

# CRS Report for Congress

## The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)

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# The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)

## Summary

On June 30, 2007, trade officials representing the United States and South Korea signed the U.S.-South Korean Free Trade Agreement (KORUS FTA). The negotiations leading to the free trade agreement (FTA) covered a wide range of subjects, including a number of sensitive issues — autos, agriculture, trade remedies, among others — that have plagued the U.S.-South Korean trading relationship for decades and these subjects are reflected in the final text of the agreement.

Congress will have to approve implementation legislation for the KORUS FTA before it can enter into force. The negotiations were conducted under the trade promotion authority (TPA), also called fast-track trade authority, that the Congress granted the President under the Bipartisan Trade Promotion Act of 2002 (the Act) (P.L. 107-210). The authority allows the President to enter into trade agreements that receive expedited congressional consideration (no amendments and limited debate). The White House has not indicated when it will send the draft implementing legislation to Congress. (The TPA sets no deadline for the President to do this.) However, in a July 2, 2007 statement, House Democratic leaders cited problems with the agreement and indicated they could not support the KORUS FTA “as currently negotiated.”

The United States and South Korea conducted the FTA negotiations with a high degree of political risk for both countries, and that risk will likely carry over as their respective legislatures debate the merits of the FTA.

The KORUS FTA is the product of much compromise. As negotiators from both countries stated, the two sides were able to accomplish some of their objectives, but neither side got everything it wanted. Reactions to the KORUS FTA in both the United States and South Korea have been mixed. U.S. business community views largely reflect perceptions of to what degree the objectives of various groups were realized in the final agreement. In general, the U.S. business community at large — particularly many financial services firms — has expressed strong support for the FTA. However, some U.S. automobile manufacturers and major U.S. unions have criticized the agreement. Major agricultural groups have delayed a full response to the negotiations until South Korea agrees to lift its restrictions on imports of U.S. beef, underscoring the political importance of resolving this issue.

This report is designed to assist Members of the 110<sup>th</sup> Congress as they consider the merits of the KORUS FTA. It examines the KORUS FTA in the context of the overall U.S.-South Korean economic relationship, U.S. objectives, and South Korean objectives. The report will be updated as events warrant.

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# The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)

On June 30, 2007, trade officials representing the United States and South Korea signed the U.S.-South Korean Free Trade Agreement (KORUS FTA). The negotiations leading to the free trade agreement (FTA) covered a wide range of subjects, including a number of sensitive issues — autos, agriculture, trade remedies, among others — that have plagued the U.S.-South Korean trading relationship for decades and these subjects are reflected in the final text of the agreement. The FTA negotiations were at times contentious and their successful completion in doubt.

Congress will have to approve implementation legislation for the KORUS FTA before it can enter into force. The negotiations were conducted under the trade promotion authority (TPA), also called fast-track trade authority, that the Congress granted the President under the Bipartisan Trade Promotion Act of 2002 (the Act) (P.L. 107-210). The authority allows the President to enter into trade agreements that receive expedited congressional consideration (no amendments and limited debate). The White House has not indicated when it will send the draft implementing legislation to Congress. (The TPA sets no deadline for the President to do this.) However, in a July 2, 2007 statement, House Democratic leaders cited problems with the agreement and indicated they could not support the KORUS FTA “as currently negotiated.”

The United States and South Korea conducted the FTA negotiations with a high degree of political risk for both countries, and that risk will likely carry over as their respective legislatures debate the merits of the FTA.

The U.S.-South Korean alliance remains very strong. The United States and South Korea have been allies since the United States intervened on the Korean Peninsula in 1950 and fought to repel a North Korean takeover of South Korea. Over 33,000 U.S. troops were killed and over 100,000 were wounded during the three-year conflict.<sup>1</sup> However, the alliance also has shown signs of fraying. Some observers argue that the FTA would help to strengthen the alliance.

U.S.-South Korean trade frictions have diminished over the last decade and a half as political leaders have been forced to give higher priority to foreign policy and national security concerns, and the United States and South Korea have increasingly used the multilateral dispute settlement mechanism of the World Trade Organization (WTO) and other fora to address bilateral trade problems. In addition, South Korea has introduced a number of reforms to open its economy to foreign competition and

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<sup>1</sup> For more on the U.S.-South Korean alliance, see CRS Report RL33567, *Korea-U.S. Relations: Issues for Congress*, by Larry A. Niksch.

investment that have addressed some of the U.S. complaints. Yet, even though tensions have diminished, a number of long-standing, deep-seated differences in trade and investment relations have remained below the surface.

This report is designed to assist Members of the 110<sup>th</sup> Congress as they consider the merits of the KORUS FTA. It examines the contents of the proposed KORUS FTA in the context of the overall U.S.-South Korean economic relationship, U.S. objectives, and South Korean objectives. The report will be updated as events warrant.

## The Results of the Negotiations

The KORUS FTA is the product of much compromise. As negotiators from both countries stated, both sides were able to accomplish some of their objectives, but neither side got everything it wanted. The reactions in the United States and South Korea show that while some groups believe the proposed KORUS FTA has adequately addressed their concerns, other groups view the FTA as a “missed opportunity” to resolve their issues and are opposed to it. Some highlights of the results of the negotiations are provided based on official U.S. and South Korean summaries and comments as well as comments from informed private sector representatives.

### Agriculture

As expected, agriculture proved to be one of the most sensitive issues, pitting the more efficient U.S. producers against the highly protectionist South Korean agriculture sector. In general, the United States had pressed for complete trade liberalization in agriculture while South Korea wanted a number of products to be excluded from trade liberalization.

**Rice** was the most sensitive area for South Korea, and it was an issue that negotiators did not resolve until the end of the negotiations. The United States agreed to let South Korea exclude rice from FTA coverage; thus, South Korea would be able to maintain its quota on rice imports. U.S. negotiators came to the conclusion that their South Korean counterparts could not relent on rice because of domestic political pressures and that continuing to press the issue could jeopardize the entire negotiations. Deputy United States Trade Representative (USTR) Karan Bhatia stated that, “Ultimately, the question that confronted us was whether to accept a very, very good albeit less perfect agreement or to lose the entire agreement because Korea refused to move on rice.”<sup>2</sup>

South Korean restrictions on imports of U.S. **beef** was and continues to be a critical issue that could impede congressional consideration of implementing legislation for the KORUS FTA. At the conclusion of the FTA negotiations, South Korean officials did not provide a date by which their government would allow

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<sup>2</sup> USTR Says Beef Market Access Must Precede Signing of Korea FTA. *Inside U.S. Trade*. April 6, 2007.

shipments of U.S. beef to enter.<sup>3</sup> In December 2006, South Korean meat inspectors prohibited the entry of the first three shipments of U.S. beef after they found bone fragments. South Korea claimed that the shipments violated a September 2006 agreement to lift a ban that was imposed in December 2003 after a case of mad-cow disease was discovered in a cow in Washington State. Some Members of Congress, including Senate Finance Committee Chairman Max Baucus and Committee Ranking Member Charles Grassley, indicated that implementing legislation for the KORUS FTA would not pass Congress without a resumption of imports of U.S. beef into South Korea.<sup>4</sup> Before the ban was imposed, South Korea was the third-largest foreign buyer of U.S. beef. Korea resumed imports of boneless beef in late April but still embargos imports of bone-in beef.

South Korean officials said that they would resume the imports of bone-in beef if the World Organization for Animal Health (OIE) determines that the United States is a “controlled risk” country.<sup>5</sup> In an address to the nation, South Korean President Roh Moo-hyun noted that he personally had promised President Bush that Seoul would “uphold the recommendations” of the OIE and “open the Korean [beef] market at a reasonable level.”<sup>6</sup> The OIE made that determination on May 22. However, Korean officials have indicated that they still need to make sure that U.S. procedures are adequate to track accurately the origins of cattle and meat to ensure that they are safe. This beef issue was not actually part of the formal FTA negotiations but was discussed in parallel with the talks.

However, other market access issues in trade in beef and other meats were a direct part of the negotiations and the results include a phaseout of South Korean tariffs on beef over a 15-year period; a 10-year phaseout of tariffs on fresh and chilled pork products; a 12-year phase out of tariffs on frozen chicken breasts and wings; and a phaseout to be completed in 2014 of tariffs on frozen and processed pork products.<sup>7</sup>

In addition to rice and beef, trade in citrus products was also sensitive and was not resolved until the final days of the negotiations. The United States wanted complete elimination of tariffs on citrus, while South Korea wanted quotas and tariffs to remain, primarily because of their importance to the economy of Jeju Island. In a compromise, the negotiators agreed to a two-part solution: First, the 50% South Korean tariff will be maintained on imports of U.S. navel oranges in excess of 2,500 metric tons for shipments during South Korea’s September 1-February 28 growing season, and the quota will be increased 3% per year. Second, the tariff on out-of-season shipments will be reduced immediately from 50% to 30% and phased out over seven years. In addition, the South Korean tariff of 30% on grapefruit will be phased

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<sup>3</sup> *Washington Trade Daily*. April 23, 2007.

<sup>4</sup> *CQ Today*. April 9, 2007. p. 7.

<sup>5</sup> Wiesenmeyer, Jim. South Korea Officials Signal Change Re: U.S. Beef Purchases. AgWeb.com.

<sup>6</sup> South Korean Blue House, “Address to the Nation,” April 2, 2007.

<sup>7</sup> USTR Says Beef Market Access Must Precede Signing of Korea FTA. *Inside U.S. Trade*. April 6, 2007.

out over five years, and a 144% tariff on mandarin oranges will be phased out over 15 years.<sup>8</sup>

Also regarding agriculture, the negotiations resulted in:

- a phase-out of over twenty years of South Korean tariffs on apples and pears;
- immediate duty-free treatment for wheat, feed corn, soybeans for crushing, hides and skins, and cotton;
- immediate duty-free treatment for almonds, pistachios, bourbon whiskey, wine, raisins, grape juice, orange juice, fresh cherries, frozen french fries, frozen orange juice concentrate, and pet food;
- phase-out of tariffs over two years on avocados, lemons, dried prunes, and sunflower seeds;
- phase-out over five years of tariffs on food preparations, chocolate and chocolate confectionary, sweet corn, sauces and preparations, alfalfa, breads and pastry, and dried mushrooms; and
- increased quotas with zero in-quota tariffs (that is, tariffs that are applied to imports that enter within the quota) on skim and whole milk powder, whey, cheese, dextrins and modified starches, barley, popcorn, and feed-grade soybeans.<sup>9</sup>

## Automobiles

The United States had wanted South Korea to revise, if not eliminate, various tax regimes that the U.S. auto industry has cited as barriers to foreign competition in the South Korean market. Trade in autos proved to be another highly contentious issue that was not resolved until the final hours of the negotiations. As a result of the negotiations, the United States agreed to eliminate its 2.5% tariff on imports of Korean cars with engines up to 3,000 ccs, and to phase out the tariff on larger South Korean vehicles over three years. The United States also would phase out its 25% tariff on imports of South Korean light trucks over 10 years.

South Korea agreed to eliminate its 8% tariff on auto imports. In addition, South Korea agreed to revise its engine displacement tax regime so that there would be fewer tax categories and that the tax would be applied to most cars that are made in the United States in the same manner as it is applied South Korean-made cars.

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<sup>8</sup> *Congress Daily AM*. April 12, 2007.

<sup>9</sup> Office of the United States Trade Representative. *Trade Facts: Free Trade with Korea — Summary of the KORUS FTA*.



