

## **The U.S.-South Korea Free Trade Agreement (KORUS FTA): Looking Ahead--Prospects and Potential Challenges**

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### Abstract

The KORUS FTA could present some immediate and longer-run benefits and challenges for the U.S.-South Korea relationship at large as well as the economic relationship. It also will likely present economic and political implications for the United States and South Korea individually. This article explores overall U.S.-South Korea relations, the KORUS FTA, and the agreement's potential prospects and implications.

**Keywords:** KORUS FTA, free trade agreements, the Republic of Korea, United States, U.S.-ROK economic relations, U.S.-ROK alliance, Kaesong Industrial complex.

## **Introduction**

At this writing, the Obama Administration appears to be close to introducing in Congress the draft implementing legislation for the U.S.-South Korea Free Trade Agreement (KORUS FTA). When the President has submitted the draft legislation to both houses of Congress, he will start a process of expedited (“fast-track”) procedures for congressional consideration of the free trade agreement (FTA)—a process that must be completed for U.S. obligations under the KORUS FTA to enter into force. He will also be bringing to its final stages a process that began in February 2006 when U.S. and South Korean officials announced their intention to launch negotiations on the KORUS FTA the following June.

The two sides completed those negotiations on April 30, 2007, in time to meet a deadline inscribed in the Trade Promotion Authority (TPA) statute. Yet, the negotiations were not quite completed. Negotiators returned to the table in order to include language on workers’ rights and environmental protection as stipulated in an understanding/agreement reached on May 10, 2007, between the Bush Administration and congressional leaders. This understanding applied to the other three pending FTAs—Colombia, Panama, and Peru (now in force)—as well. The KORUS FTA was signed on June 30, 2007. Nevertheless, the Bush Administration did not submit implementing legislation for the KORUS FTA to the 110<sup>th</sup> Congress because of strong opposition from some members of Congress and parts of the auto sector who viewed the KORUS FTA, as signed, as not sufficiently addressing South Korean barriers to U.S. exports of cars. Others opposed the agreement until a separate but parallel issue of South Korean restrictions on imports of U.S. beef from cattle older than 30 months was settled.

President Obama came into office supporting the view that auto industry concerns needed to be addressed. After several months of discussions, U.S. and South Korean negotiators agreed to modifications of the KORUS FTA largely on the auto provisions.<sup>2</sup> As a result, the auto industry and the United Auto Workers (UAW) agreed to support the agreement, as did many members of the business and agricultural communities and services providers who supported the agreement in its original version. Other labor groups have remained opposed as have representatives of import-sensitive industries. The fact that both sides were willing and able to return to the negotiating table to modify the agreement indicates the importance each assigns to its final approval.

The timing of congressional consideration of the KORUS FTA is now linked with the broader congressional and Obama Administration trade agendas that include consideration of the other two pending FTAs, trade adjustment assistance (TAA), and trade preference programs for developing countries.

The KORUS FTA could present some immediate and longer-run benefits and challenges for the U.S.-South Korea relationship at large as well as the economic relationship. It also would likely present economic and political implications for the United States and South Korea individually. This article explores the overall U.S.-South Korea relations, the KORUS FTA, and the agreement's potential prospects and implications.

### **U.S.-South Korea Economic Ties**

The U.S.-South Korea relationship is very strong and South Korea as arguably the closest U.S. ally in East Asia at the present time. Bilateral economic ties are a critical pillar of that relationship and have evolved over time from one between the 1960s and the 1990s in which the United States was the dominant partner to the present period in which South Korea has become, if not an equal partner, at least a partner approaching parity with the United States. While national security matters, especially the potential threat from North Korea, will likely be the highest priority in the alliance for some time, economic considerations will continue to gain importance. Securing the economic relationship is one of the major reasons the United States and South Korea have entered into the KORUS FTA.

South Korea is an important economic partner for the United States. In 2010, two-way trade between the two countries totaled \$86.9 billion, making South Korea the United States's seventh-largest trading partner. (**See Table 2**). South Korea, in fact, is among the United States's largest markets for agricultural products. Major U.S. exports to South Korea include semiconductors, machinery (particularly semiconductor production machinery), aircraft, and agricultural products. Among the leading U.S. imports from South Korea have been electronics products and passenger cars and car parts.

**Table 2. Annual U.S.-South Korea Merchandise Trade, Selected Years**

(billions of U.S. dollars)

Year	U.S. Exports	U.S. Imports	Trade balance	Total trade
1990	14.4	18.5	-4.1	32.9
1995	25.4	24.2	1.2	49.6
2000	26.3	39.8	-13.5	66.1
2003	22.5	36.9	-14.4	59.5
2004	25.0	45.1	-20.1	70.1
2005	26.2	43.2	-17.0	69.4
2006	30.8	44.7	-13.9	75.5
2007	33.0	45.4	-12.4	78.4
2008	33.1	46.7	-13.6	79.8
2009	27.0	38.7	-11.7	65.7
2010	38.0	48.9	-10.9	86.9
Major U.S. Export Items	Industrial machinery; chemicals; semiconductor circuits; corn & wheat; specialized instruments.			
Major U.S. Import Items	Cell phones; semiconductor circuits; cars & car parts; iron & steel.			

