

Tensions in U.S.-Korea Economic Relations

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Abstract

Following a relatively successful period for U.S.-South Korea economic relations under the Bush and Obama administrations, Washington and Seoul have entered a new period of economic tension in the Trump administration. Unlike prior U.S. presidents, who placed a priority on negotiating fair rules in the United States' economic relationships, President Trump has prioritized outcomes. As a result, one of his administration's earliest moves was to renegotiate the KORUS Free Trade Agreement. While the results of the renegotiation were modest, they may help to expand the sale of American automobiles in the Republic of Korea in the long-run. The largest outcome of the negotiations may be to protect the Ford Motor Company from South Korean competition in the U.S. market as the company transitions to sales focused on light trucks. While the renegotiation has eased tensions for the moment, the prospect of economic engagement with North Korea, the Trump administration's continued use of national security to erect trade barriers, and the emergence of new technologies such as artificial intelligence and autonomous vehicles could result in growing tensions in the relationship.

Keywords: United States, South Korea, North Korea, U.S.-Korea Free Trade Agreement, KORUS FTA, Trump administration, Section 232, trade policy

Introduction

Following a relatively successful period under U.S. presidents George W. Bush and Barack Obama, the U.S.-South Korea economic relationship was shaken up under Donald Trump. While the Bush and Obama administrations negotiated the U.S.-Korea Free Trade Agreement (KORUS FTA), improving the two countries' economic relationship, President Trump considered the agreement, along with the North American Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership, unfair to the United States. His administration has also taken a more confrontational approach to trade, creating tensions in the alliance.

How Is the Trump Administration’s Approach to Trade Different than Prior U.S. Administrations?

As a candidate and president, Donald Trump has had a profound impact on how trade is discussed in the United States. Since at least the 1980s, he has held views on trade that are closer to protectionism in the post-WWII discourse on trade than the free trade policies espoused by more recent administrations. President Trump’s use of rhetoric such as “America First” or “Make America Great Again” reflects a desire to make a substantial shift in a range of American policies. From his perspective, the United States should place its interests above those of others, and ground trade and foreign policy in protecting American workers, companies, and jobs.¹ For the Trump administration, “the world is not a ‘global community,’” but an arena where nations “compete for advantage.”²

Rhetorically speaking, President Trump is perhaps not as far outside the mainstream of U.S. politics as some might conclude. In his 1980 campaign, Ronald Reagan used the slogan “Let’s make America Great Again,”³ perhaps the inspiration for Trump’s “Make America Great Again.” The rhetorical similarities extend to Trump’s language on trade. On the campaign trail, he called for fair trade and viewed himself as a fair trader. In his first address to Congress, President Trump remarked, “I believe strongly in free trade, but it also has to be fair trade.”⁴ In more recent remarks, he suggested that trade should be reciprocal.⁵ The rhetoric of fair trade is not unique to Donald Trump. When signing NAFTA, President Bill Clinton said, “We will insist that expanded trade be fair to our businesses and to our regions,”⁶ In 1996 Hillary Clinton remarked that “I think everybody is in favor of free and fair trade.”⁷

However, what has made President Trump different from his predecessors is his framing and objectives when it comes to trade. President Reagan spoke of “mutually beneficial relations” with allies in his inaugural address.⁸ In contrast, President Trump has taken a more nationalistic tone in calling for foreign affairs to “benefit American workers and American families,”⁹ regardless of the impact on Washington’s friends and allies. He has abandoned the idea that policies can be mutually beneficial, while shifting the political debate in the U.S. on the meaning of fair trade from rules-based to outcome-based agreements. President Trump no longer defines “fair” to mean everyone competing under the same rules and that American exporters not facing

unfair trade practices in foreign markets. Rather, he views trade through the lens of absolute gains rather than relative gains.

While other candidates, to include Clinton and Obama, moved to more pro-trade policies once in office, President Trump has acted on his campaign rhetoric since becoming president. Although the Trump administration has yet to pursue some of the more extreme promises made on the campaign trail—such as placing a 35 percent tariff on American companies that move production overseas¹⁰ or levying a 45 percent tariff on all Chinese goods to bring down the trade deficit¹¹—it has nonetheless followed throughout on many campaign pledges. Early actions include renegotiating NAFTA and the KORUS FTA. President Trump has taken on China as well, placing tariffs on \$250 billion worth of Chinese exports to date to pressure Beijing to end its theft of U.S. intellectual property and unfair trade practices.¹²

However, his focus on the trade deficit, and specifically the renegotiation trade agreements as a tool to reduce the trade deficit, will likely be unsuccessful in the end. The size of the U.S. trade deficit is determined by domestic savings and consumption. As long as businesses, consumers, and the U.S. government continue to consume more than they save, the United States will run a trade deficit.¹³ FTAs play a marginal role in shaping trade flows and are primarily about establishing the rules of trade.