South Korea would also reduce over three years the excise tax on cars from 10% to 5% and reduce the number cars that would be subject to the tax.<sup>10</sup>

South Korea and the United States agreed to create a special dispute settlement mechanism for the commitments in the FTA pertaining to passenger cars. Specifically, the United States could bring a complaint to a special dispute panel if it believes that South Korea has violated a KORUS FTA commitment on autos or otherwise nullified or impaired expected benefits under that commitment. If the panel finds that (1) the relevant FTA provision has been violated or the benefits of the United States have been nullified or impaired and (2) the infringement has caused material injury to the U.S. industry, the panel can permit the United States to return or “snap-back” the auto tariff from zero to the MFN tariff, which is 2.5% in the case of the United States.<sup>11</sup> South Korea also agreed to loosen emission standards for certain categories of imported cars, to a grace period until December 31, 2008, for the application of an onboard diagnostics system for manufacturers that sell 10,000 or fewer cars in Korea, and to a two-year grace-period for the application of new South Korean safety standards.<sup>12</sup> The two sides would also create an Autos Working Group as a forum to address potential auto issues.

### **“The New Trade Policy for America”**

On May 10, 2007, a bipartisan group of congressional leaders and the Bush Administration released a statement that provided language to be included in pending and future FTAs. Among other things, the statement, or framework, called “The New Trade Policy for America,” requires U.S. FTA partners to commit to enforcing the five basic international labor standards and would require that the commitment be enforceable under the FTA.<sup>13</sup> The framework also requires FTAs to adhere to seven major multilateral environmental agreements and for this commitment to be enforceable under the FTA. “The Trade Policy for America” was completed after President Bush notified the Congress on April 1, 2007, of his intention to sign the KORUS FTA but prior to the signing on June 30. At first, South Korean officials balked at opening negotiations to add the language but eventually agreed to do so. After the two sides held negotiations, they included the language in the final text that was signed on June 30, 2007.

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<sup>10</sup> Bhatia Cool to Auto Changes in Korea FTA, Takes on Critics. *Inside U.S. Trade*. April 6, 2007.

<sup>11</sup> Michigan Members Defer Korea FTA Judgment Pending Full Text. *Inside U.S. Trade*. April 13, 2007.

<sup>12</sup> Office of the United States Trade Representative. *Fact Sheet on Auto-Related Provisions in the U.S.-Korea Free Trade Agreement*. April 3, 2007.

<sup>13</sup> The five standards are: freedom of association; the effective recognition of the right to collective bargaining; the elimination of all forms of forced or compulsory labor; the effective abolition of child labor and a prohibition on the worst forms of child labor; and the elimination of discrimination in respect of employment and occupation.

## Other Provisions

The FTA reportedly will cover a broad range of other areas. According to the Office of the USTR, 95% of U.S.-South Korean trade in **consumer and industrial products** would become duty-free within three years after the agreement enters into force, and virtually all remaining tariffs would be lifted within 10 years.

In **services**, the two countries agreed to use the negative list approach to making their commitments. That is, all sectors are considered targets for trade liberalization unless identified exempt in the relevant annexes. The commitments are ratcheted — when new services emerge in the U.S. or South Korean economies, those services are automatically covered by the FTA and if either country unilaterally liberalizes a measure that it had listed as an exemption, it is automatically covered under the FTA.

Furthermore, South Korea lifted some restrictions on trade and investment in various sectors. For example, South Korea agreed that the state-owned Korea Post, which sells insurance, would be subject to an independent state regulator as opposed to being self-regulated, and it would not be able to offer new insurance products.<sup>14</sup> U.S. financial institutions will be able to establish branches of banks, insurance companies, and assets management firms. U.S. companies would be able to *control* up to 100% of domestic Korean telecommunications companies, although they would still only be able to directly *own* up to 49% with remaining ownership held by a Korea-based holding company.<sup>15</sup>

Regarding **textiles and apparel**, the FTA, with some exceptions, would use the yarn-forward rule of origin; that is, in order for products to be considered FTA-eligible, they must be produced from components made in either the United States or South Korea. About 61% of U.S.-South Korea trade in textiles and apparel would become duty-free immediately. The FTA would also provide a special safeguard mechanism for textile and apparel imports, permitting the imposition of 24-month restrictions on imports that cause injury. The restrictions could be extended for an additional two years.<sup>16</sup>

**Trade remedies** were a critical issue for South Korea and a sensitive issue for the United States. The FTA would apparently allow, but not require, the United States to exempt imports from South Korea from an escape clause (section 201) measure if the South Korean imports are not a major cause of serious injury or a threat of serious injury to the U.S. domestic industry. In addition, the FTA would require the United States to inform the South Korean government of the right under U.S. trade remedy law to seek a suspension agreement in an antidumping duty or

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<sup>14</sup> Industry Supports Insurance, Telecom Language in Korea FTA. *Inside U.S. Trade*. April 13, 2007.

<sup>15</sup> Office of the United States Trade Representative. *Trade Facts: Free Trade with Korea — Summary of the KORUS FTA*.

<sup>16</sup> U.S. textile Industry Col to Korea FTA; Importers Neutral. *Inside U.S. Trade*. April 13, 2007.

countervailing duty case. The FTA would also provide for a binational consultative committee to review trade remedy decisions involving one another.<sup>17</sup>

In addition, concerning:

- **pharmaceuticals and medical devices**, the two countries agreed to establish an independent body to review recommendations and determinations regarding South Korean pricing and government reimbursement for medicines and medical devices and to improve transparency in the process for making those determinations.
- **Kaesong Industrial Complex**, one year after the KORUS FTA enters into force, a binational committee would be formed to study the possibility of eventually including products from “Outward Processing Zones” using North Korean labor sometime in the future. U.S. officials have emphasized that the word “Kaesong” does not appear in the FTA text nor does the inclusion of this provision imply that products from Kaesong will eventually be included.

## Preliminary Reactions to the Negotiations

Reactions to the KORUS FTA to date have been mixed. Major agricultural groups have expressed support for the agreement conditioned on South Korea resuming imports of U.S.-origin beef.<sup>18</sup> However, representatives of U.S. rice producers expressed disappointment with the exclusion of rice claiming that it would set a precedent for future FTAs.<sup>19</sup>

The U.S. business community at large has expressed strong support for the FTA. The National Association of Manufacturers (NAM), the Business Roundtable, among other groups that represent U.S. manufacturing, have expressed support for the negotiations and the results.<sup>20</sup> However, the Automotive Trade Policy Council, Ford, and Chrysler all issued statements expressing disappointment in the results of the negotiations. On the other hand, General Motors, which has substantial investment in the Korean car maker Daewoo, was somewhat more positive, stating that the FTA could lead to improved access for U.S.-made cars.<sup>21</sup>

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<sup>17</sup> Trade Remedy Piece of Korea FTA Ignores Korean ADF Demands. *Inside U.S. Trade*. April 13, 2007.

<sup>18</sup> American Farm Bureau Federation. Letter from Bob Stallman, President, to USTR Susan Schwab. July 11, 2007.

<sup>19</sup> USA Rice Federation. *U.S.-Korea FTA Rice Exclusion Dismays Industry*. Press release. April 3, 2007.

<sup>20</sup> National Association of Manufacturers. Press Release. April 2, 2007. Business Roundtable. Press release. April 2, 2007.

<sup>21</sup> Michigan Members Defer Korea FTA Judgement Pending Full Text. *Inside U.S. Trade*. April 13, 2007.

Organized labor opposes the results of the negotiations. AFL-CIO President John Sweeney stated that the FTA “contains no enforceable protections for workers’ rights.” He also stated that his organization is concerned that the FTA would “open the door to possible market access benefits for products” made in the Kaesong Industrial Complex.<sup>22</sup> The United Auto Workers has also recommended that Congress reject the agreement.<sup>23</sup>

Reactions in Congress have also varied and largely reflect the Members’ respective constituencies. However, in a statement released on July 2, 2007, House Speaker Nancy Pelosi, House Majority Leader Steny Hoyer, House Ways and Means Committee Chairman Charles Rangel, and Trade Subcommittee Chairman Sander Levin, indicated that, “Unfortunately, the KFTA [U.S.-South Korean Free Trade Agreement] as currently negotiated is a missed opportunity. The agreement does not address in an effective manner the persistent problem of non-tariff barriers, particularly those blocking access of U.S. manufactured products in South Korea’s market.... As a consequence, we cannot support the KFTA as currently negotiated.”<sup>24</sup>

Reactions in South Korea appeared to have been more widespread and intense than in the United States, a reflection of the stronger sensitivity the negotiations have had there. In South Korea, the conclusion of and debate over the KORUS FTA talks has generated front-page headlines. Some polls show public support for the agreement in the 50%-60% range, though most also show widespread belief that the United States benefitted more than South Korea. Generally, polls have shown that public opinion began tilting slightly in favor of the agreement in the summer of 2006, which is also when the Korean government began launching a more aggressive public relations campaign in favor of the FTA talks.<sup>25</sup> The two leading candidates for the presidency according to most polls strongly favor the agreement. Many observers predict that the Korean National Assembly will pass the agreement because it is supported by leaders of Korea’s two largest parties, the opposition Grand National Party (GNP), and the pro-government Uri Party, which was founded by President Roh. Between them, the GNP and Uri parties control 235 of 296 seats (127 for the GNP and 108 for the Uri Party). The exclusion of rice from the KORUS FTA removes what could have been a major political stumbling block.

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<sup>22</sup> AFL-CIO. *Statement of AFL-CIO President John Sweeney on the Proposed Korea-U.S. Free Trade Agreement April 2, 2007*. Press release.

<sup>23</sup> Bhatia Cool to Auto Changes in Korea FTA, Takes on Critics. *Inside U.S. Trade*. April 6, 2007.

<sup>24</sup> House Ways and Means Committee. Press release. Pelosi, Hoyer, Rangel, and Levin Statement on Trade. July 2, 2007.

<sup>25</sup> Jim Marshall, “KORUS FTA Supported by Half of South Korean Public,” *Opinion Analysis*, M-50-07, State Department Office of Research, April 5, 2007; Kim Sue-young, “51 Percent of People Support FTA,” *The Korea Times*, April 4, 2007; “Most Koreans Support FTA, Poll Shows,” *Chosun Ilbo* (in English), April 4, 2007.

However, many analysts say the agreement's passage is not a certainty, for a number of reasons.<sup>26</sup> Opposition to the agreement remains relatively strong (in the 35%-45% range in several polls) and intense, particularly among rural residents and politicians, unions, and left-leaning individuals and organizations. For instance, on average South Korea has experienced about one public anti-FTA demonstration a day since the talks were announced in February 2006.<sup>27</sup> As discussed below, in June 2007, the South Korean government presented the outlines of a plan to provide more than \$200 billion in trade adjustment assistance for sectors negatively affected by the KORUS FTA.

Moreover, party identity and discipline in South Korea often are weak and likely will become weaker during the build-up to the country's presidential election in December 2007. By law, President Roh cannot run for re-election. If Korea's past presidential elections are any guide, the coming months will see a whirlwind of defections, alliances, splits, and mergers as would-be presidents and ruling parties jockey for position. The fact that parliamentary elections are scheduled for April 2008 is likely to exacerbate the volatility of South Korean politics this year. Additionally, President Roh's political standing is low; even though his public approval ratings rose significantly after the KORUS FTA completion was announced, they remain in the 30% range (up from the 10%-20% range), and it is unclear how many Uri Party votes he can "deliver" for the FTA. An additional factor to consider is that in the past, on some controversial matters, sizeable minorities in the Assembly have delayed or prevented votes through such tactics as boycotts and physically blocking the speaker from assuming the chair.