**Sources:** 1990 and 1995 data from Global Trade Information Services. 2000-2008 data from U.S. International Trade Commission. The 2000-2010 U.S. export data are for U.S. domestic exports and the data for U.S. imports are for imports on a consumption basis.

South Korea is far more dependent economically on the United States than the United States is on South Korea. In 2010, the United States was South Korea's third-largest trading partner--its second-largest export market and third-largest source of imports. The United States is South Korea's largest supplier of foreign direct investment (FDI).

A number of factors have been driving the two countries' economies together. One is the seeming complementarity of their economies. For example, the United States is well endowed with arable land and is a major producer and exporter of agricultural products, especially grains and meats. South Korea, by contrast, is resource-poor and is highly dependent on imported food. South Korea's limited agricultural sector is notoriously inefficient and survives through subsidies, protectionist trade policies and South Koreans' sense of cultural heritage. In 2010, the United States was South Korea's largest supplier of imported grains,

accounting for 64% of those imports. In the same year, it was the second largest supplier of imported meat and accounted for 32% of imports (while Australia accounted for 31%). Prior to the imposition of the South Korean ban at the end of 2003 on imported U.S. beef after the discovery of a BSE-infected cattle, the United States was the largest source of imported beef, far ahead of second place Australia.<sup>3</sup> Machinery products dominate U.S.-South Korean bilateral trade, both exports and imports. This pattern is another sign of the complementarity of U.S.-South Korean trade as a factor that binds the relationship. In 2010, 41% of U.S. exports to South Korea and 50% of U.S. imports from South Korea were in machinery, suggesting a large amount of intra-industry trade, including trade within production networks.<sup>4</sup>

Two more factors have contributed to the complementarity of the U.S.-South Korean trade relationship. One is the orientation of U.S. and South Korean economies and policies over the decades. Since the 1960s, successive South Korean governments have employed export-oriented economic growth policies. Understandably, South Korean policymakers determined that for a resource-poor economy, such as theirs, to grow, it would have to emphasize manufacturing, and, because it is a small economy, it would have to promote exporting in order to take advantage of economies of scale. These policies have largely worked, but they have required foreign markets that are receptive to their exports. Other advanced East Asian developing countries were in the same situation as South Korea and were employing similar, export-oriented policies, making them unlikely consumers of South Korean exports. Japanese regulations and trade practices to limit import penetration and Japan's emphasis on savings over consumption have limited its role as a market for South Korean exports. The United States, on the other hand, with its relatively open economy and high consumption rates has played a significant role in South Korean trade and South Korea's economic success. This complementarity, though, has generated tensions from time to time as U.S. policymakers and import-sensitive industries have denounced the seeming lack of reciprocity in U.S.-South Korean trade that has led to U.S. trade deficits with South Korea.

In addition to commercial and other economic factors, some political/national security interests have driven the economic relationship. The United States and South Korea have built a strong alliance rooted in the experiences of the Korean conflict and in mutual security needs in East Asia. During the 1980s, trade disputes frequently

erupted between the two countries, especially over South Korean practices and policies that the United States alleged were denying market access to U.S. exports. While the United States threatened to impose sanctions against South Korea, many analysts have argued the importance of maintaining the health of the overall alliance helped to temper the tensions.

### **The Declining Relative Importance of U.S.-South Korean Trade Ties**

U.S.-South Korea merchandise trade remains significant for both countries, but that significance has been decreasing over the last decade, reflecting the rise of China and other East Asian economies, globalization and the growth of transnational production networks. In 1999, the United States accounted for 20.5% of the value of South Korean exports, but that share declined to 10.7% in 2010. In 1999, Japan accounted for 11.0% of the value of South Korean exports but only for 6.0% by 2010. In contrast, China accounted for 9.5% of the value of South Korean exports in 1999 but for 22.0% in 2010. In addition, the rest of East Asia (Asia excluding Japan and China) has lost some of its importance as a market for South Korean exports, with its share of the market in terms of value declining from 23.1.0% in 1999 to 20.0 % in 2010.

The United States and Japan have also lost relative standing to China as sources of South Korean imports. In 1999, the United States accounted for 20.7% of the value of, and was the number one source for South Korean imports. In 2010, the U.S. share had dropped to 9.5% in terms of value, and the United States had declined to the third largest source of South Korean imports. In 1999, Japan was the second largest source of South Korean imports with a 20.1% share in terms of value. In

2010 it was still number two, but its share had decreased to 15.2%. On the other hand, in 1999 China ranked third as a source of South Korean imports with a 7.1% share but ranked first in 2010 with a 16.8% share. The rest of East Asia has maintained a relatively constant share of South Korean imports, accounting for 14% in 1999 and 14% in 2010.

Similarly, South Korea's shares of U.S. trade have declined. South Korea's shares of imports in terms of value have decreased somewhat over the years, from 3.1% in 1999 to 2.6% in 2010. South Korean shares of U.S. exports, by contrast, have remained fairly constant over the last decade. In 1999, South Korea accounted for 3.1% of the value of U.S. exports and for 3.0% in 2010.

