U.S.-ROK FREE TRADE AGREEMENT*

Wonhyuk Lim

Despite the enthusiasm exhibited by the chief negotiators on both sides on February 2, 2006, the official launch of negotiations for a Korea-U.S. Free Trade Agreement (KORUS FTA) came as a surprise to many Koreans. In their view, it represented at best a puzzling move and at worst an abrupt about-face by the Roh Moo-hyun government, raising a number of procedural and substantive issues.

Foremost among procedural and tactical issues is the lack of consensus-building about the Roh government's apparently new economic and trade policy. In 2003 and 2004, the Roh government made efforts to strike "a grand social bargain" between labor and management, combining social cohesion with economic liberalization. The *polder* model of the Netherlands was held up as a possible benchmark.(1) More recently, the government made "bipolarization," or increasing economic and social inequality, a major economic issue, addressing popular concerns about the impact of globalization.

As for trade policy, the Roh government actively participated in the multilateral Doha Development Round (DDR) negotiations and pursued FTAs in two directions. First, it negotiated essentially "exploratory" FTAs with smaller countries that had a great deal of previous experience with FTAs and posed little threat to Korea's vulnerable agricultural sector. As a result of these negotiations, Korea signed free trade agreements with Chile, Singapore, and the European Free Trade Association (EFTA). Second, the Roh government also pursued more "strategic" FTAs with a view toward promoting peace and prosperity in Northeast Asia.(2)

Building on the goodwill generated by the Kim-Obuchi declaration of a new partnership in October 1998, a Korea-Japan FTA received top priority. Most experts in Korea believed that this FTA would be mutually beneficial for both sides, with manageable risks for Korea's manufacturing and Japan's primary sector. By comparison, many felt that a Korea-China FTA would be detrimental to Korea's agricultural sector, even though it would give a significant boost to manufacturing exports. A Korea-US FTA was widely regarded as a long-term project, driven mainly by high politics than economics, for it would impose significant adjustment costs not only on Korea's agriculture but services as well, with less tangible benefits for the manufacturing sector. Most believed that there were economically superior alternatives to a Korea-U.S. FTA with far lower political costs. Against this background, it is only natural that many Koreans are wondering what has changed in the past year to justify the government's new-found enthusiasm for a Korea-U.S. FTA and "left-wing neoliberalism" (in President Roh's words) -- with Mexico rather than the Netherlands held up as a benchmark.

The next series of questions have to do with political economy. Can President Roh, with his low approval ratings, form a winning coalition to secure the passage of something as contentious as the KORUS FTA in the last year of his term? Why didn't he take up the challenge of liberalization shortly after he took office in February 2003 or after his ruling party secured a majority in the National Assembly in April 2004? Wouldn't it have made much more sense to liberalize one sector at a time instead of taking on every interest group from movie actors to farmers at once? It is one thing to label the critics of the proposed FTA "anti-American" and hope they will shut up, but quite another to counter their claims with sophisticated arguments based on solid research. Has the government done the preparatory work to address the concerns of various interest groups? Although some academics and politicians argue that it is necessary to use external pressure to overcome the resistance of anti-liberalization forces (or, "chop heads with a borrowed sword"), the government has done preciously little to try to liberalize the protected sectors in the first place. Besides, it is extremely doubtful that the United States would be just content to lend its sword to the Korean government instead of pursuing its own agenda in the trade negotiations. From a political and tactical point of view, what the Roh government has done since 2003 makes little sense.

Another procedural issue has to do with the lack of open debate and transparency. Unlike in the United States, where Congress controls trade negotiations and solicits feedback from various constituencies, the National Assembly in Korea plays a rather ineffective role. As a result, far less information is available in public domain in Korea. Moreover, much of what is publicly available has been challenged as little more than ex post rationalization.

Finally, the Roh government's negotiating tactics -- or lack thereof -- are troubling, to say the least. The announcement to launch formal negotiations for the KORUS FTA followed Korea's apparently unilateral concessions in four contentious areas: beef, automobiles, pharmaceuticals, and screen quotas.(3) Although the Roh government insists that it has "voluntarily" liberalized these sectors as part of its general economic policy, this "coincidence" begs the question of why the government gave away precious bargaining chips just a few months before the official launch of the trade negotiations. This move is reminiscent of the government's previous decision to de-link the issue of "strategic flexibility" from the relocation of the U.S. military bases in Korea, weakening Korea's bargaining position and aggravating the potential financial burden of Korean taxpayers. Even more puzzling is the Roh government's apparent preoccupation with concluding the FTA before the expiration of the U.S. Trade Promotion Authority in June 2007, for it further weakens Korea's bargaining position. Under various guises, fast-track authority regarding trade negotiations has been granted to the U.S. President a number of times since 1974.