Regardless of party affiliation, many legislators representing rural constituencies — by one estimate numbering 80 lawmakers — are likely to oppose the deal, as they did in the case of Korea-Chile FTA, which took nearly a year to be ratified after it was signed in 2003 in part because scores of rural representatives took over the Assembly floor to prevent debate.<sup>28</sup> According to two polls of nearly every South Korean lawmaker taken days after the agreement was reached, over 40% were noncommittal over the deal, with around 30% expressing support and around 25% in opposition.<sup>29</sup>

## **An Overview of the U.S.-South Korean Economic Relationship**

South Korea is a major economic partner for the United States. In 2006, two-way trade between the two countries exceeded billion, making South Korea the

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<sup>26</sup> See, for instance, "The Line-up for the FTA Ratification Fight," Andy Jackson's posting on The Marmot's Hole discussion group (<http://www.rjkoehler.com/>), posted on April 4, 2007 at 9:15 am, filed under South Korean politics.

<sup>27</sup> "Reason Must Prevail," *Korea Herald*, April 9, 2007.

<sup>28</sup> "FTA may face uphill battle in Korean Assembly approval," *Hankyoreh*, April 4, 2007.

<sup>29</sup> Kim Sue-young, "42% of Lawmakers Noncommittal Over Deal," *Korea Times*, April 3, 2007; Jin Hyun-joo, "112 Lawmakers Undecided," *The Korea Herald*, April 3, 2007.

United States's seventh-largest trading partner. (See **Table 1.**) South Korea 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.

**Table 1. 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
Major U.S. Export Items	Semiconductor chips and manufacturing equipment; aircraft; corn and wheat; plastics. (See Appendix C for more details.)			
Major U.S. Import Items	Semiconductor circuits; televisions and flat panel screens; cars; steel. (See Appendix C for more details.)			

**Sources:** 1990 and 1995 data from Global Trade Information Services. 2000-2006 data from U.S. International Trade Commission.

South Korea is far more dependent economically on the United States than the United States is on South Korea. In 2006, the United States was Korea's third-largest trading partner, second-largest export market, third-largest source of imports, and its second largest supplier of foreign direct investment (FDI). In 2003, China for the first time displaced the United States from its perennial place as South Korea's number one trading partner. In 2005 Japan overtook the United States to become South Korea's second-largest trade partner.

**Table 2. Asymmetrical Economic Interdependence (2006)**

	Total Trade	Export Market	Source of Imports	Source of FDI
For the U.S., South Korea ranks	#7	#7	#7	#28 (2004)
For South Korea, the U.S. ranks	#3	#2	#3	#2

**Sources:** U.S. Department of Commerce, U.S. Census Bureau and Bureau of Economic Analysis; Bank of Korea.

Increased economic interaction between the United States and South Korea has been accompanied by numerous disagreements over trade policies. In general, U.S. exporters and trade negotiators identify the lack of transparency of South Korea's trading and regulatory systems as the most significant barriers to trade with South Korea in almost every major product sector. Many U.S. government officials also complain that Seoul continues to use government regulations and standard-setting powers to discriminate against foreign firms in politically sensitive industries, such as automobiles and telecommunications. Another major cross-sectoral complaint is that rigidities in the South Korean labor market, such as mandatory severance pay, raise the cost of investing and doing business. Finally, the United States and other countries have pressed South Korea to open further its agricultural market, which is considered one of the most closed among members of the Organization for Economic Co-operation and Development (OECD).<sup>30</sup>

The intensity of these disputes has diminished considerably since the late 1980s and early 1990s, in part because South Korea has enacted a set of sweeping market-oriented reforms as a *quid pro quo* for receiving a U.S.-led \$58 billion package from the International Monetary Fund (IMF) following the near collapse of the South Korean economy in 1997. In particular, as a result of the reforms, South Korea opened its doors to foreign investors, ushering in billions of dollars of foreign portfolio and foreign direct investment (FDI). The result is that foreign companies, including U.S. firms, now are significant shareholders in many prominent industrial conglomerates (*chaebol*), at one point owned about one-third of the South Korean banking industry and an estimated 40% of the value of the shares traded on South Korea's stock exchange. Since the 1997 crisis, FDI commitments by U.S. companies have totaled approximately \$20 billion.

Additionally, the United States and South Korea appear to have become more adept at managing their trade disputes. This may be partly due to the quarterly, working-level "trade action agenda" trade meetings that were initiated in early 2001. Both sides credit the meetings, which appear to be unique to the U.S.-South Korean trade relationship, with creating a more constructive dialogue that helped pave the way for the two sides to feel sufficiently confident to launch FTA negotiations.

## **U.S. Interests and FTA Negotiating Objectives**

An FTA with South Korea would have immediate economic and foreign policy implications for U.S. relations with South Korea specifically, but it could also have broader implications for U.S. economic and foreign policy interests in East Asia and beyond. The United States entered the negotiations with a number of issues and objectives.

### **Why an FTA?**

As indicated earlier, South Korea is the seventh largest U.S. trading partner overall. It is also the third largest U.S. trading partner in East Asia (behind China and

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<sup>30</sup> OECD, *Economic Survey - Korea 2004*.

Japan). Many supporters view an FTA as a logical extension of the bilateral economic relationship that would provide a means by which the two trading partners could address and resolve fundamental issues and, thereby, raise the relationship to a higher level. The FTA could also stand as a symbolic indication of the firmer relationship.

An FTA may also be viewed by some as a means to reassert the importance of a critical foreign policy and national security alliance by rising above differences that have caused the U.S.-South Korean alliance to fray recently. For example, the Bush Administration and South Korean leaders have differed over how to manage relations with North Korea. Specifically, South Korea's "sunshine policy" of emphasizing bilateral reconciliation with North Korea generally has meant that Seoul has not supported U.S. diplomatic and rhetorical efforts to pressure North Korea, especially on North Korea's nuclear weapons programs. The re-positioning of U.S. troops in South Korea has also generated some friction between the two allies.<sup>31</sup>

Some experts have suggested that a KORUS FTA could curb the rising tide of China's economic and political influence in East Asia. China has surpassed the United States as the most important export market for South Korea and the second most important source of imports into Korea (behind Japan). China is also forging ties with the 10-member Association of Southeast Asian Nations (ASEAN) in an ASEAN+3 arrangement (China, Japan and South Korea), arrangements from which the United States is excluded. An FTA could ensure that the United States has an institutional presence in East Asia. In addition, trade expert Claude Barfield of the American Enterprise Institute suggests that a KORUS FTA could generate a "domino effect" that leads to other countries, such as Japan, pressing to enter into similar arrangements with the United States.<sup>32</sup> All of this came as the discussions within the Asian-Pacific Economic Cooperation (APEC) forum on forming a free trade area of the Asia-Pacific region were making little headway.

In terms of broader U.S. trade policy, an FTA with Korea would build on the policy first introduced by then-USTR Robert Zoellick, "competitive liberalization," that uses free trade agreements and multilateral trade agreements to encourage trading partners to remove trade and investment barriers and be a model for others. In that sense, the KORUS FTA would be a major step forward in the policy. It would be the largest U.S. FTA in terms of mutual trade and investment, since the North American Free Trade Agreement (NAFTA) went into effect in 1994. It would also respond to some critics of Bush Administration trade policy that the FTAs that the United States has entered into since NAFTA account for very little trade and yield relatively little in commercial benefits.

South Korea has entered into FTAs with Chile, Singapore, the European Free Trade Association (EFTA), the Association of Southeast Asian Nations (ASEAN),

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<sup>31</sup> CRS Report RL33567, *Korea: U.S.-Korea Relations: Issues for Congress*, by Larry Nikisch.

<sup>32</sup> Barfield, Claude. U.S.-South Korea FTA: A Tipping Point. *The Policy Monitor*. Medley Global Advisors. April 13, 2007.



and is negotiating with other countries, including Japan.<sup>33</sup> A U.S. FTA could help prevent U.S. exporters from being placed at a competitive disadvantage with these other countries in the South Korean market.

## U.S. Issues and Negotiating Objectives

The decision to launch the KORUS FTA talks generally received bipartisan support in the Congress and broad approval in the U.S. business community, many members of which see the agreement as an opportunity to obtain the removal of long-standing South Korean tariff and non-tariff barriers to trade and investment.<sup>34</sup> Some groups opposed the negotiations and expressed early opposition to the FTA after the negotiations were completed because they doubt that an FTA can address their problems of doing business in South Korea. For example, organized labor raised concerns about workers' rights issues in South Korea and about the possibility that products that North Korean workers produce in the Kaesong industrial zone could be transshipped duty free to the United States through South Korea.<sup>35</sup> Representatives of U.S.-based auto manufacturers expressed early opposition to the FTA, because they believe that it does not address the South Korean barriers to auto imports.

The issues that the United States raised during the negotiations cut across many sectors and other areas of interest.

**Agriculture.** Agriculture was high on the U.S. agenda and, as expected, was among the most contentious in the negotiations. Agriculture is an important sector in U.S. trade as a whole and in trade with South Korea. It is also an area that has generated a great deal of bilateral trade friction because of Korea's highly protectionist agricultural policies.

Negotiations pertaining to access to Korea's domestic **rice** market were among the most contentious, pitting a diminishing but nevertheless highly vocal community of South Korean rice farmers against an equally influential community of U.S. rice growers who are also major exporters. Although agriculture accounts for around 7% of South Korean employment, strong cultural ties to rural areas still makes the agriculture sector a formidable political force that is manifested in very strict controls on imports of agricultural products, including rice.

As the South Korean economy has become more dependent on exports of manufactured goods, South Korea's trading partners, including the United States,

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<sup>33</sup> EFTA is comprised of Iceland, Norway, Switzerland, and Liechtenstein. ASEAN consists of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.

<sup>34</sup> Primosch, William. *Testimony of Senior Director, International Business Policy, National Association of Manufacturers on the Proposed United States-Korea Free Trade Agreement for the Trade Policy Staff Committee, Office of the U.S. Trade Representative.* March 14, 2006.

<sup>35</sup> Lee, Thea M. *Testimony on the Proposed U.S.-South Korea Free Trade Agreement.* Submitted by the American Federation of Labor and Congress of Industrial Organizations. March 14, 2006.

have demanded that South Korea reduce restrictions on agricultural imports in exchange for greater access for South Korea's exports of manufactured goods. As part of the WTO Uruguay Round Agreements that went into effect on January 1, 1995, South Korea opened its rice markets to imports but was given "special treatment" by being allowed to do so under an import quota system that gradually increased the volume of rice imports. The program was due to expire at the end of 2004, but South Korea reached an agreement with major rice-exporting countries to continue importing rice under a growing, but restrictive, quota that is in effect through 2014.

U.S. rice producers had expressed support for the U.S.-South Korean FTA negotiations. However, they wanted the FTA to include completely free trade in rice, requiring Korea to remove the quotas completely. Furthermore, they wanted the quotas and tariffs to be phased out faster than in the FTA United States agreed to with the Dominican Republic and Central American countries (DR-CAFTA), and in the FTAs with Peru and Colombia. U.S. rice producers also opposed emergency safeguards measures for Korean rice imports beyond the phase-out period.<sup>36</sup> During the negotiations, South Korea insisted on excluding rice from the FTA, while the United States insisted that it should be included. The issue remained a point of contention until the very end of the negotiations when the negotiators decided to exclude rice from the FTA.