Many analysts have suggested that the relative decline in the significance of the U.S.-South Korean bilateral trade may not be as great as the bilateral data show, because of the reported shift of South Korean production from its home base to China; from there products are shipped to the United States. However, data showing such triangular trade trends are difficult to develop, although the explanation is certainly plausible. Still the point remains: South Korea has become a less important partner to the United States in merchandise trade.

### **Other Trends in the Bilateral Economic Relationship**

While the significance of the United States and South Korea as partners in merchandise trade has slipped somewhat, their bilateral economic relationship has tightened in other areas, including services and foreign investment. It could be these areas that prove to have greater importance in the long-term. The United States is a global leader in producing services. From 1999 to 2010, the share of services in U.S. exports to South Korea increased from 24% to 28%. During that period, the share of service imports increased from 15% to 17%.<sup>5</sup>

Another trend in the bilateral economic relationship has been the growth in foreign direct investment (FDI). Because FDI usually involves investment in manufacturing facilities and other hard assets, it connotes a long-term commitment. Therefore, FDI trends can be considered an indicator of a firm economic relationship. The stock of U.S. direct investment in South Korea soared over 260% between 1999 and 2009 (latest U.S. data available), from \$7.5 billion to \$27.0 billion, according to U.S. data. This increase followed South Korea's 1997 financial crisis, which led to a devaluation of the Korean won and to market-oriented economic reforms. Similarly, the stock of South Korean direct

investment in the United States increased 344% during the same period, from \$2.7 billion to \$12.0 billion.<sup>6</sup> While South Korea accounts for small shares of U.S. FDI, the United States is the most significant source of foreign direct investment in South Korea. By 2010, it accounted for 32% of accumulated FDI in South Korea, ahead of Japan (15%).<sup>7</sup> The increased importance of services and foreign investment in the U.S.-South Korean economic relationship is reflected in the emphasis both countries placed on these two areas during the KORUS FTA negotiations and in the text of the agreement itself.

### **Shares of South Korean Inbound FDI, 1962-2010 (Cumulative)**

### **Overall U.S. and South Korean Objectives**

U.S. and South Korean policymakers have shared certain goals in launching and completing the negotiations on the KORUS FTA. Both governments have seen in the FTA a logical extension of an already important economic relationship that will provide a means by which the two trading partners can address and resolve fundamental issues, and, thereby, raise the relationship to a higher level. For the United States these issues have included high tariffs and other restrictions on agricultural imports. For South Korea, they have included perceived U.S. discrimination toward South Korean imports in the application of trade remedies and the treatment of products made at the Kaesong Industrial Complex in North Korea.

While sharing some broad objectives, U.S. and South Korean leaders have also approached the KORUS FTA from different perspectives as reflected in the conduct and outcome of the negotiations. A primary objective of the United States has been to gain access to South Korean markets in agricultural products, pharmaceuticals and medical

equipment, some other high-technology manufactured goods, and services, particularly financial and professional services—areas in which U.S. producers are internationally competitive but for which South Korean barriers have seemed high. South Korean trade barriers are much higher than those of the United States so an FTA would provide increased access to the South Korean market. The average South Korean tariff is 17.0%, while the average U.S. tariff is 3.5%.

For South Korea, gaining a large increase in market access has not been as critical a priority since South Korean exporters already have a significant presence in areas in which they have proved to be competitive—consumer electronics and autos, for example—and in which they already face only low or non-existent U.S. tariffs. South Korea has stood to gain increased access to a U.S. market of 310 million people compared to its domestic market of 50 million.

However, South Korea arguably did seek to preserve its share of the U.S. market in the face of growing competition from emerging East Asian producers, especially Thailand, Malaysia, Vietnam, and possibly China. South Korea has also aimed to improve its competitive position in the U.S. market vis-à-vis Japan where the elimination of even low tariffs might give South Korean exporters some price advantage.

Launching the FTA negotiations, in fact, was largely at the initiative of South Korea. Its main objective in securing an FTA with the United States was much broader than gaining reciprocal access to the U.S. market. Entering an FTA with the United States meshed with a number of former South Korean President Roh Moo-hyun's long-term economic and strategic goals. Roh made an FTA his top economic priority during his presidency, which expired in February 2008.<sup>8</sup> Soon after his election in 2002, Roh committed himself to raising South Korea's per capita gross domestic product (GDP) to \$20,000 by the end of the decade and to transforming South Korea into a major "economic hub" in Northeast Asia by expanding the economic reforms begun by his predecessor following the 1997 Asian financial crisis. Ongoing competitive pressure from Japanese firms, increased competition from Chinese enterprises, and the rapid ageing of the South Korean workforce have heightened the sense of urgency about boosting national competitiveness. Continuing along this line of thinking, ex-Prime Minister Han Duk-soo has said that a failure to adopt significant economic changes will mean that "Korea's long term growth potential is likely to deteriorate."<sup>9</sup> Lee Myung-bak, who was elected President in December 2007, made the economy the

centerpiece of his campaign and has supported the KORUS FTA as part of a larger program to promote South Korean economic growth.