Why did the Trump Administration Push to Renegotiate the KORUS FTA?

During the presidential campaign, then-candidate Trump consistently criticized the KORUS FTA as a “horrible”¹⁴ deal and argued that the agreement had cost the United States upwards of 200,000 jobs.¹⁵ While the jobs claim was double the estimate in a study by the Economic Policy Institute that candidate Trump cited, his concerns with the KORUS FTA predate both his presidential campaign and his administration’s decision to renegotiate the agreement. A significant portion of his concerns with the KORUS FTA appear in his 2011 book, *Time to Get Tough: Make America Great Again*, another theme which predates his presidential campaign.¹⁶

The KORUS FTA is America’s most modern FTA and one of the few agreements with an advanced economy. Nonetheless, the U.S. trade deficit with the Republic of Korea (ROK) has also risen since the agreement came into effect. Since 2001, the U.S. merchandise trade deficit with South

Korea has grown from \$12.4 billion to a high of \$28 billion in 2015 before declining to \$22.9 billion in 2017.¹⁷ Though the Trump administration is largely focused on merchandise trade, the U.S. surplus in services has expanded from \$7 billion in 2011 to \$12.2 billion in 2017, reducing the overall U.S. bilateral trade deficit to \$10.3 billion.¹⁸

In addition to the increased trade deficit, the implementation of the KORUS FTA raised issues as well. The Korean Customs Service began conducting import verifications in a manner that raised concerns that American goods such as automobiles, frozen concentrated orange juice, and other items weren't receiving the reduced tariffs they were due.¹⁹ The issues related to orange juice symbolized the challenges faced by that U.S. exporters. Although customs authorities were given tours of American facilities to demonstrate that the items qualified for tariff benefits, Korean officials took time to resolve the issue.

The increased trade deficit and implementation issues notwithstanding, there was an expectation that the Trump administration would focus on NAFTA during its first year in office. Within Asia, many believed the new administration would push to start negotiations on an FTA with Japan rather renegotiate the KORUS FTA. Instead the Trump administration quickly moved to revise the KORUS FTA following the impeachment of South Korean President Park Geun-hye. After his first summit meeting with President Moon Jae-in, President Trump, to the surprise of the South Korean delegation, tweeted that the U.S. would get a "new trade deal" with South Korea.²⁰ This was not something that South Korea had agreed to at the summit.²¹ Regardless, the U.S. Trade Representative formally requested consultations to amend the KORUS FTA shortly thereafter.²² In early September 2017, only weeks after meeting with President Moon, President Trump was set to withdraw from the agreement, but reversed course and committed to renegotiate the FTA after North Korea tested a hydrogen bomb.²³

The Results of the KORUS FTA Revisions

In late March of 2018, Washington and Seoul reached a preliminary agreement to revise the KORUS FTA. While some details remain to be concluded as of this writing, the general outlines of the agreement have been announced by the two governments.

With the U.S. trade deficit with South Korea concentrated in automotive trade, the most significant changes to the agreement relate to trade in automobiles and auto parts. Perhaps most importantly, the

agreement extends the 25 percent tariff on light trucks exported to the U.S. by 20 years until 2041. The agreement calls for Seoul to double the number of American vehicles exempted from South Korean safety standards to 50,000 units per producer.²⁴ It also calls for the harmonization of emission testing requirements, expanding the “eco-credits” available to help U.S. exporters meet fuel economy standards, and recognizing U.S. standards for American auto parts used to service U.S. vehicles.²⁵

Outside of the automotive industry, the revised agreement also calls on Seoul to improve issues related to customs procedures to ensure that American exports receive the expected benefits under the KORUS FTA, as well as changing South Korea’s Premium Pricing Policy for Global Innovative Drugs to guarantee fair and non-discriminatory treatment for U.S. pharmaceuticals.²⁶

The ROK was also able to obtain concessions from the U.S. In concluding the talks in a relatively short period of time, South Korea was able to avoid prolonged uncertainty over the renegotiations that Mexico and Canada have faced with the talks to renegotiate NAFTA, while also limiting the scope of the discussions. One successful objective was primarily defensive, ensuring that agriculture was not part of the negotiations. Seoul was also able to secure changes to the Investor-State Dispute Settlement System to increase transparency, improvements on the rules of origin for South Korean textile exports, and an agreement by the U.S. to increase transparency on American anti-dumping and countervailing duty case against South Korean companies.