In addition to restrictions on rice, the USTR and agriculture trade groups indicated the following among U.S. priorities in the negotiations:<sup>37</sup>

- eliminate "unnecessary" and unscientific South Korean sanitary and phyto-sanitary (SPS) regulations, with Korea reaffirming its commitment to the WTO SPS agreement that requires SPS regulations to be "science-based;"
- ensure that the phase-out periods for agricultural tariffs and quotas would not be unnecessarily long and eliminate non-tariff barriers, including permit and licensing requirements;
- eliminate unnecessary restrictions on perishable imports and cyclical agricultural products;
- provide special rules of origin for U.S. beef shipments to South Korea that would include a "born, raised, and

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<sup>36</sup> USA Rice Federation. *Submission to the Trade Policy Subcommittee in Response to the Federal Register Notice of February 9, 2006 — U.S.-Korea Free Trade Agreement*. March 14, 2006.

<sup>37</sup> Office of the United States Trade Representative. Notification to Congress of intent to begin free trade agreement negotiations with the Republic of Korea. *Congressional Record*. February 2, 2006. p. S503-S505.

slaughtered rule” giving preferential treatment to U.S. beef producers;<sup>38</sup> and

- eliminate export subsidies on all South Korean agricultural products.

**Autos and Autoparts.** Negotiations on trade in some manufactured goods have also been intense, particularly on trade in cars and auto parts. After a rough start in the 1980s and 1990s, South Korean manufactured passenger cars have been achieving competitive success in the U.S. market, especially as soaring gasoline prices have increased demand for smaller, gas-efficient vehicles. However, U.S.-based car manufacturers have been much less successful in gaining shares of the Korean domestic car market. South Korean imports of foreign automobiles totaled around 37,000 in 2006 — including about 6,500 U.S. vehicles — just over 4% of total car sales in the South Korean market. In contrast, South Korean auto manufacturers exported nearly 750,000 cars to the United States in 2006, capturing over 4% of the U.S. market.

U.S.-based auto producers have blamed various Korean regulations for limiting the U.S. market share. In 1998, the United States and South Korea signed a Memorandum of Understanding (MOU) in which the Korean government agreed to take steps to address the U.S. issues. While the Office of the USTR reports that South Korea has fulfilled many of the commitments, U.S. negotiating objectives include other steps to be taken to prevent discrimination toward U.S. auto exporters. Among them were to reduce or eliminate the 8% tariff on car imports and to revise the domestic taxes that are applied to the full price (including tariffs) of imported cars and car taxes that are based on engine displacement that allegedly disadvantage U.S.-made cars, which tend to be larger than domestically-produced Korean cars.<sup>39</sup> An indication of the importance of the issue in the negotiations is that a special working group on the auto issue was part of the structure of the negotiations.

Charles Ulthus, vice-president of the Automotive Trade Policy Council, complaining about past South Korean anti-import policies on autos, laid out the U.S. auto industry position stating:

Given Korea’s status as a major global player, its closed market to imports, and [the] long history of unsuccessful U.S. efforts to dismantle Korea’s nontariff barriers, we are advocating for a comprehensive dismantling of Korea’s nontariff barriers and we are asking that Korea demonstrate up front that its market is open before we unilaterally provide it with preferential access to the U.S. market... [W]e are looking for something more than just promises that the

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<sup>38</sup> R-CALF USA. United Stockgrowers of America. Press Release. Korea FTA Could Provide Substantial Benefits to U.S. Cattle Producers. March 16, 2006.

<sup>39</sup> Office of the United States Trade Representative. *National Trade Estimates — Foreign Trade Barriers Report, 2006*. April 2006. p. 413-414.

market will open, more than just commitments to address one tariff barrier, which very well could be circumvented at a later date.”<sup>40</sup>

In a March 1, 2007 letter from several House Ways and Means Committee and Senate Finance Committee members to President Bush proposed the following: the immediate elimination of Korea’s 8% auto tariff; the longest possible phase out for the 2.5% U.S. auto tariff, with the United States progressively reducing its tariff only after certain numbers of U.S. cars were sold in Korea; the creation of a safeguard mechanism for the U.S. auto industry that would go into effect when the U.S. auto tariff is phased out; and the exclusion of the 25% U.S. tariff on pickup trucks from the FTA negotiations. The letter was supported by major U.S. auto industry groups.<sup>41</sup>

As mentioned above, in the end, the United States agreed to eliminate its 2.5% tariff on imports of Korean cars with engines up to 3,000 ccs, and to phase out the tariff on larger South Korean vehicles over three years. The United States also would phase out its 25% tariff on imports of South Korean light trucks over 10 years.

In addition, South Korea agreed to eliminate its 8% tariff on auto imports. In addition, South Korea agreed to revise its engine displacement tax regime so that there would be fewer tax categories and that the tax would be applied to most cars that are made in the United States in the same manner as it is applied South Korean-made cars. South Korea would also reduce over three years the excise tax on cars from 10% to 5% and reduce the number of cars that would be subject to the tax.

**Other Manufactured Goods.** In addition, U.S. exporters of manufactured goods indicated that they wanted to see the following objectives, among others, included in a final U.S.-South Korea FTA:

- eliminate tariffs and other barriers to reciprocal access to the South Korean market for U.S. textile and apparel products with reasonable phase-in periods;
- eliminate immediately tariffs on 99% of imports of manufactured goods (as is the case in the U.S.-Australia FTA);
- remove non-tariff barriers and prevent new ones from emerging, for example, health and safety requirements that differ widely from accepted practices in other countries; unnecessarily burdensome technical standards; duplicative testing requirements for foreign products; and requirements to submit proprietary manufacturing information;
- provide access to U.S. exporters in the development of South Korean domestic regulations; and

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<sup>40</sup> Quoted in *International Trade Reporter*. May 18, 2006. p. 760.

<sup>41</sup> “Korea, U.S. Congress Hold Firm On Conflicting Auto Positions,” *Inside US Trade*, March 9, 2007.

- address the use of adjustable border taxes, adjustment taxes, domestic taxes, and indirect government support for local industries that adversely affect U.S. exports.<sup>42</sup>

**Intellectual Property Rights (IPR) Protection.** U.S. negotiators wanted to secure South Korean agreement to strengthen enforcement of intellectual property rights, including controls over unauthorized online transmission and distribution of copyrighted works, the seizure of pirated goods and equipment to make and transmit pirated goods, and proper compensation to victims of IPR violations.<sup>43</sup> The U.S. business community targeted specific Korean policies and practices in intellectual property issues. For example, the Korean Food and Drug Administration (KFDA) requires that proprietary data on pharmaceutical manufacturing processes be submitted for new drugs; in addition, the South Korean government has, in some cases, approved marketing of some pharmaceuticals before it has determined that the applicant is the rightful owner of the patent and trademark.<sup>44</sup> The USTR has continued to place South Korea on the special 301 “Watch List.” The USTR indicated that the South Korean government has strengthened its enforcement of copyright laws but still needs to go further.<sup>45</sup>

**Services.** The United States pressed South Korea to reduce barriers to sales of U.S.-origin media in South Korea. South Korea took a major step in this direction, leading up to the launch of the negotiations, by reducing by half to 73 days per year the number of days that South Korean cinemas have to show South Korean films. U.S. movie producers and distributors wanted a further reduction during the negotiations. U.S. providers in telecommunications, financial services, professional services, and other services sectors wanted to see greater market access in South Korea, and the United States pushed for improved transparency and predictability of South Korean government regulatory procedures in all services sectors.

**Foreign Investment.** In the area of South Korean foreign investment policies and regulations, U.S. negotiators pressed South Korea to: remove trade distorting barriers (export and local content requirements) to U.S. investment; provide timely resolution of disputes between U.S. investors and South Korean authorities; and extend national treatment for U.S. investors in Korea, so that U.S. investors would be treated no less favorably than domestic South Korean investors. U.S. negotiators aimed to obtain other rights for U.S. investors comparable to their rights in the

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<sup>42</sup> Primosch, William. *Testimony of Senior Director, International Business Policy, National Association of Manufacturers on the Proposed United States-Korea Free Trade Agreement for the Trade Policy Staff Committee, Office of the U.S. Trade Representative.* March 14, 2006.

<sup>43</sup> Office of the U.S. Trade Representative.

<sup>44</sup> Primosch, William.

<sup>45</sup> Office of the USTR. *Special 301 Report.* April 2006.

United States but make sure that South Korean investors in the United States are not accorded rights that are more favorable than U.S. domestic investors.<sup>46</sup>

**Competition Policy.** The United States encouraged discussion, in the areas of competition policy, anti-competitive business conduct, designated monopolies, state enterprises, and other competition-related issues as appropriate. It also wanted to prevent the application of South Korean competition laws and regulations in a discriminatory manner and apply anti-trust laws effectively against South Korean firms. U.S. businesses have complained that the *chaebols*, the family-owned business conglomerates that dominate the South Korean economy, have made it difficult for foreign companies to compete in the Korean market.<sup>47</sup> U.S. and other foreign businesses also have complained that the opacity of the *chaebols'* ownership structure makes it difficult, if not impossible, for foreigners to acquire majority stakes in major South Korean companies. Additionally, the relationship between major *chaebol* and the South Korean government occasionally has led to trade disputes between the two governments. In 2003, for instance, the United States and the European Union assessed punitive countervailing duties tariffs against Hynix Semiconductor, then the world's third-largest producer of dynamic random access memory (DRAM) semiconductor chips, for allegedly receiving subsidies from the South Korean government. South Korea challenged the rulings in the WTO, which eventually upheld the U.S. duties. Hynix formerly was part of the Hyundai *chaebol*.

**Other U.S. Objectives.** In addition to the above, the USTR indicated that the following were among U.S. goals in the negotiations:<sup>48</sup>

- ensure that South Korea does not discriminate in **e-commerce trade**.
- get South Korea to reaffirm its commitments under the WTO Agreement on **Technical Barriers to Trade**.
- press South Korea to expand its commitments under the WTO Agreement on **Government Procurement** to cover more government agencies and at lower contract-value thresholds.
- provide **safeguards** measures in the form of temporary revocation of tariff preferences during a transition period to protect against import surges.

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<sup>46</sup> Office of the United States Trade Representative. Notification to Congress of intent to begin free trade agreement negotiations with the Republic of Korea. *Congressional Record*. February 2, 2006. p. S503-S505.

<sup>47</sup> *Inside U.S. Trade*. April 21, 2006.

<sup>48</sup> *Ibid* unless otherwise indicated.

- encourage South Korea to pursue policies that limit **currency intervention** and allow the won/dollar exchange rate to be set by the market.<sup>49</sup>
- promote trade and **environment** policies that are mutually supportive and ensure South Korean commitment to enforcing **labor** rights.