During the negotiations, South Korean officials and other South Korean proponents of the KORUS FTA tended not to focus on the increased access to the U.S. market. Rather, they emphasized the medium and long-term gains that would stem from increased allocative efficiency of the South Korean economy, particularly in the services industries. These would presumably be brought about by an influx of U.S. investment and technology into South Korea and by the spur of increased competition with U.S. firms.<sup>10</sup> Senior officials in particular emphasized the need to boost the competitiveness of South Korean service industries. An FTA with the United States, they argued, would help address South Korea's increased economic polarization by spurring job creation in fields such as medical, legal, education, and accounting in a free trade agreement.<sup>11</sup> Some, however, say an FTA will worsen South Korea's income gap.<sup>12</sup> Also, during the talks, there were continuous and often large scale anti-FTA protests, generally led by South Korean farmers and trade unionists.

The absence of mirror-image or reciprocal U.S. and South Korean objectives in the negotiations is reflected in the structure of the KORUS FTA. Except for some provisions dealing with issues specific to U.S.-South Korea economic relations, for example, South Korea taxation of autos and the Kaesong industrial complex, the structure of the KORUS FTA largely resembles the structure of other FTAs, such as Dominican Republic-Central American FTA (DR-CAFTA) that the United States has entered into. This conclusion does not suggest that South Korea has not brought to the table its own specific demands, which it has (such as the exclusion of rice) and has held to them firmly.

Furthermore, the KORUS FTA would have important diplomatic and security implications. Some argue it could help to boost the U.S.-South Korean alliance over the medium and longer term by deepening bilateral economic and political ties. However, in concrete terms, it is difficult to see how the KORUS FTA would make a significant difference in the strategic relationship, as it is unlikely to alter either country's fundamental interests on the peninsula or in Northeast Asia. In contrast, while the passage of the KORUS FTA is unlikely to have a major substantive impact on the strategic relationship, a collapse of the KORUS FTA would probably have a profound symbolic effect, particularly upon the way policymakers in the two countries view the

alliance. Many might see it as a betrayal of trust, particularly since leaders on both sides made politically costly decisions to reach a final agreement. Moreover, if the KORUS FTA were to fail in the United States, some Korean politicians and policymakers believe this would lend credence to arguments in South Korea that the U.S. commitment to Korea and Northeast Asia is declining. If these perceptions take hold, it would increase the political costs of South Korean leaders' taking unpopular decisions on behalf of the alliance, such as increasing South Korean payments for relocating U.S. troops on the Korean peninsula.

In many respects, the fate of the KORUS FTA may go beyond strengthening U.S.-South Korea ties and have profound implications for U.S. trade policy and the future course of East Asian economic institutions. For instance, some have suggested that a KORUS FTA would help to solidify the U.S. presence in East Asia to counterbalance the increasing influence of China. Additionally, many East Asian leaders see such a move as a sign that the United States is disengaging from East Asia, where most countries are pursuing a variety of free trade agreements. South Korea has perhaps been the most aggressive in this FTA push. As part of its effort to institutionalize the U.S. economic presence in East Asia, the Obama Administration has been pursuing a regional Trans-Pacific Partnership (TPP) negotiation among nine countries in the Asia-Pacific.<sup>13</sup> A failure to ratify the KORUS FTA could make it much more difficult for the TPP talks to succeed.

### **The KORUS FTA in Summary**

A major U.S. and South Korean objective in concluding the KORUS FTA has been to deepen the bilateral economic relationship by eliminating tariffs, reducing other trade barriers, establishing rules on foreign investment, ensuring protection of intellectual property rights, and improving market access for trade in services. The two countries have also sought to strengthen the relationship by resolving politically difficult issues that have lingered over decades and have prevented the two countries from forging even closer ties. For the United States these issues have included the huge and growing imbalance in the trade in autos and perceived South Korean barriers to auto imports and to high tariffs and other South Korea restrictions on agricultural imports. For South Korea, these difficult issues have included perceived U.S. discrimination toward South Korean imports in the application of trade remedies and treatment of products made at the Kaesong Industrial

Complex (KIC) in North Korea. South Korean economic reformers have viewed the KORUS FTA as a means to promote economic liberalization in their country.

The KORUS FTA appears to have addressed many of these issues. The agreement is very comprehensive, covering a broad range of trade and trade-related activities. It follows the template the United States has used in most of its FTAs with modifications to fit the relevant bilateral trade relationship. It may set the standard for future South Korean FTAs. In fact, the EU-South Korea FTA that went into effect on July 1, 2011, closely resembles the KORUS FTA in many respects.

In agriculture, the United States obtained South Korean concessions to eliminate tariffs on most agricultural products, including sensitive goods such as dairy products, and beef and citrus fruits, either immediately or over time. For example, South Korea agreed to eliminate its 40% tariff on beef imports over a 15-year period. The two sides also managed to address successfully the issue of U.S. exports of oranges to South Korea. For its part, the United States has acceded to South Korean wishes to allow it to maintain restrictions on rice. (South Korea is already committed to eliminating these restrictions under a multilateral agreement under the World Trade Organization (WTO).) The U.S. agriculture community has supported the KORUS FTA despite the fact that the agreement does not include rice nor have parallel negotiations completely settled the issue of South Korean restrictions on imports of U.S. beef as a result of the BSE discovery in 2003.