In addition to these procedural and tactical concerns, the proposed KORUS FTA raises a number of substantive and strategic questions as well. In economic terms, a free trade agreement (or, "a preferential trade agreement (PTA)," as a multilateralist like Jagdish Bhagwati would have it)(4) typically includes "border measures" as well as elements of "deep integration" -- that is, common disciplines for regulatory regimes covering such subjects as services, investment, intellectual property, government procurement, and competition.(5) The United States, with a much lower average tariff rate and a much more complex set of regulatory rules than Korea's, represents a formidable FTA partner for Korea. In a nutshell, adjustment challenges associated with tariff reduction and institutional harmonization are likely to be rather lop-sided between the two sides.

Yet, most of current discussions in Korea tend to degenerate into a war of words, overlooking the substantive implications of the proposed FTA. In the extreme, the opponents of the deal (including a former Minister of Agriculture and Forestry) claim that the KORUS FTA will make Korea "an economic colony" of the United States; whereas, its proponents (including the Blue House) accuse the critics of subscribing to the same world view as the Confucian literati who wanted to block any "foreign infiltration" in the nineteenth century, even though some of these critics have raised a number of legitimate concerns. This kind of discourse is rather depressing.

Korea is already the seventh largest trading partner for the United States, and the U.S. is the third largest trading partner for Korea, after China and Japan (see the Appendix). The KORUS FTA will not make Korea an economic colony of the United States. Nor will the collapse of the deal make Korea a hermit kingdom; Korea is an established member of the multilateral trading regime. Instead of engaging in a war of words, it will be far more productive to examine in detail the benefits and costs of the proposed FTA.

According to the proponents of the KORUS FTA, the expected benefits for Korea include preferential access to the U.S. market and improvement in economic efficiency, especially in the service sector. They argue that the proposed FTA is likely to raise productivity in such areas as education, health care, finance, logistics, and legal services, as internationally competitive U.S. firms enter the Korean market on preferential terms. Some even contend that with China's rise as "the world's factory," Korea's economic future lies in services, not manufacturing.

However, upon closer examination, these arguments appear rather suspect. For Korea to make a significant gain from preferential market access under an FTA, the difference between the counterparty's tariff rates applied to FTA-signatories and non-signatories has to be large, as in such countries as China. As the U.S. average tariff rate is already quite low, at approximately 2.5 percent, Korea's expected gain from preferential access to the U.S. market is likely to be small. By contrast, because Korea's average tariff rate is relatively high, the U.S. gain from preferential access to the Korean market is likely to be large. In fact, the Korea Institute for International Economic Policy (KIEP) estimates that in the medium- to long-term, Korea's exports to the U.S. will increase by $7.1 billion while the U.S. exports to Korea will rise by $12.2 billion.(6)

Certainly, even in the U.S., there are some sectors such as textiles, sugar, and dairy products where high import tariffs are imposed to protect domestic producers. However, Korea's prospects of making a significant gain in these sectors are rather bleak. First of all, these heavily protected sectors in the U.S. tend to have strong political clout, and the vested interests in these sectors are unlikely to make concessions unless they are amply compensated for their expected losses. Second, restrictive rules of origin such as "yarn forward" in textiles are likely to prevent Korea from greatly increasing its exports to the U.S. even after signing the free trade agreement. Third, Korea has no comparative advantage in such "vulnerable" U.S. sectors as sugar and dairy products, and as a result, its ability to benefit from preferential market access is inherently limited in these sectors. In sum, the KORUS FTA is unlikely to raise Korea's share of the U.S. market by a significant amount from its current level of 2.6 percent.

General efficiency gain from the FTA is more likely, but this effect should not be exaggerated. According to the previously mentioned KIEP study, Korea's expected overall benefit from the FTA would amount to 1.99 percent of its GDP "over the long term" -- not each year. Although this is not an insignificant figure, it is by no means large and is quite sensitive to the underlying assumptions of the estimation model. A 2001 study by the International Trade Commission (ITC), for instance, showed that Korea's expected benefit would be equivalent to 0.7 percent of its GDP.(7) This is a rather disappointing figure in view of the fact that the computable general equilibrium (CGE) models used in these studies assume costless adjustment. In addition, econometric studies on the estimated impact of the FTA would be more convincing if they could point to tangible gains in specific sectors (and the mechanism through which these gains are made) rather than just making projections based on debatable assumptions about efficiency improvement.