## South Korean Interests in an FTA with the United States

### Why an FTA?

Entering an FTA with the United States meshes with a number of South Korean President Roh Moo-hyun's long term economic and strategic goals. Roh has made an FTA the top economic priority for the remainder of his tenure, which expires in February 2008.<sup>50</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 has heightened the sense of urgency about boosting national competitiveness. Continuing along this line of argument, South Korean 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>51</sup>

During a televised debate over the proposed FTA in March 2006, Prime Minister Han went further, arguing that the KORUS FTA is essential for South Korea's survival, a word also used by President Roh.<sup>52</sup> To accelerate Korea's reform efforts — and also to avoid being left out from other FTAs being created globally and in Asia — President Roh has pursued an aggressive effort to negotiate FTAs, the first of which South Korea signed with Chile in 2004. Convincing the United States to

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<sup>49</sup> Primosch, William.

<sup>50</sup> "ROK Editorial: Roh's 'Special Lecture'," *The Korea Times*, posted on the Open Source Center, KPP20060329042002, March 29, 2006.

<sup>51</sup> Ministry of Finance and Economy Weekly Briefing, "Korea-US FTA Projected to Boost the Korean Economy," March 9, 2006.

<sup>52</sup> Korea Broadcast System, March 31, 2006 Broadcast in Korean, summarized by the Open Source Center, "ROK TV Carries Economic Minister's Comments on ROK-US FTA," April 10, 2006, FEA20060410021900. (Han was Finance Minister when he made these remarks). South Korean Blue House, "Address to the Nation," April 2, 2007.

launch an FTA became a part of this larger effort, and South Korea first proposed the idea in 2003.<sup>53</sup>

### South Korea's FTA Drive

#### Completed FTAs:

- Chile (entered into force April 2004)
- Singapore (entered into force March 2006)
- EFTA (entered into force September 2006)
- United States (completed March 2007)

#### FTAs being negotiated:

- ASEAN (final agreement on goods reached May 2006; excludes Thailand due in part to South Korea's exemption of rice from the agreement; negotiations continuing on services)
- Mexico (launched September 2005)
- Canada (launched July 2006)
- India (negotiations begun March 2006)
- Japan (launched December 2003; negotiations currently stalled)
- EU (negotiations to be launched May 2007)

#### FTAs under consideration:

- China (joint study being conducted)
- Australia (plans for joint study announced in December 2006)

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 that South Korean firms presumably would receive, despite the predictions that South Korean manufacturing exports would increase significantly. 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. This 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>54</sup> The President and other senior officials in particular emphasized the need to boost the competitiveness of South Korean service industries. An FTA with the United States, they argued, will help address South Korea's increased economic polarization by spurring job creation in fields such as medical, legal,

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<sup>53</sup> In an April 2, 2007 speech to the nation following the completion of KORUS FTA talks, Roh said, "Once more, I would like to mention that the FTA negotiations were first proposed and initiated by the Korean Government." The President was responding to criticism that the United States had pressured South Korea to begin negotiations. South Korean Blue House, "Address to the Nation," April 2, 2007.

<sup>54</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), p. 116-117; Inbom Choi and Jeffrey Schott, *Free Trade between Korea and the United States?* (Washington, DC: Institute for International Economics, 2001), p. 79-82.



education, and accounting services in a free trade agreement.<sup>55</sup> Some, however, say an FTA will worsen South Korea's income gap.<sup>56</sup>

Strategically, some in South Korea and the United States also see the FTA as a means for boosting the U.S.-South Korean alliance. In announcing the launch of the FTA, for instance, Trade Minister Hyun-chong Kim stated that the FTA launch was "the most important event" in the history of the alliance, one that would take the U.S.-South Korean relationship "to the next tier, the next level."<sup>57</sup> Some in Korea and the United States feel a need to boost the relationship because of bilateral strains over major alliance issues, primarily brought about by different views about how to handle North Korea and China. Since the late 1990s, even as Americans have come to feel that the danger from North Korea has increased, South Koreans' perception of a threat from North Korea has declined markedly.<sup>58</sup> This has led some to question the purpose of the U.S.-South Korea alliance, which is predicated upon deterring an attack by North Korea.

Additionally, South Korea's policy of emphasizing bilateral reconciliation with North Korea generally has meant that South Korea has not supported U.S. efforts to pressure North Korea. Another major difference between Seoul and Washington is that many South Korean officials, including President Roh, oppose the deployment of U.S. forces based in South Korea to other areas in Asia without South Korean consent; South Korean leaders generally do not wish to antagonize China over the Taiwan issue. In the face of these growing questions about the utility of the alliance to Seoul, many argue that an FTA will provide a counterweight to help balance areas of difference and help provide a "new basis" for the alliance with something to "stand for" rather than "stand against."<sup>59</sup>

There is an expectation among some Koreans that a U.S.-South Korea FTA will have even broader strategic effects. Some analysts in Seoul believe that an FTA will improve South Korea's standing in Northeast Asia by boosting its status as a middle power. President Roh has spoken vaguely of South Korea asserting a future role as a "balancer" among the major powers in the region. An FTA conceivably might help South Korea play this role not only by boosting South Korea's economic performance, but also by ensuring that the United States remains a strategic and economic counterbalance to China and Japan.<sup>60</sup> Some South Koreans have turned

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<sup>55</sup> "Roh's 'Special Lecture'," *The Korea Times*, March 26, 2006.

<sup>56</sup> Korea Broadcast System, March 31, 2006 Broadcast.

<sup>57</sup> USTR Press Release, "Remarks by U.S. Trade Representative Rob Portman and Republic of Korea Trade Minister Hyun-chong Kim, Launch of U.S.-Korea Free Trade Agreement," US Capitol, February 2, 2006.

<sup>58</sup> See, for instance, Jim Marshall, "South Korean Public's Frustration with Engagement," *Opinion Analysis M-130-06*, State Department Office of Research, November 9, 2006.

<sup>59</sup> For more on U.S.-Korean strategic relations, see CRS Report RL33567, *Korea: U.S.-Korean Relations*, and CRS Report RL33590, *North Korea's Nuclear Weapons Development and Diplomacy*, both by Larry Niksch.

<sup>60</sup> ROK President Roh Moo-hyun's speech at the 53rd Air Force Academy Graduation and (continued...)

this argument on its head, positing that China might consider a U.S.-South Korean FTA a threat to its interests.<sup>61</sup> Additionally, some South Korean proponents of an FTA believe that successfully negotiating an agreement could lessen disagreements between Washington and Seoul over North Korea policy, by compelling “politicians and officials in each nation toward a deeper understanding of the broad forces at play in the other.”<sup>62</sup> Given the importance of North Korea in the foreign policies of both countries, however, it is unlikely that an FTA will have much impact on the overall thrust of either country’s approach toward Pyongyang.

## Criticism of the FTA within South Korea

Criticism of the decision to launch an FTA with the United States intensified in the early spring of 2006, fanned in part by public opposition by some former senior members of Roh’s ruling camp. Although it appears that a narrow majority of South Koreans support the FTA, opposition at times has been intense, particularly among farmers, unions, and rural residents. In early 2007, a number of prominent left-of-center politicians, including two former chairmen of Roh’s Uri Party who are running for president, publicly stated their opposition to the KORUS FTA.<sup>63</sup> As of April 2007, both candidates were polling in the single digits. Many observers of the Korean political scene have criticized the Roh government for not waging an earlier and more assertive campaign to promote the its decision to launch the KORUS FTA.

One reason for the intensity of the opposition to a proposed FTA with the United States is that the negotiations have merged a number of forces in the Korean polity, including anti-American forces on the far left of Korea’s political spectrum and traditional trade liberalization opponents, such as farmers and trade unions. The latter groups also have opposed other trade deals. South Korean farmers engaged in occasionally violent protests during the December 2005 multilateral Doha Development Agenda (DDA) ministerial meetings in Hong Kong, and one Korean farmer committed suicide outside the meetings in the 2003 Cancun DDA Ministerial Meeting. After the Roh government signed Korea’s first FTA, with Chile, in 2003, it took South Korea’s National Assembly nearly a year to ratify the agreement because of the strength of the opposition, particularly from farm groups and rural legislators.<sup>64</sup> Some Koreans argue that an FTA with the United States will primarily benefit Korean *chaebol* (conglomerates), thereby widening economic disparities inside South Korea.<sup>65</sup>

Barring a dramatic reversal in Roh’s political fortune, the South Korean President is in a weak political position to try to sell the FTA to the National

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<sup>60</sup> (...continued)

Commissioning Ceremony, March 8, 2005, translated by FBIS, KPP20050308000923.

<sup>61</sup> “Former Presidential Aide Slams FTA Talks With U.S.,” *Yonhap*, April 4, 2006.

<sup>62</sup> *Feasibility and Economic Effects of a Korea-U.S. FTA*, p. 139.

<sup>63</sup> “Progressive Lawmakers in United Front Against FTA,” *Chosun Ilbo*, March 18, 2007.

<sup>64</sup> “Assembly Passes Chile FTA at Last,” *The Korea Herald*, February 17, 2004.

<sup>65</sup> “Korea-U.S. FTA Remains Contentious,” *The Korea Herald*, April 25, 2006.

Assembly for ratification. According to many observers, the full force of the “lame duck” phenomenon has hit Roh; South Korea will hold its presidential election in December of 2007 and by law Roh cannot run for a second term. Roh is widely regarded as an unpopular president; various polls before the completion of the FTA talks put his popularity at the 20% level. His Uri party lost control of the National Assembly in 2005, when it was routed in successive bi-elections by the main opposition group, the conservative Grand National Party (GNP). Complicating the political difficulties for President Roh is that, as a left-of-center politician, he has drawn significant political support from many of the groups that oppose the KORUS FTA. Indeed, many of these groups have turned lukewarm toward Roh since his election in 2002, as a result of his support for continued market-opening measures and his periodic efforts to cooperate with the United States, particularly his dispatch of over 3,000 Korean troops to Iraq after the U.S.-led invasion.

## **South Korea’s Proposed Trade Adjustment Assistance**

In late June 2007, as U.S. and South Korean negotiators were finalizing negotiations to sign the KORUS FTA, the South Korean Ministry of Finance and Economy provided the Korean National Assembly with the outlines of the trade adjustment assistance package that could be expected if the Assembly and the U.S. Congress approve the deal. Seoul has provisionally budgeted for approximately 131 trillion won (approximately \$143 billion at an exchange rate of 920 won per U.S. dollar) through 2013 to be provided to farmers and fishermen negatively affected by the KORUS FTA. Farmers and fishermen would be able to apply for government support equivalent to 85% of their revenue reduction from the KORUS FTA. Additionally, the assistance package is designed to help restructure the South Korean economy by helping adversely affected farmers and fishermen to move into other lines of work. To that end, businesses that employ farmers or fishermen who leave their vocation reportedly will receive monthly payments, as will elderly farmers who sell their land and retire from farming. The government also will encourage the creation of private equity funds in order to boost investment in promising areas of the agricultural sector. The government will increase its budget for research in the pharmaceutical industry from about \$20 million in 2007 to around \$90 million by 2012. Additionally, manufacturing and service firms that experience more than a 25% drop in revenues due to the KORUS FTA will receive government loans.<sup>66</sup>

## **South Korean Issues and Negotiating Objectives**

Generally, the United States sets the agenda of U.S.-ROK trade talks, with South Korean officials typically reacting to U.S. demands. Not only is South Korea far more economically dependent on the United States, but the United States also has lower and fewer tariff and non-tariff barriers than Korea. Judging from the

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<sup>66</sup> “South Korea to Spend \$140 Bln for U.S. Trade Deal,” *Reuters*, June 28, 2007; “85% of Farming Losses to Get Compensated,” *Korea Times*, June 28, 2007; “SKorea Unveils Measures to Protect Domestic Market,” *Agence France Presse*, June 28, 2007; He-suk Choi, “ROK Daily: Seoul to Pay 85 Percent of Farmers’ Income From Free Trade Losses,” *The Korea Herald*, June 28, 2007.

summaries of the KORUS FTA, it appears that South Korean officials were more proactive than they typically have been in the overall bilateral relationship.

