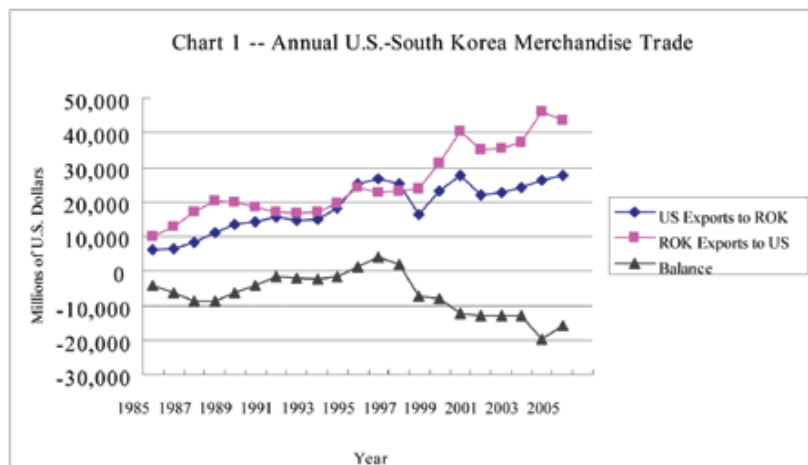


SOUTH KOREA – U.S. ECONOMIC RELATIONS AND BILATERAL FREE TRADE NEGOTIATIONS

Junko Saito

I. THE ECONOMIC RELATIONSHIP

In 2006, South Korea and the U.S. continued to be major trade and investment partners. Bilateral trade was \$78 billion, an increase of \$7 billion over 2005. U.S. exports to the ROK reached levels not seen since before the Asian financial crisis of 1997, but Korean exports to the U.S. increased even more, widening the U.S. bilateral trade deficit. (See Chart 1.)



Source: U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch

The ROK was the United States’ seventh-largest trading partner, after Canada, Mexico, China, Japan, Germany, and the United Kingdom. Its primary exports to the U.S. were cellular phones, cars, semiconductors, televisions, flat panel screens, and construction vehicles. Korean companies in major industries had steadily increased their market share in the U.S. over the past few decades.

The Korean economy relied heavily on the U.S. The U.S. was the ROK’s third-largest trading partner after China and Japan, and its largest contributor of FDI. (See Chart 2.) The most important U.S. exports to Korea were agricultural products, semiconductors, machinery, and aircraft. In October 2006, Boeing sold fifteen aircraft to Korean Air worth \$5.5 billion, the largest order ever for the national airline. With Korea’s airline industry expected to grow at 5-6% a year over the next two decades, American companies stood to profit further from such sales.

Chart 2: Economic Interdependence in 2005

	Total Trade	Export Market	Source of Imports	Source of FDI
For the U.S., the ROK ranks	#7	#7	#7	#28
For the ROK, the U.S. ranks	#3	#2	#3	#1

Source: CRS Report for Congress, “The Proposed ROK-U.S. Free Trade Agreement”

While the ROK and the U.S. had been strengthening their economic ties, a recent financial scandal revealed complications in the relationship. In November 2005, ROK prosecutors alleged illegal activities in the 2003 sale of Korea Exchange Bank (KEB) to Lone Star, a U.S. private equity firm. Lone Star and KEB were accused of manipulating the share price of KEB Credit Services in order for KEB to buy out minority shareholders at a lower price. In light of the investigation, Lone Star canceled an agreement to sell its controlling stake in KEB to Kookmin Bank.

II. FREE TRADE AGREEMENT NEGOTIATIONS

1. BACKGROUND

The year 2006 saw a historic step in ROK-U.S. economic relations. On February 2, the two countries announced their intention to begin negotiations on a free trade

agreement, which they referred to as the KORUS FTA. The two sides worked intensively throughout the year to conclude KORUS FTA negotiations before the expiration of U.S. trade promotion authority (TPA) on July 1, 2007. TPA, formerly known as “fast-track authority,” was legislation passed by the U.S. Congress granting authority to the president to negotiate trade agreements that the U.S. Congress may approve or reject but not amend. Without TPA, Congressional passage of any free-trade legislation was considered by most experts to be highly unlikely. TPA required the president to notify Congress 90 days in advance of the signing of a potential trade agreement, so the two countries needed to complete negotiations before April 2, 2007.

2. THE SIGNIFICANCE OF A KORUS FTA

The KORUS FTA would have significant effect on economic growth and stability in both countries. The FTA would facilitate a substantial increase in exports and strengthen the presence of each country in the other’s region.