Also, each country has made concessions in auto trade. The United States has agreed to eliminate its 2.5% tariff on South Korean passenger vehicles and to phase out the 25% tariff on pickup trucks. South Korea has agreed to eliminate its 8% tariff on U.S. passenger cars, to reduce the discriminatory effects of its engine displacement taxes, to amend emissions standards for some U.S.-exported cars, and to allow the United States to return to, or “snap back” tariffs, on cars to their original MFN level if South Korea does not abide by its commitments on auto trade under the KORUS FTA.

Importantly, when discontent from some members of the auto sector helped to delay the approval process in the United States, both sides, especially South Korea, agreed to modifications in the agreement. For its part, South Korea allowed the United States to delay the removal of its 2.5% tariff on passenger cars until the fifth year of the agreement and to delay the phase out of its 25% tariff on trucks, which was originally to

begin the first year the agreement is in force, until the eighth year. It would then be phased out in three-year periods. South Korea also agreed to amend provisions to allow more U.S.-made cars to be imported into South Korea under U.S. safety and emission standards, as opposed to South Korean standards, potentially facilitating U.S. cars sales. In return, the United States allowed South Korea to delay the removal of its 8% tariff on car imports and to delay the removal of its tariff-rater quota on pork imports.

Furthermore, under the KORUS FTA the United States and South Korea agreed to liberalize trade in services. The KORUS FTA, like some other U.S. FTAs, adopts the “negative list” approach to services; that is, the assumption is that a service would be covered under the agreement unless specifically listed as an exception, making the default trade liberalization. This approach is in contrast to the “positive list” used in the WTO’s General Agreement on Trade in Services (GATS) in which the assumption is that a service is not covered for liberalization unless it is specifically listed. This step has required concessions more from South Korea than from the United States as the U.S. market is largely open. But it means that the United States could realize opportunities in South Korea’s burgeoning market for financial and professional services. Some representatives of U.S. service providers consider the KORUS FTA a model for future FTAs.

Foreign investment has been a sensitive issue in U.S.-South Korean relations for many years as U.S. investors have tried to make inroads into the South Korean economy. U.S. investors’ criticisms have included restrictions on foreign investment in key sectors, such as communications, and the lack of adequate protection for intellectual property. The two countries have tried to negotiate a bilateral investment treaty (BIT), but the negotiations collapsed largely over U.S. opposition to South Korea’s so-called screen quota on domestic films and the latter’s resistance to lifting or reducing it. Among other things, the FTA has set down general principles of non-discrimination for the treatment by South Korea and the United States of investors and investments from one partner the other. Similar to other U.S. FTAs, the KORUS FTA would establish procedures for the settlement of investor-state disputes involving investments covered under the agreement in which the investor from one partner-country alleges that the government of the other partner-country is violating his rights under the FTA. In addition to these provisions, the KORUS FTA would establish rules and procedures on

labor rights and environmental protection, government procurement, trade remedies, and intellectual property rights.

One of South Korea's major objectives during the KORUS FTA negotiations was to ensure that products from the Kaesong Industrial Complex (KIC) would benefit from preferential treatment accorded to South Korean products under the FTA. The U.S. strongly objected to such a proposal and South Korean insistence proved to be one of the most difficult stumbling blocks threatening to derail the negotiations. The two sides managed to produce a compromise that seemed to address their respective concerns. It required the two countries to establish a committee a year after the KORUS went into effect so that the FTA could study the possibility of including products from industrial zones inside North Korea. Before such products would be considered, provisions required that conditions in the industrial zones (including the KIC) had to meet a list of criteria, including acceptable working conditions. They also required that the South Korean National Assembly and the U.S. Congress approved any proposal by the committee to include products from any North Korean-based industrial zone.

### **Potential Economic Impact of the KORUS FTA**

Economists have released several studies estimating the potential effects of the KORUS FTA. As required by the TPA statute, the USITC conducted a study in 2007 of the KORUS FTA at the request of the President.<sup>14</sup> The USITC study concluded that U.S. GDP would increase by \$10.1 billion to \$11.9 billion (approximately 0.1%) if the KORUS FTA were fully implemented, a negligible amount given the size of the U.S. economy. The USITC based this estimate primarily on the removal of tariffs and tariff-rate-quotas, that is, barriers that could be relatively easily quantified. The study concluded that U.S. exports of goods would likely increase by \$9.7 billion to \$10.9 billion, primarily in agricultural products, machinery, electronics, and transportation equipment, including passenger vehicles and parts. U.S. imports would increase \$6.4 billion to \$6.9 billion, primarily in textiles, apparel, leather products, footwear, machinery, electronics, and passenger vehicles and parts.<sup>15</sup>

This list did not take into account the impact of the reduced barriers services and foreign investment flows and the impact of changes in regulations as a result of the KORUS FTA. The study noted that U.S. exports in services would increase as a result of South Korean commitments under the KORUS FTA, and that changes in the regulatory

environment in both countries would also help to increase bilateral trade and investment flows.