**Agriculture.** The Korean delegation appeared to have taken a consistently hard line on agriculture in the talks. When asked about opening Korea's farm market at the February 2, 2006 launch of the FTA, Trade Minister Kim said that while South Korea is ready to make "tough decisions," he added that "I don't know a single free trade agreement whereby there are no exceptions, or a staged implementation period...."<sup>67</sup> An outline of the South Korean government's goals presented to the National Assembly in May 2006 by the South Korean Ministry of Foreign Affairs and Trade (MOFAT) mentioned excluding some highly sensitive agricultural goods. For other items, the draft envisioned long-term tariff reductions, tariff rate quotas, and special safeguards.<sup>68</sup> In his address to the nation following the completion of the agreement, President Roh stated that "...most of our demands [on agriculture] were included in the final outcome," and South Korea's refusal to include rice in the KORUS FTA was in keeping with other trade agreements it has reached. In May 2006, for instance, South Korea and the ASEAN announced a trade agreement on goods that excluded a number of agricultural items, including rice. Thailand, a major rice exporter, did not join in the agreement.

**The Kaesong Industrial Complex.** A consistent and significant goal for South Korea in the FTA talks was securing preferential treatment for products made in the Kaesong Industrial Complex (KIC) located in North Korea, a position the United States adamantly opposed. Located near the North Korean city of Kaesong (also spelled "Gaesong"), 40 miles north of Seoul, the KIC is designed for South Korean companies to employ North Korean workers. A pilot site at Kaesong, housing the factories of over fifteen South Korean firms, opened in 2004, and as of late 2006 employed over 11,000 North Korean workers. (See **Table 3.**) In 2006, firms in the complex produced nearly \$75 million in manufactured goods, mostly light industrial products such as textiles and electronic goods.<sup>69</sup>

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<sup>67</sup> USTR, "Remarks by U.S. Trade Representative Rob Portman And Republic of Korea Trade Minister Hyun-chong Kim, Launch of U.S.-Korea Free Trade Agreement," February 2, 2006.

<sup>68</sup> South Korean government report to the National Assembly, "Negotiating Objectives of Korea-U.S. FTA," translation provided by the U.S. Embassy; BNA International Trade Reporter, "South Korea's MOFAT Outlines Goals of Draft Free Trade Agreement with U.S.," May 18, 2006.

<sup>69</sup> Ministry of Unification, "Key Statistics for Gaeseong Industrial Complex (As of January 31, 2007)."

**Table 3. Snapshot of the Kaesong Industrial Complex**

	End 2005	End 2006
Number of ROK Manufacturing Firms	11	18
Approx. Number of North Korean Workers	6,000	11,000
Approx. Number of South Korean Workers	n.a.	700
Production (US\$ Millions)	\$14.9	\$73.7

**Sources:** Ministry of Unification, “Update on the Gaeseong Industrial Complex (As of February 17, 2006)”;

“Key Statistics for Gaeseong Industrial Complex (As of January 31, 2007).”

There are plans to expand the zone dramatically, though South Korean officials say the pace and scope of the expansion is contingent upon the status of negotiations over North Korea’s nuclear programs. In early 2006, some KIC officials expressed their desire to expand the complex to 300 tenant South Korean companies employing about 70,000 North Koreans by the end of 2007.<sup>70</sup> Following North Korea’s missile tests in July 2006, however, the South Korean government suspended taking new applications from South Korean firms to invest in the second phase of the KIC. In January 2007, the South Korean Unification Minister announced that an additional 40 firms, which had been selected prior to the suspension, would open operations in Kaesong in 2007.

The United States officially supports the KIC. In 2004 and 2005, the United States approved several export controls clearances that were required by U.S. law for South Korean firms to bring items — such as computer and telecommunications equipment — to Kaesong.<sup>71</sup>

Since the KIC opened, it has been South Korean policy to request that its FTA partners allow exports from Kaesong to be considered as “Made in Korea” (meaning South Korea), thereby enabling these products to receive the preferential status conferred by the FTA. The Korea-Singapore, Korea-EFTA, and Korea-ASEAN FTAs contain such a provision.<sup>72</sup> In May 2006, the South Korean government reported to the National Assembly that it would seek treatment comparable to that provided in the South Korea’s FTA with EFTA.<sup>73</sup> That agreement lists a specific set

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<sup>70</sup> April 2006 conversations with South Korean officials.

<sup>71</sup> U.S. Embassy in Korea, “Questions and Answers from Economic Press Roundtable with Embassy Official,” February 8, 2006; January and February 2006 conversations with officials familiar with the Kaesong export control discussions.

<sup>72</sup> For instance, the South Korea-ASEAN FTA reportedly includes a list of 100 items that will be recognized as “Made in Korea,” as long as more than 60 percent of the materials from which they are made are of South Korean origin or if the added value of South Korean materials put in the product is more than 40 percent. *Dong-A Ilbo*, “One Hundred Gaesong Product Items Recognized as ‘Made in Korea,’” May 17, 2006.

<sup>73</sup> South Korean government report to the National Assembly, “Negotiating Objectives of (continued...)”

of products that will receive FTA treatment if the KIC's contribution to the final product is no more than 40%, if final production takes place in South Korea, and if the final product is exported from South Korea. When questioned about this policy during the February 2, 2006 launch of the FTA, USTR Portman stated that the FTA would cover only products made in South Korea. The United States maintained this position until the final stage of the negotiations. Several Member of Congress publicly stated that including Kaesong-origin products in an FTA could sink the agreement's chances in Congress.<sup>74</sup>

Two important issues for the United States in considering South Korea's demand are the conditions for North Korean workers and the income the KIC provides for the North Korean government. Some U.S. labor and human rights advocates have argued that North Korean workers in Kaesong are being exploited. South Korean officials, as well as other analysts, counter by saying that conditions — including wage conditions — at Kaesong are far better than those in the rest of North Korea.

The North Korean government derives hard currency from several sources in the KIC project, including leasing fees and surcharges levied on North Korean workers' wages, which are paid to an arm of the North Korean government agency before being passed on to employees (in the form of North Korean *won*).<sup>75</sup> To date, according to information provided by the South Korean government, these streams likely total less than \$20 million in hard currency. However, if the South Korean government realizes its most ambitious goals for the Kaesong project, by the middle of the next decade the North Korean government would likely derive hundreds of millions of dollars annually from tax revenues and its slice of North Korean workers' wages, assuming the KIC's current tax and wage structures remain in place.<sup>76</sup> Some South Koreans caution that the uncertainties over the future course of the KIC project make such projections highly speculative.

The KIC arguably has become the centerpiece for South Korea's "sunshine policy" of engaging North Korea. The South Korean government envisions the

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<sup>73</sup> (...continued)

Korea-U.S. FTA," translation provided by the U.S. Embassy, Seoul.

<sup>74</sup> See, for instance, *Washington Trade Daily*, June 16, 2006.

<sup>75</sup> North Korean workers in Kaesong receive a base monthly salary of \$50 for a 48-hour work week. In 2005, the average workweek (including overtime) at Kaesong was 55 hours, bringing the average gross monthly salary to \$67 per month. South Korean officials say they are unsure of precisely how much is taken by the North Korean government, but from conversations with workers and other sources, they estimate the government takes an estimated 30% "social services fee" from the wages to pay for housing and other services that are to be provided the North Korean state. If these figures are correct, the average Kaesong worker's take-home monthly pay in 2005 was just under \$37, paid in North Korean *won*. Presumably, payments are made at the official rate of exchange, which is much lower than black market rates. The North Korean government also levies a 15% social insurance surcharge, which is paid by the South Korean employer, to pay for unemployment and occupational hazards.

<sup>76</sup> Moon Ihlwan, "Bridging the Korean Economic Divide," *Business Week*, March 8, 2006.

complex, which has broad support inside South Korea, as a way to ensure stability on the Korean Peninsula and ease 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. The complex is also designed to encourage legitimate North Korean economic activity. Additionally, the worsened economic situation for many South Korean small and medium sized enterprises has led many in South Korea to see cheaper North Korean labor as a way to compete against lower-cost Chinese firms.

The controversy became highly public and political both countries. Many South Korean officials appeared to view the U.S. position on including Kaesong in the KORUS FTA as a litmus test for the U.S. approach toward Seoul's entire sunshine policy of engaging North Korea. To some in the United States, however, the South Korean push to include Kaesong in the FTA appeared to be an attempt to move U.S. policy from not opposing the KIC to promoting it. In the final compromise — to set up a committee to establish criteria for including “outward processing zones” on the Korean Peninsula in the future — represents a middle ground between the two positions. According to the details of the agreement released thus far, it appears the United States backed away from the principle of not ever expanding the KORUS FTA to North Korea-made products, a significant achievement for South Korea.

At the same time, the United States appeared to give up little in substance in the near-to-middle term. Reportedly, the FTA does not specify the committee's membership, the committee will not meet until at least a year after the agreement takes effect, and according to lead U.S. negotiator Wendy Cutler both countries' legislatures would have to approve decisions made by the committee. If these descriptions of the agreement are accurate, the United States would be able to control the decision to and pace of any move to grant preferential treatment to North Korea-made products. Any perceptions of foot-dragging by the United States may come at a diplomatic price if future South Korean governments push for more rapid integration of North Korean industrial zones into the FTA.

**U.S. Antidumping Practices.** Trade remedies is another area where the two sides papered over their differences by establishing a consultative committee. For over a decade, South Korea has chafed at the U.S. use of antidumping (AD) and countervailing duty (CVD) laws that raise tariffs on South Korean exports. According to one study, in July 2000 the five CVD and 18 AD orders against South Korean exports covered approximately \$2.5 billion, or over 7%, of U.S. imports from South Korea in 1999. Moreover, these tariff hikes have tended to be concentrated in a handful of South Korean industries — semiconductors, steel, televisions, and telecommunications equipment — that have considerable political influence in Seoul. The Ministry of Foreign Affairs and Trade (MOFAT)'s May 2006 draft FTA contains provisions that would constrain U.S. use of AD measures.<sup>77</sup> South Korea is specifically concerned about the U.S. practice of zeroing in determining antidumping margins and cumulation in determining material injury in antidumping and

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<sup>77</sup> South Korean government report to the National Assembly, “Negotiating Objectives of Korea-U.S. FTA,” translation provided by the U.S. Embassy, Seoul; BNA, “South Korea's MOFAT Outlines Goals of Draft Free Trade Agreement.”

countervailing duty determinations. It is also concerned about U.S. sunset reviews of countervailing duty and antidumping cases, which South Korea alleges results in antidumping and countervailing duty orders being extended unnecessarily. In the multilateral Doha Development Agenda talks, South Korea is one of several countries demanding revisions to global antidumping rules, changes the United States opposes.<sup>78</sup>

**Visa Issues.** Prior to the opening of the talks, South Korea announced it would ask the United States to grant more temporary worker visas to South Korea, especially “E” visas.<sup>79</sup> The issue apparently did not become a topic for formal negotiations under the FTA because the Administration argued that granting more temporary visas to South Korea was a matter for Congress. In response, South Korean officials have begun discussing this possibility with congressional offices.<sup>80</sup>

Another priority issue for Seoul that was not formally part of the FTA talks was South Korea’s status in the U.S. Visa Waiver Program (VWP), under which foreigners traveling from certain countries are permitted to travel to the United States for up to 90 days without obtaining a visa.<sup>81</sup> Any changes made by the United States in this area are likely to play a political role in selling the agreement in Seoul. Korean officials, including Trade Minister Kim, have said they hope South Korea is added to the program as early as the end of 2007.<sup>82</sup>

For years, South Korean officials, Korean businesses, the American Chamber of Commerce in South Korea, Korean-Americans, and others have questioned why South Korea is not a participant in the VWP. Since the United States put in place new visa procedures after the September 11, 2001 terrorist attacks, almost all South Koreans who want to visit the United States must interview for a visa at the U.S. Embassy in Seoul. Reportedly, the U.S. consular section in Seoul has become among the busiest and largest U.S. nonimmigrant visa processing posts in the world, processing an average of almost 2,000 visas per day. The visa waiver program issue

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<sup>78</sup> In his address at the December 2005 Doha Development Round ministerial in Hong Kong, South Korean Trade Minister Kim said that a “tangible outcome” in anti-dumping was “indispensable” for South Korea. Statement by Mr. Hyun Chong Kim Minister for Trade, World Trade Organization Ministerial Conference Sixth Session Hong Kong, WT/MIN(05)/ST/19 14 December 2005 (05-5992).