In a February 2 press conference, U.S. Trade Representative Rob Portman said that a KORUS FTA “is the most commercially significant free trade negotiation we have embarked on in 15 years.... Removing trade and investment barriers between our two nations through an FTA will increase market access for our farmers, ranchers, workers, and businesses to the dynamic and growing Korean economy, boosting trade in goods and services.” Not only would exporters gain – the U.S. would also bolster its strategic presence in Northeast Asia.

An FTA with the U.S. had been President Roh Moo-hyun’s long-held goal. In the February 2 announcement of the intention to negotiate a KORUS FTA, Korean Trade Minister Kim Hyun-chong emphasized the importance of trade for the ROK, noting that “70 percent of our GDP is dependent on trade. We have to trade ourselves out. ... So we have no choice. We have continued to reform and liberalize.”

ROK officials recognized that a major economic benefit of an FTA with the U.S. would be to strengthen the ROK’s competitiveness in the long run by introducing additional U.S. investment and technology. In addition, from a strategic point of view, some Koreans and Americans thought that the KORUS FTA would strengthen the ROK-U.S. alliance, which had been focused on the deployment of U.S. forces based in the ROK and on dealing with the challenges posed by North Korea. President Roh stated on February 2 that an FTA would improve the ROK’s position in Northeast Asia “by increasing its status as a middle power, [and] also by ensuring that the U.S. presence remains a strategic and economic counterbalance to China and Japan.”

3. TIMELINE OF THE KORUS FTA NEGOTIATIONS

According to Inbom Choi and Jeffrey J. Schott of the Institute for International Economics in Washington, D.C., the ROK and the U.S. first discussed the idea of a KORUS FTA in the 1980s. Due to the rapid increase in the ROK’s exports to the U.S., the ROK faced severe U.S. economic sanctions under section 301 of U.S. trade law. In addition, as a result of the 1994 North American Free Trade Agreement (NAFTA), the ROK faced discrimination in the U.S. market. Under these circumstances, the ROK approached the U.S. about creating a bilateral FTA in the late 1980s. The U.S. was interested in expanding exports to the Korean market, and informal discussions and feasibility studies were initiated. Nevertheless, the two countries continued to focus more on multilateral trade fora such as the Uruguay Round and the WTO.

In November 1999 and again in May 2001, Max Baucus, a Democratic member of the Senate Finance Committee, introduced a bill calling for an FTA with the ROK. His draft legislation followed years of pressure from the ROK and U.S. business communities for a bilateral FTA. In 2001, the Finance Committee requested that the International Trade Commission (ITC) study the potential economic impact of a KORUS FTA. The ITC subsequently projected that, within four years of FTA implementation, U.S. exports to the ROK would increase by 54% while imports would rise by 21%. (The larger increase in U.S. exports would be a function of Korea’s higher initial tariffs.) The ITC estimated that the FTA would boost U.S. GDP by 0.2% and Korean GDP by 0.7%. An earlier study by the Washington-based private Institute for International Economics produced similar results. Both studies concluded that a KORUS FTA would have a positive economic impact: U.S. companies would enjoy improved access to the ROK market, and Korean companies, responding to increased competition, would boost their efficiency, enabling them to compete better not only in the U.S. but also globally.

In addition to FTA discussions, the two countries had considered since the late 1990s the possibility of a bilateral investment treaty (BIT) aimed at improving the climate for foreign investors. Though formal talks were initiated in 1998, they were ultimately unsuccessful, mainly due to U.S. objections to the ROK’s movie screen quota requiring Korean movie theaters to dedicate 40% of showings to domestic films.

Before the official announcement on February 2 of their intention to negotiate a KORUS FTA, the two governments had spent several years in informal discussion. The U.S. commitment to the goal of an FTA came after the ROK government assured the U.S. of its political will for economic reform. The U.S. also reportedly made clear

to the ROK that it would need to make four changes for the FTA negotiations to be successful: a reduction of the film quota, changes in the pharmaceutical pricing system, changes in domestic taxes on imported autos, and the reinstatement of U.S. boneless beef imports, which had been banned since bovine spongiform encephalopathy (BSE or “mad cow” disease) was discovered in the U.S. in 2003.

4. NEGOTIATION ROUNDS

By the end of 2006, the two countries had held five rounds of FTA negotiations. Before the first official round, held June 5-9 in Washington, the two countries exchanged draft agreements, and during the meeting they reviewed their respective proposals line by line.