The Potential Impact of the Revisions to the KORUS FTA

The revisions to the KORUS FTA should help to improve access for American automotive exports to South Korea. However, they will likely have a minimal effect on the U.S. trade deficit with the ROK, especially in the short term. Doubling of the safety exemption and mutually recognizing auto parts should help with the sales of American vehicles in South Korea by allowing each automotive company to sell more lines of vehicles and make it easier to repair American vehicles in South Korea.

The revised agreement’s most important measure may be the defensive measure that delays the phase out of the light truck tariff by 20 years. While not known at the time, the Ford Motor Company recently announced it plans to transition to primarily selling only light trucks, commercial vehicles, and SUVs by 2020; the Ford Mustang and a new crossover, the Ford Focus Active, as the only two sedans it will sell in the

North American market.²⁷ The light truck tariff was set to phase out in 2021, as Ford will complete its transition. The extension will help to protect Ford's market share by forcing Hyundai and Kia to either produce in the U.S. or Mexico, depending on the outcome of the NAFTA renegotiation talks, if they decide to enter into this market segment before the light truck tariff is phased out.

However, the American auto industry still faces challenges in the Korean market. There has been significant growth in the sales of foreign automobiles in the ROK, where 16.7 percent of the vehicles purchased are now imports. Imports account for a larger percentage of automobile sales in South Korea than in China (4.2 percent), Japan (7.6 percent), and is comparable to the European Union (15.2 percent). Only the United States, at 26 percent, has a higher percentage of imported vehicles.²⁸

Despite progress in the South Korean market, sales growth has largely been in the luxury vehicle segment rather than in the passenger vehicle segment of the market. Sales of Mercedes-Benz have grown from 16,115 units in 2010 to 68,861 units in 2017. In contrast, Ford's sales grew from 4,184 units in 2011 to 11,220 units in 2016 before declining to 10,727 units in 2017.²⁹ While Ford has seen its sales more than double since the KORUS FTA came into effect in 2012, Mercedes-Benz has seen sales increase by more than four times since the EU's FTA with Korea came into effect in 2011.

Even if the changes to the KORUS FTA help double the exports of American vehicles and parts, it will only have a small impact on the U.S. trade deficit with the ROK. In 2017, American firms exported a little over \$2 billion in parts, vehicles, and commercial vehicles to the ROK, while importing \$20.6 billion from South Korea. Even if American companies were to double exports to South Korea and Korean producers were to increase production within the U.S., there would still be a sizable automotive trade deficit due to a disparity in the market size. This is largely a structural issue that cannot be addressed by the KORUS FTA. In 2017, total vehicle sales in the U.S. were 17.25 million units;³⁰ sales in South Korea were only 1.75 million units during the same year.³¹

While the auto industry may have been the focus of the renegotiation, the changes related to pharmaceuticals could also be significant in the long-run. Currently, only Germany, Italy, Japan, and Finland are super-aged societies, or societies with 20 percent or more of the population over the age of 65. However, by 2030, the ROK will have become a super-aged society as well.³² As South Koreans age, a greater percentage of their

income will be spent on healthcare. In 2016, South Korea spent 7.7 percent of its GDP on healthcare according to the Organization for Economic Cooperation and Development, while Germany spent 11.3 percent, Japan 10.9 percent, Finland 9.3 percent, and Italy 8.9 percent.³³

South Korea is the third largest pharmaceutical market in Asia and 13th largest in the world, with total sales expected to reach \$18.3 billion by 2020.³⁴ The U.S. exported \$927 million in pharmaceuticals to the ROK in 2015, but that fell to \$693 million in 2017. As a comparison, the American exports to the super-aged societies exclusive of Finland which has a much smaller population, which has a much smaller population, totaled over \$3 billion.³⁵ Generic drugs make up about half of pharmaceutical sales in South Korea.³⁶ If the revisions to the KORUS FTA are able to address industry concerns related to pricing and reimbursement, South Korea should be a growing market for American pharmaceutical exports.