The study estimated that changes in aggregate U.S. employment would be negligible given the much larger size of the U.S. economy compared to the South Korean economy. However, while some sectors, such as livestock producers, would experience increases in employment, others such as textile, wearing apparel and electronic equipment manufacturers would be expected to experience declines in employment.<sup>16</sup>

Other studies have drawn the same basic conclusions, although the magnitudes differ because they employ different models from the USITC study. For example, a University of Michigan analysis commissioned by the Korea Economic Institute estimated that U.S. GDP would increase by \$25.12 billion (0.14% of U.S. GDP). This was larger than the USITC estimate, but, in part, this was because its authors quantified the effects of liberalization in the services trade.<sup>17</sup> The authors also analyzed the impact of a KORUS FTA before the final text had been released and assumed, among other things, that the rice trade would be liberalized, which, in the end, was not the case.

In December 2005, the Korea Institute for International Economic Policy (KIEP) published a study measuring the potential economic impact of a U.S.-South Korean FTA on South Korea alone. The study estimated some of the dynamic, or long-run, economic effects in addition to the static, or one-time, effects of the FTA on South Korea. The KIEP study estimated that the FTA would eventually lead to a 0.42% to 0.59% increase in South Korea's GDP, according to a static analysis, and 1.99% to 2.27%, according to a dynamic analysis.

## **Prospects and the Views of the Stakeholders**

In order for the KORUS FTA to go into effect, both the South Korean National Assembly and the U.S. Congress must approve it. The KORUS FTA is eligible for expedited (fast-track) U.S. congressional consideration under the Trade Promotion Authority (TPA), that is, time-limited committee consideration, guaranteed floor action, limited debate, and no amendments. Under TPA, the legislative procedures begin when the President submits the draft implementing legislation to each house of Congress, the timing of which is at presidential discretion. As of this writing, the President has sent the agreement to Congress. The timing of the National Assembly's consideration of the KORUS FTA is not certain

either, although National Assembly leaders have indicated they will consider the agreement only after the U.S. Congress has acted.

Another factor that must be taken into account is that the timing of congressional consideration of the KORUS FTA is also interlinked a broader trade agenda. That agenda includes renewal of an expired Trade Adjustment Assistance (TAA) program; a program was enacted in 2009 as part of a government stimulus program in response to the global financial crisis and economic downturn. The White House and Democratic leaders have indicated that, until a deal is worked out to reinstate the program, the KORUS FTA and the other two FTAs will not be submitted to Congress. Republican members have argued that the TAA program is too expensive under current U.S. budget constraints and that delaying the consideration of the FTAs will cause U.S. farmers, ranchers, and firms to lose business to competitors. The trade agenda also includes renewal of the expired Generalized System of Preferences Program (GSP) and the Andean Trade Preferences Program for developing countries.

In South Korea, the ruling Grand National Party's (GNP) losses in the April 2011 bi-elections have further complicated consideration of the KORUS FTA, as some newly assertive members of the GNP reportedly are not only less enthusiastic about the agreement than other GNP members, but also appear reluctant to ram the agreement through the National Assembly. If this group holds sway over GNP decision-making, it likely will give more influence to South Korea's main opposition party, the Democratic Party (DP). Most DP members oppose the KORUS FTA. Some DP members argue that the Lee government conceded too much to U.S. concerns in the December 3, 2010 modifications and did not receive adequate concessions from the United States. In addition, South Korean farmers remain a vocal element and oppose the KORUS FTA as a threat to their livelihood because of increased competition from U.S. imports.

In the United States, the prospects for passage of the KORUS FTA implementing legislation in Congress will be influenced by the relative strength of the views and political clout of those with the largest stake, both positive and negative, in the agreement. Not surprisingly, those who stand to benefit the most from the agreement have expressed strong support while those who would benefit the least or who could be adversely affected by the agreement oppose its approval.

Most of the U.S. business community supports the KORUS FTA. However, two of Detroit's big three auto manufacturers—Chrysler and

Ford—opposed the agreement when it was initially signed on June 30, 2007, because, they argued, the agreement did not address adequately market access in South Korea for U.S.-made cars. General Motors took a neutral position reflecting its large investments in Daewoo Motors. As a result of the December 3, 2010, modifications, all three auto manufacturers now support the agreement as does the United Auto Workers (UAW) union. That shift would appear to have increased the likelihood that the KORUS FTA will be approved. Many other manufacturing sectors also approve of the agreement.

U.S. agriculture producers are also pressing for approval, even though the beef access issue remains unresolved. This support reflects the gains they expect to realize from the removal of South Korean tariffs, tariff-rate quotas, and other restrictions.

As part of the December 3, 2010, agreement, South Korea and the United States agreed to engage in discussions on South Korean imports of U.S. beef from cattle older than 30 months. U.S. beef producers and some members of Congress have argued that U.S. beef from cattle older than 30 months meet international standards for BSE risk and should be allowed to be sold in South Korea. The agreement to hold future discussions on this issue appear to be an acceptable compromise between South Korea's allowing the U.S. beef to be imported, a position that would be politically unacceptable in South Korea, and maintaining the status quo, a position that would have been unacceptable to influential members of Congress and would likely have scuttled any action on the KORUS FTA in Congress.