The second round was held July 10-14 in Seoul. The negotiations on pharmaceuticals were suspended because the U.S. disagreed with the ROK’s decision on health care system reforms. Despite this disagreement, the two countries agreed on the framework for a tariff concession schedule for goods and they also agreed to exchange tariff offers for goods, textiles, and agricultural products in August 2006.

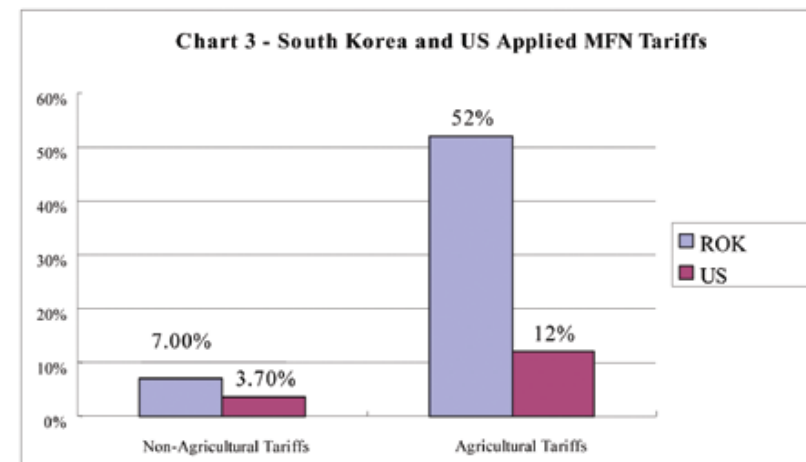
The third round was held September 6-9 in Seattle. Each country strongly requested that the other further improve its tariff offers. During this round, hundreds of Korean and U.S. protesters demonstrated outside the conference hall each day against an FTA. Nine Korean protesters were detained by police for trying to march into the building where the negotiations were being conducted. Korea expert Bruce Klingner observed that the two countries had made almost no progress on increased market access in the third round. The lack of progress, however, reportedly underlined for Trade Minister Kim and President Roh the need for intensified efforts to meet the TPA deadline.

The fourth round was held from October 23-27 on Jeju Island. The two countries began to make progress, and they looked toward the fifth round – held in Montana, a major U.S. beef-producing state and the hometown of KORUS advocate Senator Baucus. Some observers reported that Montana was chosen to increase pressure on the ROK to liberalize its beef market. In this fifth round, the ROK pushed the U.S. to make concessions on its anti-dumping measures and countervailing duties. The U.S. refused Korea’s requests, leading to the suspension of not only the trade remedies negotiation but also of discussions on autos and pharmaceuticals, both sectors important to the U.S. Despite these problems, the countries made progress in less-sensitive areas, including trade in various goods and services, as well as intellectual property rights.

5. U.S. INTERESTS

(a) Agriculture

Although agriculture now accounts for only about 7% of total employment in the ROK, the sector enjoys disproportionately strong domestic political support. Thus, while the average ROK tariff for non-agriculture products is 7%, its average tariff for agriculture products is 52%, much higher than that of the U.S. (See Chart 3.) Negotiations on trade in agricultural products, especially access to the ROK rice market, generated strong opposition in the ROK. ROK farmers engaged in determined protests against a KORUS FTA. The Korean government stood its ground during the KORUS FTA talks, with an official at the Ministry of Agriculture and Forestry reportedly warning, “If the U.S. takes issue with the ROK’s closed market for rice, the ROK will risk breaking off negotiations with the U.S.”



Source: USTR, WTO

(b) Beef

As noted above, Korea banned all imports of American beef due to the discovery in December 2003 of BSE in a cow in the U.S. (thought to have been imported from Canada, with which the U.S. shared an open market). The ROK had been the third-largest market for U.S. beef exporters, consuming \$815 million worth in 2003. In January 2006, the ROK partially lifted the import ban, allowing imports of boneless cuts (only) from cattle less than 30 months old. (Some believed that bone-in cuts of meat carried a greater risk of BSE.) However, the ROK government rejected the first three shipments of U.S. beef after inspectors found them to contain small bone fragments. In December 2006, the U.S. National Cattlemen’s

Beef Association criticized the decision as “political and fundamentally protectionist,” adding that “it is impossible to remove all bone fragments from exported beef.”

Technically, beef was a separate issue from the KORUS FTA, but the U.S. maintained from the beginning of the negotiations that Congress would not approve an FTA agreement unless the ROK fully reopened its market to American beef, both boneless and bone-in.

