include South Korea.

US Section 232 measures against Korean steel exports have long been the most restrictive of any measures on imports from US allies. Enlarging the quotas to make them comparable to those applied to EU steel in the context of a trade and climate deal could yield both economic and environmental benefits if linked to Korean commitments to reduce the carbon intensity of its steel production. This trade-climate linkage is important and should be a priority of US and Korean officials.

Lowering emissions from global steel production is a key component of plans to achieve the targeted emissions cuts promised at the Glasgow climate summit in November 2021. About 8 percent of global emissions derive from steel production; emissions could be reduced significantly by switching from traditional blast furnace and basic oxygen furnace (BF-BOF) production to electric arc furnace (EAF) and newer production technologies. For example, Korea's BF-BOF steel production generates about one-third higher CO₂ emissions per metric ton of steel produced than US and French producers and about 20 percent higher than German and Italian firms.⁷

However, emissions from Korean EAF steel production are comparable to those of German and French firms; Korean steelmaker POSCO [announced](#) new investments in EAF and green hydrogen production aiming to reduce emissions by 20 percent from 2017-2019 levels by the end of this decade. With these investments in greener steel production, Korea deserves a seat at the table negotiating an arrangement that establishes international rules for fair and sustainable steel trade. Such a pact could pave the way for reducing or eliminating special US (and EU) border measures against less carbon-intensive steel imports.

CONCLUSION

Both the European Union's proposed CBAM and the proposed CCA now before the US Congress could affect billions of dollars of Korean exports, starting as soon as January 1, 2023 in the case of the EU CBAM. Korean exporters cannot rely on the K-ETS nor on Korea's decade-old EU and US free trade agreements for protection, as emissions allowances are auctioned at significantly lower prices under the K-ETS than under the EU ETS and the FTAs contain broad exemptions for environmental protection. Given that current Korean steel production is carbon-intensive, it is likely to be targeted by both the EU CBAM and the CCA from the start.

Of the two EU CBAM proposals under consideration, Korea faces a much larger threat from the European Parliament proposal, which expands CBAM coverage beyond the five categories in the Commission proposal to include

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⁷ Data reflect production in 2016; see <https://www.belfercenter.org/sites/default/files/files/publication/how-clean-is-the-us-steel-industry-nv.pdf> (November 2019), accessed on June 27, 2022.

organic chemicals, hydrogen, ammonia, polymers, and indirect emissions released during the production of electricity used in the production of CBAM-covered goods or upstream products. The four additional sectors together would nearly triple the coverage of the original proposal, accounting for 15.3 percent of Korea's total exports to the European Union from 2019 to 2021. Irrespective of its coverage, the threat the EU CBAM poses to Korean exports is imminent: The CBAM is likely to require importers to buy emissions certificates starting on January 1, 2026.

Proposals for a US CBAM are much less developed and face tremendous obstacles in Congress, given both a lack of strong Republican support and bipartisan aversion to introducing domestic taxes ahead of the November 2022 mid-term elections. A new Supreme Court ruling constraining the use of regulatory measures to enforce cuts in GHG emissions further complicates the politics of new US climate legislation. Still, Korea actively faces two threats from the United States: (1) harsh tariff-rate quotas on Korean steel exports applied under the "national security" authority of Section 232 of US trade law that are more restrictive than measures imposed against European and other steel exporters and (2) countervailing duties from the US Department of Commerce. Korean participation in the US-EU talks on a "Global Arrangement on Sustainable Steel and Aluminum" could allow the resolution and phased removal of these restrictions in conjunction with efforts to reduce GHG emissions in steel production.



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