While the renegotiated agreement includes potentially useful revisions, the ultimate result of the talks was rather modest; the revised agreement is unlikely to change significantly the U.S. trade deficit with South Korea. This raises the question of why the Trump administration threatened to withdraw from the KORUS FTA if its objectives were so narrow? Moreover, why would the administration have risked damaging a crucial alliance during a time of heightened tensions with North Korea when its objectives almost certainly could have been achieved through other means?

The answer is unclear. The administration's threat to withdraw from the KORUS FTA was real, as demonstrated by the near-U.S. withdrawal from the agreement in September 2017. However, there are likely two reasons that the Trump administration took the hardline stance it did over the agreement. First, in a break with prior U.S. administrations, the Trump administration believes that it gains maximum leverage by being willing to walk away from or ending agreements. We have now seen this same tactic take place across a series of U.S. policies, such as the threat to withdrawal from NAFTA and the recent withdrawal from the Iran nuclear deal. Pressure tactics are part of the Trump administration's modus operandi rather than something to be reserved for critical situations. Every U.S. administration has pressured U.S. allies or adversaries at some point, but the Trump administration is merely more willing to do it openly and more frequently.

Second, the Trump administration doesn't appear to have the same views on the linkage between trade and security. Both the Bush and

Obama administrations viewed the KORUS FTA agreement as a means to strengthen the U.S.-Korea alliance. Its threats to withdraw from the KORUS FTA indicate the Trump administration doesn't share that outlook.

Agreements on Steel and Currency

In addition to reaching an agreement on the KORUS FTA, Washington and Seoul announced in late March that they had reached agreements on steel and currency. In early 2018, the Department of Commerce submitted the results of a Section 232 investigation on the impact of steel imports on the United States' national security. Having concluded that imports of steel were harming national security, President Trump announced the imposition of a 25 percent tariff on all steel imports with the exception of those from Canada and Mexico, which were expected to be resolved as part of the renegotiation of NAFTA.³⁷

In 2017, South Korea exported 3.4 million metric tons of steel to the United States. The country has been America's third largest source of steel imports since 2011.³⁸ With the U.S. accounting for nearly \$4 billion in exports of South Korean steel, Seoul worked to ensure that it was exempted from the new steel tariff. As part of the agreement, negotiators in Washington and Seoul agreed to limit South Korea steel exports to the U.S. to 70 percent of the average of South Korean exports for 2015-2017.³⁹

In addition to the agreement on steel, the United States and South Korea reached a preliminary understanding on currency. While the agreement is still being finalized, the U.S. Trade Representative indicated that it will include elements on transparency, as well as a commitment not to engage in competitive devaluations or currency manipulation.⁴⁰ Since new criteria for currency manipulation were established under the Trade Facilitation and Trade Enforcement Act of 2015, South Korea has remained on the Treasury Department's watch list.⁴¹ The ROK is one of the few countries that does not make its interventions into currency markets public. Accordingly, the new transparency provisions should aid in clarifying the nature of South Korea's interventions into international currency markets.

Is the KORUS FTA Out of the Woods?

While Washington and Seoul successfully renegotiated the KORUS FTA, it would be premature to assume that America will never withdraw from the agreement. There are three factors that could still lead to the

United States withdrawal from the KORUS FTA: (1) if there is not progress in the areas where the renegotiations took place; (2) if the trade deficit begins to climb; or (3) domestic political reasons.

As previously noted, the provisions negotiated on automobiles will have a minimal effect on the overall U.S. trade deficit with South Korea. If sales of American autos fail to grow or the industry continues to face non-tariff barriers in South Korea, President Trump could decide that the KORUS FTA is not fixable and decide to withdraw. In this scenario, he may seek to negotiate a better agreement, pursuing a course he has taken with the Iran nuclear deal. Despite having praised the renegotiation of the KORUS FTA, President Trump stated shortly thereafter that he might hold back on implementing the agreement until after the summit meeting with North Korea to give him leverage.⁴² He is less wedded to agreements than other American presidents.

Increasing trade deficits are a second reason that would lead Washington to leave the KORUS FTA. As noted, trade agreements such as the KORUS FTA don't cause trade deficits, which instead are driven by factors such as domestic savings and consumption. As the macroeconomic factors that drive trade deficits change, we could see an increase in the U.S. trade deficit with the ROK despite the revised agreement.

Domestic political considerations are the final factor that could lead to an American withdrawal. President Trump will likely face a difficult reelection in 2020. Withdrawing from NAFTA would have negative consequences for Trump supporters, and if the current efforts to pressure China into changing its trade practices are unsuccessful, President Trump may decide he needs to demonstrate that he is still tough on trade. As the United States' largest bilateral FTA with a country less integrated into the U.S. economy than either Canada or Mexico, the KORUS FTA could become a political casualty, especially if the trade deficit were to rise.