The KORUS FTA, however, is opposed by a number of labor unions, including the AFL-CIO, the International Association of Machinists (IAM), and United Steel Workers (USW). Their opposition is largely consistent with their positions on most of the other U.S. FTAs. It is based on their concerns about the increased competition from increased imports of South Korean steel and other products. Labor unions also criticize provisions in the KORUS FTA and other U.S. FTAs to facilitate foreign direct investments. They argue that such provisions encourage U.S. multinational corporations to shift production overseas, thereby reducing employment opportunities in the United States at a time when unemployment is high.

## Potential Challenges

The final outcome of the debate on the KORUS FTA remains unclear at this writing. It is the subject of political jousting in both countries. Whatever the outcome, the FTA presents some possible challenges for policymakers.

### Keeping Expectations of the FTA in Perspective

At the macroeconomic level and in the short-to-medium term, the KORUS FTA is expected to have a modest impact on trade and investment flows. The economic complementarities that have driven the bilateral economic relationship will continue to be in place; a KORUS FTA is likely to affect the pace, rather than the direction, at which U.S.-South Korea economic ties expand. In the longer run the agreement will likely have a larger impact, primarily by virtue of its dynamic effects on the South Korean economy.

This implication raises a challenge faced by policymakers and other stakeholders on both sides of the debate, and that is not to exaggerate the expectations of the agreement. For example, advocates and opponents have produced numbers on jobs either gained or lost once the KORUS FTA goes into effect. In both cases, these numbers are based on assumptions and models that may not stand up to standard economic analysis.

One such standard model, used by the USITC, has concluded that the KORUS FTA will likely have only a modest impact on employment with sectors that are expected to gain, such as agriculture and autos, realizing some growth in employment while sectors adversely affected, such as textiles, seeing declines. The study does not specify numbers. Levels of employment are determined by a number of factors that become difficult to model.

It can also be argued that even if the KORUS FTA were not to enter into force, U.S. and South Korean trade and investment flows would continue. The United States is a large market for South Korean trade and investment and South Korea is a critical economy in East Asia, and, therefore, an important market for the United States. The KORUS FTA, however, would facilitate and increase those flows and would symbolize the importance of this bilateral relationship.

## **The Long-term Relevance of the KORUS FTA and the Bilateral Economic Relationship**

The rapid pace of economic globalization that has resulted from the growth of communication and transportation technologies raises questions regarding the value of traditional structures for trade and trade policy. For example, globalization has led to the emergence and growth of transnational networks in which the production processes for final goods are divided into discrete segments. The expansion of the internet and rapid transportation allows some segments of the production—from design to final assembly—to be carried out in various countries in order to take into account different comparative advantages. East Asia, especially China, has been an increasingly important focal point for production networks. The multinational production of goods might call into question the relevance of bilateral state-to-state arrangements, such as FTAs, and raise the importance of regional agreements. The Trans-Pacific Partnership (TPP) is such an arrangement for the United States.

Similarly, globalization and the rise of China raise the issue of the long-term relevance of the U.S.-South Korean bilateral economic relationship. On the one hand, the raw trade data numbers would indicate that the relevance has declined and that China has become an overshadowing figure for both the United States and South Korea. On the other hand, South Korea's emergence as a fully-developed and affluent economy and producer of world-class manufactured goods indicate that South Korea will continue to be an important U.S. partner. Likewise, the size of the U.S. market argues for its continued importance to South Korea.

Furthermore, as the United States and South Korea continue to negotiate FTAs with other countries, the relative significance of the trade preferences under the KORUS FTA will conceivably be reduced. For example, the EU-South Korean agreement that began on July 1, 2011, will arguably reduce the gains that the United States would have achieved in the absence of the FTA with the EU, a group of economies whose firms closely compete with the United States. South Korea is close to completing an FTA with Australia whose beef producers stand to acquire the same preferential treatment U.S. beef producers will enjoy under the KORUS FTA.

## **The Future of the Multinational Trade System**

The increasing use of FTAs by major countries such as the United States and South Korea generates questions about the long-term viability of the World Trade Organization (WTO). This question is especially timely with the news coming from Geneva about the difficulties that WTO members are having in completing the Doha Development Agenda (DDA) round of negotiations. On the one hand, the KORUS FTA could be viewed as an important building block to a stronger, more viable trading system. The agreement addresses issues, such as foreign investment, services trade, and agriculture that have not been feasible to address in the multilateral negotiations. On the other hand, the importance that the United States and South Korea have placed on the KORUS FTA and other FTAs would suggest that the two countries see them as the preferred path to trade liberalization.

## **Emerging and Outstanding Issues**

The evolving debate on the KORUS FTA poses issues related to the agreement that could continue, whether or not it enters into force. One such issue pertains to the imports of goods from North Korea. Starting in 2011, many opponents of the KORUS FTA began to warn that the agreement could increase imports from North Korea if South Korean firms re-export items made in the Kaesong Industrial Complex (KIC), a seven-year-old industrial park located in North Korea. There, more than 100 South Korean manufacturers employ over 45,000 North Korean workers. Although the agreement's benefits do not extend to the KIC, two concerns expressed by critics are: (1) that South Korean firms could obtain low-cost KIC-made goods or components, incorporate them into finished products and then reship the goods to the United States with "Made in [South] Korea" labels so that they would receive preferential treatment under the KORUS FTA; and, (2) that such exports would benefit the North Korean government.