Even more suspect than these quantitative exercises is the idea of upgrading Korea's service sector through the KORUS FTA. If the Roh government is serious about upgrading Korea's service sector, the best policy would be to liberalize it on a non-preferential basis under the General Agreement on Trade in Services (GATS). By contrast, using the KORUS FTA to open up Korea's service sector is likely to create two unnecessary problems. First, such a strategy will have the well-known effect of trade diversion -- in this case, discriminating against non-U.S. companies with valuable know-how. Second, Korea may have to accept rather broad investment protection provisions under an FTA, similar to Chapter 11 of the North American Free Trade Agreement (NAFTA). Article 1110 of the NAFTA guarantees foreign investors compensation for any direct or indirect expropriation or any measure “tantamount to” expropriation, where “expropriation” may mean the mere diminution in the value of an investment rather than a taking (that is, seizure of property). Also, through an investor-state dispute settlement mechanism, Chapter 11 of the NAFTA empowers private individuals and corporations to sue governments in special tribunals to demand compensation for government policies or actions that they believe are “tantamount to expropriation.” In practice, these broad investment protection provisions empower multinationals to challenge environmental, health, and other policy rules and regulations of the hosting government at the national, provincial, and local level.(8) This outcome may be something more than the Korean government has in mind. In this regard, it is interesting to note that the negotiations for the Multilateral Agreement on Investment (MAI) collapsed largely due to advanced industrial countries’ concern about the implications of its broad investment protection provisions.(9)

Moreover, despite the challenge posed by China, it would be rather imprudent to advocate a rapid shift from manufacturing to services in Korea. This argument in favor of services is somewhat reminiscent of the skepticism about the future of U.S. manufacturing in the 1980s when it faced stiff competition from Japan. Given export earnings and R&D externalities -- to say nothing of business services and jobs -- created by manufacturing, premature abandoning of manufacturing would have detrimental consequences.(10) Since the normalization of relations with China in 1992, Korea has benefited greatly by exporting manufactured products (especially, intermediate goods) to China, and on the whole has successfully climbed up the quality ladder. China’s rise as “the world’s factory” presents an increasingly tough challenge to Korea, and productivity improvement in services is a laudable goal in its own right, but the importance of manufacturing for Korea should not be overlooked.

In sum, Korea’s expected benefits from a ROK-US FTA may not be as large as claimed by its proponents. Moreover, the proposed FTA may have the effect of introducing new problems in some sectors. For instance, the negotiations may force Korea to revisit the issue of opening its rice market even though it has already dealt with this thorny problem at a multilateral level. Instead of tariffication, Korea has opted to guarantee minimum market access (MMA) for rice through the use of quotas. In December 2004, U.S. and Korean officials announced an agreement under which Korea will double the amount of rice it imports over the next 10 years and provide guaranteed access for 50,000 MT of U.S. rice each year. After much debate, this agreement was ratified by the National Assembly. Now, to sign a bilateral free trade agreement, Korea and the U.S. must liberalize “substantially all” trade between the two countries under GATT/WTO Article 24. Can Korea carve out the rice sector without making further concessions to the U.S. in the FTA negotiations since the two sides have already reached an agreement in a multilateral framework? The answer is no. In addition, in such sectors as health care, it is not at all clear Korea would benefit by institutionally harmonizing with the U.S, where there is no universal health care.

To assess the geopolitical impact of a ROK-US FTA, it may be useful to start by recalling that it was only a year ago when President Roh Moo-hyun’s speech about Korea’s role as “a balancer in Northeast Asia” caused a great deal of strain in the ROK-US alliance. Many Americans interpreted this as meaning that Korea would play the role of a balancer between the U.S. and China in the realist sense of the term, despite Korea’s bilateral alliance with the U.S. Over the past six months, however, the Roh government has accepted the principle of “strategic flexibility” despite its initial reservations and officially launched FTA negotiations with the U.S. Many Chinese are now concerned about this sudden development. In a little more than a year, the Roh government has managed to confuse the Americans and the Chinese about Korea’s geopolitical strategy. Does the official launch of the FTA negotiations represent a new trend or a pendulum swing back? No one seems to know for sure.