While there may be political logic to a future withdrawal, there would not be an economic one. As the U.S. International Trade Commission has calculated, the U.S. trade deficit with South Korea would be higher in the absence of the agreement.⁴³ Recent developments have boded positively for the economic relationship, but it is too soon to be complacent about the future of the KORUS FTA.

Areas of Potential Future Tensions in the U.S.-Korea Economic Relationship

When the KORUS FTA was originally negotiated, one of the more controversial provisions was related to outward processing zones. Of specific concern was the Kaesong Industrial Complex which was jointly run by North and South Korea in North Korea before the Park Geun-hye administration closed the complex in response to Pyongyang's nuclear tests. As Washington and Seoul move toward a potential agreement on denuclearization with North Korea, this issue could cause tensions in the relationship in two ways.

The first is economic engagement with North Korea. The Panmunjom Declaration increased expectations for South Korean economic engagement with North Korea. However, Washington is pushing for the removal of sanctions only after Pyongyang has denuclearized. While there may be some forms of economic engagement, such as reforestation projects that will fit within the scope of the current sanctions regime, there could be increasing expectations for a loosening of sanctions prior to full denuclearization.

Outward processing zones are the second area that may spark tensions. If Kaesong is reopened and plans are made to construct additional industrial complexes, South Korea may seek to amend the KORUS FTA to classify products from the new industrial zones as South Korean products, especially if there is a peace treaty ending the Korean War. This would require Congressional action, which would be difficult in the absence of progress on human rights, labor rights, and verifiable denuclearization.

Beyond North Korea, there are other issues the revised KORUS FTA failed to address that could cause tension in the future. Both countries will need to address artificial intelligence and autonomous vehicles in future discussions. While the revised KORUS FTA exempts 50,000 American vehicles from South Korean safety standards, autonomous vehicles will raise new safety issues that will likely be governed under a separate regulatory regime. The same is true of future products related to artificial intelligence. New rules will likely be necessary to determine what types of products will be acceptable, how much code will need to be shared to ensure that products are safe, and where liability rests if there are problems.

The most significant source of future economic tension may come from the Trump administration's trade policies. The Trump

administration's escalating trade war with China could negatively impact South Korea.⁴⁴ Separately, the Department of Commerce has opened a new Section 232 investigation to determine whether automobile imports are a danger to U.S. national security.⁴⁵ If the investigation determines that importing automobiles poses a risk to U.S. national security, it would create a significant tension in U.S.-Korea economic relations. Absent an exemption for South Korea, it would raise a question of why the Trump administration sought to renegotiate the KORUS FTA in the first place.

However, the current Section 232 investigation into automobile imports may not be the only national security investigation. Early during the Trump administration, Commerce Secretary Wilbur Ross suggested the administration might investigate semiconductors.⁴⁶ Dan DiMicco, a former advisor to the Trump campaign, suggested that further Section 232 investigations could be coming in semiconductors, artificial intelligence, and other areas.⁴⁷ The continued use of national security to reduce imports from foreign competition and protect domestic industries will only raise tensions with allies such as South Korea, which also have significant stakes in these industries.

The Future of U.S.-Korea Economic Relations

An important question for American and South Korean policy makers is whether the economic tensions that have arisen during the Trump administration is an aberration or the new norm. For the near-term, trade policy under the Trump administration has shifted from processes to outcomes. If the revised KORUS FTA fails to produce results, or the U.S. trade deficit with South Korea increased, there will be additional pressure from the Trump administration to show results.

However, the more immediate challenge for the economic relationship may be the Trump administration's use of Section 232 investigations. If South Korea does not receive an exemption from the Section 232 on automobiles and auto parts, and the Trump administration were to move forward with an investigation into semi-conductors, a substantial portion of South Korean exports to the United States would face additional tariffs despite the revisions to the KORUS FTA. Ongoing discussion with Pyongyang could create additional challenges for the alliance as it deals with questions related to sanctions relief and economic engagement with North Korea. The limited progress to date means that these are likely medium-term issues for the alliance.

Trade is becoming an increasingly volatile topic on a political level in the United States. Both major political parties have turned away from free trade since the last presidential election. These shifts are affecting the Trump administration's actions on trade and the American public's support for free trade. These trends are likely to continue in the near future, leading to persistent trade frictions between Washington and Seoul.

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