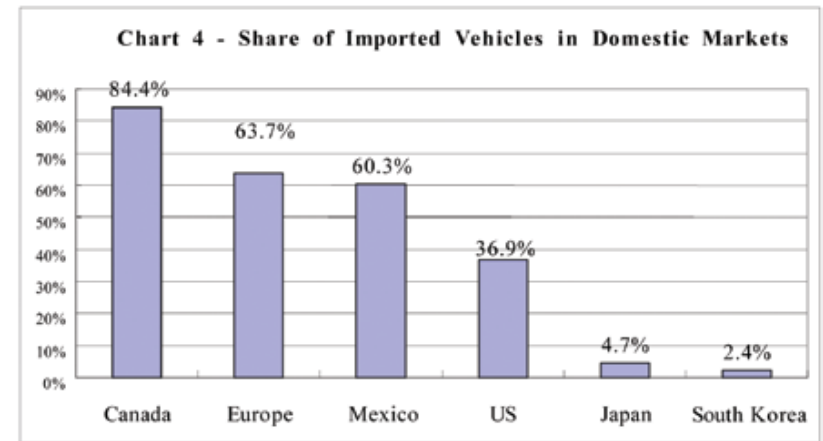
(c) Pharmaceuticals

Faced with mounting costs in its national healthcare system, Korea’s Ministry of Health and Welfare announced a new drug pricing policy in May 2006. The switch was from a “negative list system,” in which all drugs not cited were eligible for reimbursement, to a “positive list system,” in which *only* listed drugs would be eligible for reimbursement. The ROK said that the reform was necessary to reduce its health care deficit and protect Korean customers from excessive costs. American pharmaceutical makers, however, were concerned that many of their products would not be included in the list of covered drugs. The U.S. government felt that American companies, which focused on the development and production of innovative and expensive drugs, would lose, while Korean manufacturers, which focused on generic medicines, would gain. The ROK policy announcement undid a U.S.-ROK understanding that had reportedly been reached in the pre-negotiation phase, resulting in a “semi-breakdown” in the FTA talks. The announcement apparently came as a surprise not only to American FTA negotiators, but also to the Korean Ministry of Foreign Affairs and Trade as well as to some Blue House officials.

(d) Automobiles

The ROK was a major auto manufacturing country, and enjoyed a significant presence in the U.S. market since the 1980s. With the increase in gasoline prices of the last several years, relatively small and fuel-efficient Korean vehicles became popular with Americans. In 2005, the ROK exported 730,000 cars to the U.S., capturing over 4% of the U.S. market. On the other hand, U.S. car companies faced difficulty in expanding their business in Korea, exporting only 5,800 vehicles in 2005. In the ROK, U.S. and all other foreign vehicle sales combined accounted for only 2.7% of the market, while foreign autos captured 36.9% of the U.S. market in 2004. (See Chart 4.)

The U.S. argued that non-tariff barriers severely limited sales in the Korean market over the last few decades. In the 1990s, the U.S. and the ROK signed two memoranda of understanding, in which Korea agreed to take measures to address the issue of U.S. auto imports. However, these memoranda were to no avail. The U.S. again requested that the ROK take measures to remove auto barriers, including tariff reductions and reform of the domestic automotive tax structure. (Korean auto taxes were based partly on engine size, making ownership of U.S. cars generally more expensive.)



Sources: U.S.-Korea Business Council, American Chamber of Commerce in Korea, Automotive Trade Policy Council

6. ROK INTERESTS

As noted above, the ROK overall had higher tariffs and non-tariff barriers than the U.S., and, as such, did not push as hard for improved market access as the U.S. However, the ROK did consider certain issues to be very important, such as the treatment of the Gaeseong industrial complex in North Korea and U.S. antidumping policies and countervailing duties.

(a) Gaeseong Industrial Complex

Located 40 miles from Seoul and just north of the Demilitarized Zone (DMZ), the Gaeseong industrial complex (GIC) was designed to promote peace and stability on the Korean Peninsula and to reduce “the presumed

costs of an eventual North-South reunification by introducing global economic standards to North Korea and linking North Korea to the global economy.” GIC was established in 2004 using ROK capital and North Korean labor. The complex employed 10,100 North Korean workers as of September 2006, with eighteen ROK companies producing \$7.5 million in manufactured goods through October 2006.

The ROK requested that the U.S. consider all exports from the GIC to be “made in the ROK,” so that these products would enjoy FTA preferential treatment. In other Korean FTAs (including with Singapore, the EU, and ASEAN), its partners had agreed to do so. The U.S., however, clearly and consistently stated its objection to including GIC products under a KORUS FTA umbrella.