<sup>79</sup> South Korean government report to the National Assembly, “Negotiating Objectives of Korea-U.S. FTA,” translation provided by the U.S. Embassy.

<sup>80</sup> Hwang Yo’ng-chin, “(INTERVIEW) Pact Is an Offensive Tool for Survival in East Asia,” *JoongAng Ilbo*, April 5, 2007. For more on this issue, see CRS Report RL33844, *Foreign Investor Visas*, by Chad C. Haddal.

<sup>81</sup> For more on the U.S. Visa Waiver Program, see CRS Report RL32221, *Visa Waiver Program*, by Alison Siskin. Speech by ROK Ambassador to the United States Lee Tae-sik, “The Korea-US Alliance - A Partnership for the Future,” February 7, 2006 Korea Economic Institute forum, The St. Regis Hotel, Washington, DC; Balbina Hwang, “A Bumpy Road for the U.S. — ROK Free Trade Agreement,” *Heritage Foundation Executive Memorandum* No. 995, March 2, 2006.

<sup>82</sup> Hwang Yo’ng-chin, “(INTERVIEW) Pact Is an Offensive Tool for Survival in East Asia,” *JoongAng Ilbo*, April 5, 2007.



has become a topic discussed by Presidents Bush and Roh. During his November 2005 summit with President Roh in South Korea, President Bush announced that the United States would work with Seoul to develop a “roadmap to assist South Korea in meeting the requirements for membership” in the Visa Waiver Program. Following a summit in September 2006, Bush told reporters that he had “assured” Roh that “we will work together to see if we can’t get this issue resolved as quickly as possible.”<sup>83</sup>

Among the statutory requirements for countries to participate in the VWP is that the country must have a nonimmigrant visa refusal rate of below 3%.<sup>84</sup> According to State Department officials, South Korea’s visa refusal rates have consistently been over this threshold. The FY2004 rate was 3.6% and according to one report, in early 2005 the rate again was below 4%.<sup>85</sup> Meeting the refusal rate is not the only requirement. A country’s participation in the VWP must also be deemed to be in the economic, law enforcement, and security interests of the United States. Since the late 1990s, no country has been added to the VWP, an indication of the difficulty in meeting the participation requirements.

In March 2007, the Senate passed S. 4, which would reform the VWP, among other measures designed to implement the 9/11 Commission recommendations. According to some observers, the changes include could facilitate South Korea becoming a participant in the VWP by allowing the Secretary of Homeland Security to waive the refusal rate requirements.<sup>86</sup> However, S. 4 specifies that the refusal rate waivers can only be granted after the United States implements an exit system at its airports that can verify the departure of not less than 97% of foreign nationals that exit through U.S. airports. Many argue that such a system is still years away.<sup>87</sup> The House-passed version of the bill, H.1, does not contain VWP-specific provisions. In the 109<sup>th</sup> Congress, H.R. 4304, introduced by Representative James Moran (R-VA), would have designated South Korea as a program country under the VWP. The bill was referred to the House Judiciary Subcommittee and did not experience additional action.

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<sup>83</sup> White House Press Office of the Press Secretary, “Joint Declaration on the ROK-U.S. Alliance and Peace on the Korean Peninsula,” November 17, 2005; “President Bush Welcomes President Roh of Republic of Korea to the White House,” September 14, 2006.

<sup>84</sup> Specifically, to qualify for the VWP, countries must have had a nonimmigrant refusal rate of less than 3% for the previous year, or an average of no more than 2% over the past two fiscal years with neither year going above 2.5%. 8 U.S.C. §1187(c)(2)(A). The aforementioned VWP provisions of S. 4 would, if passed into law, allow the Department of Homeland Security Secretary to waive the nonimmigrant refusal rate requirement for a country’s admission to the VWP if, among other things, the country the nonimmigrant visas refusal rate was not more than 10%. For more details, see CRS Report RL32221, *Visa Waiver Program*, by Alison Siskin.

<sup>85</sup> Balbina Hwang, “Including South Korea in the U.S. Visa Waiver Program,” *Heritage Foundation Backgrounder* No. 1872, July 25, 2005.

<sup>86</sup> For more, see CRS Report RL32234, *U.S. Visitor and Immigrant Status Indicator Technology (US-VISIT) Program*, by Lisa M. Seghetti and Stephen R. Vina.

<sup>87</sup> Troy Stangarone, “U.S. Senate Passes Visa Waiver Reform,” *Korea Insight*, Volume 9, Number 4, April 2007, Korea Economic Institute.

## The Potential Economic Effects of a U.S.-South Korean FTA

A KORUS FTA would likely have important direct and indirect effects on the bilateral economic relationship as well as on U.S. economic relations throughout East Asia. South Korean tariffs are much higher than U.S. tariffs, so U.S. exporters, especially of agricultural goods, could realize gains in trade. South Korea's average applied tariff is 11.2%, and the average U.S. applied tariff is 3.7%. South Korea's average applied tariff on agricultural goods is 52%, while the U.S. average applied tariff is 12%.<sup>88</sup>

**Trade Creation vs. Trade Diversion.** Economists usually base their analysis of the impact of FTAs on the concepts of *trade creation* and *trade diversion*. These concepts were first developed by economist Jacob Viner in 1950.<sup>89</sup> Viner focused his work on the economic effects of customs unions, but his conclusions have been largely applied to FTAs and other preferential trade arrangements. His analysis was also confined to static (one-time) effects of these arrangements.

Trade creation occurs when a member of an FTA replaces domestic production of a good with imports of the good from another member of the FTA, because the formation of the FTA has made it cheaper to import rather than produce domestically. The creation of the trade is said to improve economic welfare within the group because resources are being shifted to more efficient uses. Trade diversion occurs when a member of an FTA switches its import of a good from an efficient nonmember to a less efficient FTA member because the removal of tariffs within the group and the continuation of tariffs on imports from nonmembers, make it cheaper to do so. Trade diversion is said to reduce economic welfare because resources are being diverted from an efficient producer to a less efficient producer.

In most cases, it appears that FTAs lead to both trade diversion and creation with the net effects determined by the structure of the FTA. Therefore, according to economic theory, even if two or more countries are moving toward freer trade among themselves in an FTA, the FTA could make those countries and the world as a whole worse off if the FTA diverts more trade than it creates.<sup>90</sup>

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<sup>88</sup> Office of the United States Trade Representative. Fact Sheet. *FTA: United States and Republic of Korea Economic and Strategic Benefits*. February 2006.

<sup>89</sup> Viner, Jacob. *The Customs Union Issue*. Carnegie Endowment for International Peace. 1950. New York. These concepts are discussed in CRS Report RL31356, *Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy*, by William H. Cooper.

<sup>90</sup> This conclusion is called the General Theory of the Second Best and was developed by economists Richard Lipsey and Kelvin Lancaster. Lipsey, Richard and Kelvin Lancaster. *The General Theory of the Second Best*. *Review of Economic Studies*. Vol. 24. p. 11-32. Cited and discussed in Lawrence, Robert Z. *International National Economies: Regionalism, Multilateralism, and Deeper Integration*. Brookings Institution. Washington. 1996. p. 22.

**Estimates of the Economic Effects of a KORUS FTA.** U.S.-based analysts have conducted some comprehensive estimates of the direct economic impact of an FTA on the U.S. and South Korean economies. The United States International Trade Commission (USITC) conducted a study published in 2001 that the Senate Finance Committee requested.<sup>91</sup> The non-partisan Institute for International Economics (IIE) produced a study in 2001 that it updated in 2004.<sup>92</sup> Both studies concentrated on the static economic effects, that is, the direct economic effects resulting from the elimination of tariffs and quotas on all bilateral trade, including agricultural trade. These analyses do not take into account the dynamic effects of trade liberalization, that is, the indirect longer-term economic effects on other parts of the economy. They also do not take into account the economic effects which result from changes in non-tariff and non-quota barriers, such as sanitary and phyto-sanitary regulations, intellectual property rights protection, trade-related foreign investment regulations, and services-related barriers, all of which are difficult to quantify. Therefore, the eventual impact of an FTA would likely be greater than the static estimates that the two studies present.

The two studies draw very similar conclusions. They conclude that a U.S.-South Korean FTA's economic impact on South Korea would be relatively much greater than the impact on the U.S. economy. This is a logical conclusion, since the South Korean economy is much smaller, is more protected, and is much more dependent on foreign trade than is the U.S. economy. The IIE study predicts that the FTA would increase South Korean GDP between 0.38% and 2.41%, and the USITC study estimates the growth at about 0.7%. The two studies predict very small effects on the U.S. GDP: the IIE study estimates an increase of 0.02% to 0.13% while the USITC study estimates the growth at 0.2%.

Regarding the impact on bilateral trade flows, the IIE and USITC studies draw similar conclusions. According to both studies, U.S. exports to South Korea would rise more than U.S. imports from South Korea. U.S. exports to South Korea would rise by 54% and U.S. imports from South Korea would rise by 21%, according to the USITC. The IIE estimates that U.S. exports to South Korea would increase 46% to 49%, while imports from Korea would increase 26% to 30%. As might be expected, the largest trade-flow impact of an FTA would occur in the most sensitive, and therefore the most-protected, sectors. These are the areas that are expected to present the greatest negotiating challenges. Thus, the largest gains for U.S. exports would be in agricultural exports. USITC has estimated that U.S. exports to South Korea of beef and cheese could increase as much as 60% and exports of beer by as much as 100%. The largest gains in South Korean exports to the United States would be in manufactured goods, especially in textiles and apparel, leather goods, chemicals and allied products, electronic products, and cars, according to the USITC. The USITC

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<sup>91</sup> A new, classified USITC study, that is required under the Bipartisan Trade Promotion Act of 2002, is scheduled to be submitted to the USTR by July 14, 2006.