Imports from North Korea—including goods that contain North Korea components -- require approval from the Treasury Department's Office of Foreign Assets Control (OFAC). North Korea's relative economic isolation and U.S. restrictions have resulted in less than \$350,000 in U.S. cumulative imports from North Korea since 2000. Notwithstanding such arguments, the KORUS FTA appears likely to have only a minimal impact on whether U.S. sanctions on North Korean imports are put to the test. Instead, the most significant factors likely to

determine whether U.S. restrictions on North Korean imports are tested are: 1) the quality of U.S.-South Korean customs controls, cooperation, and enforcement; and, 2) whether North Korea, one of the world's most isolated countries, becomes integrated into the global economy.

That said, the persistence of the Kaesong issue in the KORUS debate on Capitol Hill shows how concerns about North Korea could spill over into the U.S.-South Korea economic relationship. This dynamic would likely be amplified if a future South Korean government is more aggressive about economically engaging North Korea, for instance by dusting off plans to embark on a major expansion of the Kaesong complex.

In addition, opponents of the KORUS FTA have argued that provisions of the agreement pertaining to financial services could undermine the sovereignty of the United States and the ability of the U.S. government to ensure the viability of the U.S. financial system. This criticism rests on the claim that South Korean financial service providers could challenge those regulations, such as Dodd-Frank regulations, under the FTA. Supporters argue that the FTA does not prohibit either government from imposing regulations for prudential reasons. Similarly, opponents argue that the investor-state dispute settlement provision of the KORUS FTA would give private South Korean investors greater rights to challenge U.S. government measures than those accorded private U.S. investors. Proponents counter that the dispute settlement mechanism applies only to measures that violate the FTA, such as non-discrimination provisions, and that the FTA specifically states that foreign investors would not be given greater rights than U.S. investors. While these issues have been raised in debates over previous FTAs, the KORUS FTA is the first FTA since NAFTA with an advanced country (i.e., Canada) to which these issues may have significance. They could be raised during implementation of the KORUS FTA.

#### **Notes:**

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<sup>1</sup> William Cooper is a specialist in International Trade and Finance with the Congressional Research Service and Mark Manyin is a specialist in Asia Affairs with the Congressional Research Service. The views expressed are those of the authors and do not necessarily represent the views of the Congressional Research Service, the Library of Congress, or the U.S. Congress.

<sup>2</sup> The negotiators agreed to address the beef issue in separate discussions.

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<sup>3</sup> Global Trade Information Systems.

<sup>4</sup> Figures are derived from U.S. Department of Commerce data maintained by U.S. International Trade Commission (USITC) data base.

<sup>5</sup> U.S. Department of Commerce, Bureau of Economic Analysis.

<sup>6</sup> Authors' calculations are based on data from the Department of Commerce, Bureau of Economic Analysis.

<sup>7</sup> CRS calculations are based on data from the Republic of Korea, Ministry of Knowledge Economy.

<sup>8</sup> "ROK Editorial: Roh's 'Special Lecture,'" *The Korea Times*, posted on the Open Source Center, KPP20060329042002, March 29, 2006.

<sup>9</sup> Ministry of Finance and Economy Weekly Briefing, "Korea-US FTA Projected to Boost the Korean Economy," March 9, 2006.

<sup>10</sup> See, for instance, Junkyu Lee and Hongshik Lee, *Feasibility and Economic Effects of a Korea-U.S. FTA* (Seoul: Korea Institute for International Economic Policy, 2005), 116-117; Inbom Choi and Jeffrey Schott, *Free Trade between Korea and the United States?* (Washington, DC: Institute for International Economics, 2001), 79-82.

<sup>11</sup> "Roh's 'Special Lecture,'" *The Korea Times*, March 26, 2006.

<sup>12</sup> Korea Broadcast System, March 31, 2006.

<sup>13</sup> The nine countries involved in the TPP talks are Australia, Brunei Darussalam, Chile, Malaysia, New Zealand, Peru, the United States, Singapore, and Vietnam.

<sup>14</sup> Section 2104(f) Trade of 2002. P.L. 107-210. United States International Trade Commission (USITC). *U.S.-Korea Free Trade Agreement: Potential Economy-wide and Selected Sectoral Effects*. Investigation No. TA-2104-24. USITC Publication 3949. September 2007. (Hereafter referred to as USITC [2007].) In March 2011, the USITC released a study updating its analysis of the KORUS FTA's impact on the U.S. passenger vehicle market as a result of the December 2010 modifications, *U.S.-Korea Free Trade Agreement: Passenger Vehicle Sector Update*, Investigation No. 332-523, USITC Publication 4220, March 2011.

<sup>15</sup> USITC (2007), xvii-xviii.

<sup>16</sup> USITC (2007), xix.

<sup>17</sup> Kiyota, Kozo and Robert M. Stern. *Economic Effects of a Korea-U.S. Free*

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*Trade Agreement.* (Korea Economic Institute, Special Studies 4, 2007).