U.S. concerns about GIC reportedly included the fact that profits were given to the North Korean government and that working conditions for North Korean laborers might not meet international standards. Human rights NGOs and labor groups argued that North Korean workers in the GIC were being exploited, but the ROK government maintained that working conditions at GIC were better than elsewhere in North Korea. The U.S. also reportedly was concerned that hard currency earned by North Korea through leasing fees, taxes, and surcharges on DPRK laborers’ income might be directed to North Korea’s nuclear weapons program. North Korea’s October 2006 nuclear test was presumed to have further complicated the ROK’s effort to convince the U.S. to recognize products made in the GIC as “made in the ROK.”

(b) U.S. antidumping and countervailing measures

For the past few decades, the ROK was concerned with U.S. antidumping measures and countervailing duties. As of February 2006, the U.S. had implemented 24 antidumping measures and countervailing duties on ROK exports. The ROK had challenged the U.S. six times in the World Trade Organization, claiming that U.S. antidumping measures and countervailing duties unfairly increased tariff rates on ROK exports. In the KORUS FTA talks, the ROK also criticized U.S. trade practices and laws, and insisted that the U.S. give the ROK preferential status in the U.S.’s antidumping and countervailing duties procedures.

7. PUBLIC OPINION

Seeing an FTA as an opportunity to expand its access to the ROK, the U.S. business community largely welcomed the KORUS FTA negotiations. When the U.S. and Korea first announced their plan to negotiate a KORUS FTA, it came as a surprise to many Koreans – but not to American business, which had been in communication with the U.S. government during the preparatory period. Overall, the U.S. business community was optimistic about the chances of success, despite the time pressures and opposition in both countries, according to Tami Overby, head of the American Chamber of Commerce in Seoul.

While the FTA was not a significant issue among the American public, many Koreans expressed strong opposition to it. Initially, the Korean public knew little about a potential FTA and had no strong opinion about it. Early in the talks, a KBC Media survey found that 58.1% of Koreans supported an FTA while only 29.2% disapproved. However, well-organized opposition groups conducted an effective public relations campaign, and public support dramatically declined.



In contrast, debate over such trade deals was generally more balanced in the U.S., with supporters and protestors both enjoying visibility. For instance, both pro-FTA and anti-FTA advertisements appeared in U.S. newspapers.

In the ROK, major businesses generally supported a KORUS FTA but took a low-profile approach. Some experts suggested that ROK businesses feared that anti-FTA groups might retaliate, perhaps with boycotts. Also, since Korean *chaebol* (conglomerates) would likely benefit the most from an FTA, they may have feared that industries suffering losses from an FTA might appeal to them for compensation.

Since the launch of the FTA negotiations, thousands of Korean protestors, including farmers, laborers, teachers and anti-globalization activists, continuously denounced a KORUS FTA. In November 2006, violent anti-FTA demonstrations across Korea injured 63 people, including 35 police officers, and caused major property damage. One of the largest anti-FTA groups, the Korean Alliance against KORUS FTA, claimed that “this FTA



will bring benefits only to a few big companies, not to the people. The Korean government has not considered any of the consequences of the FTA.”

Some Korean service sector industries opposed an FTA that would introduce increased competition from American companies. For example, broadcasters enjoyed

government policies limiting foreign ownership to 47% of the industry, but a KORUS FTA could remove this protection. While the Korean government had partial ownership of broadcasting stations, it had limited executive control and was thus unable to prevent them from voicing opposition to an FTA. Some broadcasters ran critical ads and even produced extended programs criticizing a KORUS FTA. One American expert suggested that general anti-American sentiment undergirded this opposition.



To increase public understanding and support for an FTA, President Roh appointed Han Duk-soo, a former senior foreign ministry official, as head of a task force to travel the country and educate the public about the benefits of an FTA with the U.S.

8. PROSPECTS FOR AN AGREEMENT

After five rounds of negotiations, the two countries remained divided over key issues, including pharmaceuticals, agriculture, and trade remedies. By the end of 2006, with the TPA “deadline” only three months away, both sides were gearing up to reach agreement on these contentious issues.

The successful completion of negotiations would carry significant implications. An FTA would strengthen the economic and political alliance between the U.S. and the ROK, and arguably improve both countries’ strategic position in Northeast Asia. From the U.S. perspective, an FTA with Korea would balance increasing Chinese regional trade agreements. For the ROK, an agreement would make it the only country in East Asia to enjoy a bilateral FTA with the U.S., thus boosting its economic and diplomatic standing not only regionally but also globally.