Nonetheless, many people seem to presume that the KORUS FTA will be a new glue that holds the alliance together, a quick fix for the strained relationship between the two countries. This is a reasonable presumption if the proposed free trade agreement can be concluded. However, the process leading to such an agreement will be far from smooth. Most importantly, the bilateral nature of negotiations may create the impression that the U.S. is to blame for heavy adjustment costs Korea’s “vulnerable” sectors must bear. For multilateral negotiations, anti-liberalization forces stage a protest against globalization, a phenomenon; whereas, for bilateral negotiations, they can target a particular country. In other words, negotiations for the KORUS FTA actually run the risk of fueling anti-American sentiment in Korea and anti-Korean sentiment in the U.S. -- exactly the opposite of what its proponents intended. This would be a shame, especially in light of the fact that bilateral trade and investment have been the saving grace of the ROK-US relations in recent years.

Notes

*An earlier version of this paper was presented at the inaugural session of the Seoul-Washington Forum, co-hosted by the Brookings Institution (www.brookings.edu) and the Sejong Institute (www.sejong.org), with support from the Korea Foundation, May 1 and 2, 2006, Washington, D.C.

The complete transcript of the Forum is available at www.brookings.edu/comm/events/20060501seoul.htm. An extended version of this paper, with policy recommendations, was published in Korean as a KNSI Policy Brief. Wonhyuk Lim is a CNAPS Visiting Fellow at the Brookings Institution. He is also a Fellow at the Korea Development Institute (www.kdi.re.kr) and Korea National Strategy Institute (www.knsi.org).

(1) See, for instance, the Blue House Briefing on June 19, 2003 (in Korean). Other European countries such as Ireland and Sweden were viewed in a favorable light as well for actively responding to the challenges of globalization while maintaining social cohesion.

(2) For details on Korea's FTA strategy as of early 2005, see Wonhyuk Lim, "Economic Integration and Reconciliation in Northeast Asia: Possibilities and Limitations," in *Rethinking Historical Injustice in Northeast Asia*, edited by Soon-Won Park and Gi-Wook Shin (New York: Routledge, forthcoming), available at www.brookings.edu/comm/events/20060502_wonhyuk2.pdf. For reference materials on the KORUS FTA, see www.kiep.go.kr/sub02/sub12.asp and www.keia.org/4-1-fta.html.

(3) For details on these unilateral concessions that apparently served as a litmus test of Korea's seriousness about a free trade agreement the U.S., see Mark E. Manyin, "South Korea-U.S. Economic Relations: Cooperation, Friction, and Prospects for a Free Trade Agreement(FTA)," CRS Report for Congress, Order Code RL 30566, updated February 9, 2006. See also a revised version of this report reflecting the Korean government's position that these concessions were voluntary measures.

(4) See, for instance, Jagdish Bhagwati, *The Wind of the Hundred Days: How Washington Mismanaged Globalization* (Cambridge: The MIT Press, 2000).

(5) For a comprehensive discussion of these issues, see Wonhyuk Lim and Ramon Torrent, ed., *Multilateral and Regional Frameworks for Globalization: WTO and Free Trade Agreements* (Seoul: Korea Development Institute, 2006).

(6) Hongsik Lee, Changsoo Lee, and Kyunghee Lee, "The Need for, and Economic Impact of, a Korea-U.S. FTA," KIEP Today's World Economy 06-01, January 18, 2006 (in Korean).

(7) United States International Trade Commission (USITC), *U.S.-Korea FTA: The Economic Impact of Establishing a Free Trade Agreement (FTA) Between the United States and the Republic of Korea* (Washington, D.C.: USITC, 2001).

(8) For details on investor-to-state claims cases, see Public Citizen, “NAFTA Chapter 11 Investor-to-State Cases: Bankrupting Democracy,” September 2001, at www.citizen.org/documents/ACF186.PDF.

(9) Emmanuel Glimet, “Multilateral Agreement on Investment: Lessons of a failure three years later,” presented at the seminar on The Regulatory Framework of Globalisation, organized by the Observatory of Globalisation, University of Barcelona, October 5-6, 2001.

(10) For an earlier defense of manufacturing in the U.S. context, see Michael L. Dertouzos, Richard K. Lester, Robert M. Solow, and MIT Commission on Industrial Productivity, *Made in America: Regaining the Productive Edge* (Cambridge, Mass.: MIT Press, 1989).

Institute for Far Eastern Studies, Kyungnam University

28-42 Samchung-dong, Chongro-ku, Seoul, 110-230, Korea

Tel: 82-2-3700-0700 Fax: 82-2-3700-0707

E-mail: ifes@kyungnam.ac.kr http://ifes.kyungnam.ac.kr