<sup>92</sup> United States International Trade Commission. *U.S.- Korea FTA: The Economic Impact of Establishing a Free Trade Agreement (FTA) Between the United States and the Republic of Korea*. Investigation No. 332-425. September 2001. Also, Choi, Inbom and Jeffrey J. Schott. *Free Trade Between Korea and the United States?* Institute for International Economics. Washington. April 2001.

also concludes that at least some of the increase in U.S.-South Korean bilateral trade would be as the result of the diversion of trade from other U.S. and South Korean trade partners. For example, increased U.S. exports to South Korea would be at the expense of German and Japanese exports to South Korea. Increased South Korean exports to the United States are projected to be partially at the expense of exports from Taiwan, Japan, and Mexico to the United States.

In December 2005, the Korea Institute for International Economic Policy (KIEP) published a study measuring the potential economic impact of an FTA on South Korea alone. The study estimated some of the dynamic economic effects in addition to the static 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.<sup>93</sup>

Not captured by these studies would be the non-trade economic effects as a comprehensive FTA would be expected to promote a more efficient allocation of economic resources, especially in South Korea, the smaller and more regulated of the two economies. South Korea would likely realize welfare gains in the long term by reducing protection for agriculture and opening up its services sectors to foreign competition. On the other hand, the South Korean government would probably have to provide some type of transitional income programs to help those adversely affected by the increased competition and to obtain political support for the FTA.

## Next Steps

Under the trade promotion authority (TPA) under the Bipartisan Trade Promotion Act of 2002 (the Act) (P.L. 107-210) implementing legislation for trade agreements can receive expedited (fast-track) congressional consideration, that is time-limited committee consideration, no amendments, and time-limited floor debate.

On June 30, 2007, trade officials representing the United States and South Korea signed the U.S.-South Korean Free Trade Agreement in Washington. Now that the agreement has been signed, the President can submit draft implementing legislation to Congress at any time, as long as both Houses are in session. The White House has not indicated when he might do so. Once the President has submitted the draft legislation, Congress has up to 90 session days to consider the bill, ending in an up or down vote in the House and Senate.<sup>94</sup> (See Appendices A and B, which provide a time-line chart and a description of the fast track process.)

In the meantime, the House Foreign Affairs Subcommittee on Terrorism, Nonproliferation, and Trade held a hearing on the KORUS FTA on June 13, 2007, with Ambassador Karan Bhatia, deputy USTR, and Ambassador Christopher Hill, Assistant Secretary of State, appearing as witnesses.

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<sup>93</sup> Lee, Junyu and Hongshik Lee. *Feasibility and Economic Effects of a Korea-U.S. FTA*. Korean Institute for International Economic Policy. December 2005. p. 86.

<sup>94</sup> For more details on congressional procedures under TPA, see CRS Report RL33743, *Trade Promotion Authority (TPA): Issues, Options, and Prospects for Renewal*, by J.F. Hornbeck and William H. Cooper.

On the Korean side, where the FTA must be ratified by a majority vote in the unicameral National Assembly to take effect, trade agreements are not subject to any fast-track time lines. Indeed, with presidential elections in December 2007 and parliamentary elections in April 2008, some political observers are suggesting that the KORUS FTA may not be voted upon until after a new president and a new assembly are elected. On the other hand, some commentators speculate that these same events will spur President Roh and Members of Parliament to move quickly to consider the agreement.

Even before the two legislatures are formally asked to debate the FTA, Korea's actions on its ban on imported U.S. beef are likely to be scrutinized carefully. It is widely expected that the FTA would run into great difficulties in Congress if Korea's ban is not lifted. Thus, observers will be watching Korea's reaction to the World Organization for Animal Health (OIE)'s report on the risks associated with U.S. beef that was released on May 22, 2007. Seoul has pledged to uphold the OIE's recommendations.

## Other Relevant CRS Products

CRS Report RL31356, *Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy*, by William H. Cooper.

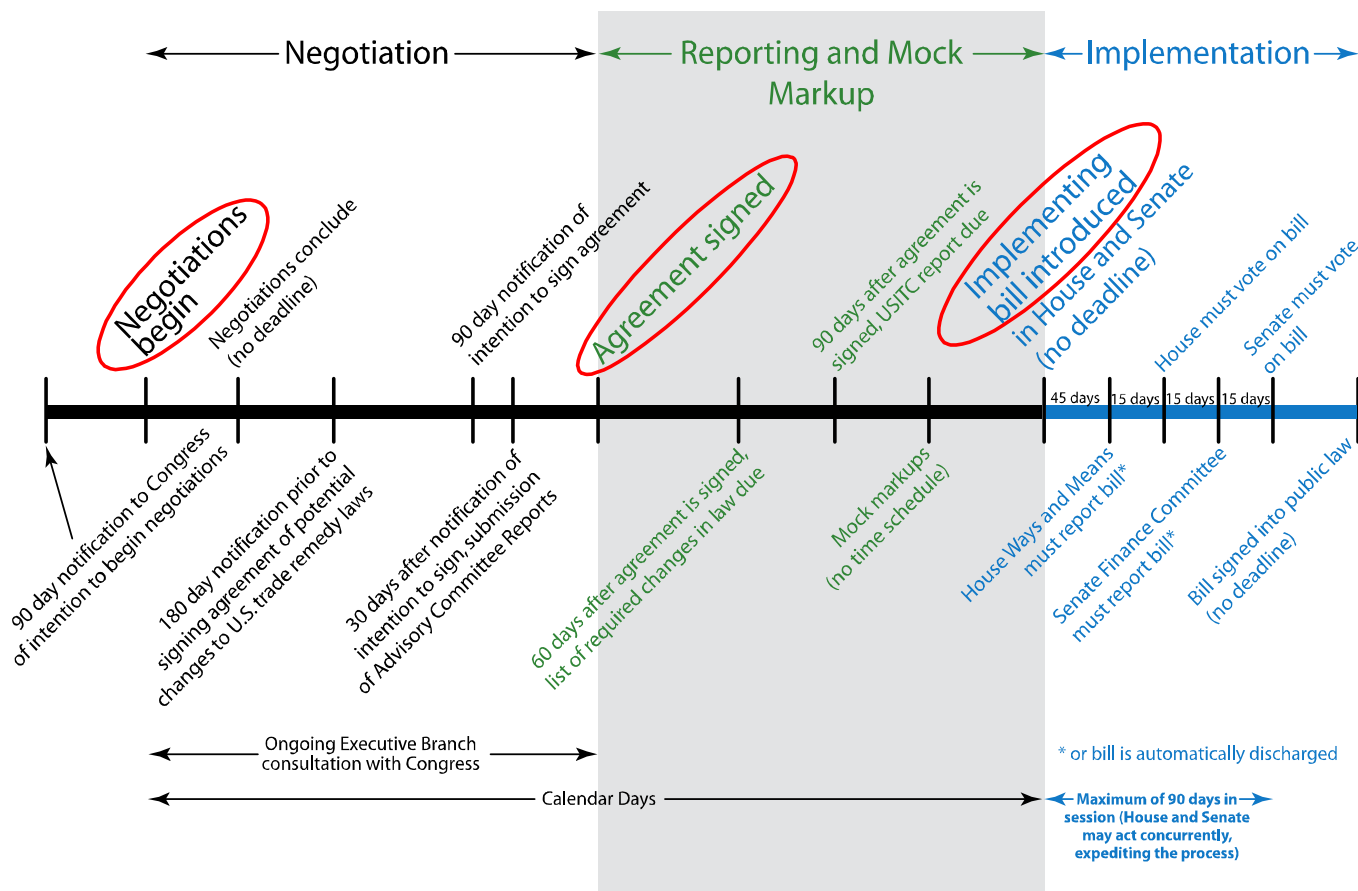
CRS Report RL33567, *Korea: U.S.-Korean Relations: Issues for Congress*, by Larry A. Niksch.

CRS Report RL30566, *South Korea-U.S. Economic Relations: Cooperation, Friction, and Prospects for a Free Trade Agreement (FTA)*, by Mark E. Manyin.

CRS Report RS22339: *Trade Liberalization Challenges Post-CAFTA*, by Raymond J. Ahearn.

CRS Report RL32221, *Visa Waiver Program*, by Alison Siskin.

## Appendix A. Timeline for Negotiation, Congressional Consultation, and Legislative Implementation of Trade Agreements Under TPA



Source: CRS from CRS Report RL33743, *Trade Promotion Authority (TPA): Issues, Options, and Prospects for Renewal*, by J. F. Hornbeck and William H. Cooper.

## Appendix B. A Short Guide to the Expedited Legislative Procedures for Passage of Trade Implementing Bills Under TPA<sup>95</sup>

- I. Before the formal TPA expedited procedures come into play, the House Ways and Means and Senate Finance Committees typically hold “mock markups” on informal drafts of the implementing legislation, voting to approve or disapprove. The vote and any amendments to the draft legislation, however, are non-binding on the Administration. These hearings provide the last opportunity to make recommendations to the Administration before it sends final implementing legislation to Congress, initiating the expedited rules procedures.
- II. The President sends a final legal draft text of the trade agreement and a draft implementing bill (with supporting materials) to Congress. Identical bills are subject to mandatory introduction in each House of Congress the day received. The bills may, or may not, reflect some or all of any non-binding amendments passed by committees in the mock markup.
- III. The bills are jointly referred to the “appropriate committees”: House Ways and Means, Senate Finance, and others if jurisdiction warrants.<sup>96</sup>
- IV. Each committee has 45 legislative (in session) days to report the bill or it is automatically discharged and placed on the appropriate calendar.<sup>97</sup> Under the U.S. Constitution, as a revenue bill, the Senate must pass the House bill, in which case to report the bill, the Senate Finance Committee would have the longer of either 45 legislative days from the time the bill was introduced in the Senate, or 15 days from the time the bill was sent over from the House.<sup>98</sup>
- V. Each house has 15 days to complete floor action from the time the committees report, after which any member may request a vote. The implementing bill is privileged so:

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<sup>95</sup> Title XXI of the Trade Act of 2002 (P.L. 107-210) and section 151 of the Trade Act of 1974, as amended. A detailed summary, including committee consideration and floor procedures, may be found in CRS Report RL32011, *Trade Agreements: Procedure for Congressional Approval and Implementation*, by Vladimir N. Pregelj.

<sup>96</sup> For example, the U.S.-Chile Free Trade Agreement implementing bill contained a provision affecting immigration law, requiring the bill to be referred to the House and Senate Judiciary Committees.

<sup>97</sup> Cumulatively, the whole process can take as long as 90 legislative days, potentially lasting many months.

<sup>98</sup> In fact, the Senate can and has acted before the House. In the case of the Chile FTA implementing bill, the Senate Finance Committee reported out first. When the House bill came over, it was held at the desk and put on the Senate calendar directly, given it was identical to the Senate version. For the CAFTA-DR bill, the whole Senate actually voted first, necessitating a second (procedural) vote to substitute the language of the later-passed House bill for the Senate-passed bill.

- consideration is limited to 20 hours of debate evenly divided between those for and against, and
- it cannot be amended, and a motion to suspend the no-amendment rule or request to suspend it by unanimous consent, is not in order.

VI. A bill passes by simple majority. Because the House and Senate bills are identical, no conference is needed so the final votes clear the measure to be presented to the President. Once the implementing bill is signed, under its terms, the agreement enters into force for the United States by Presidential proclamation.<sup>99</sup>

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<sup>99</sup> The material in Appendix B was taken from CRS Report RL33743, *Trade Promotion Authority (TPA): Issues, Options, and Prospects for Renewal*, by J.F. Hornbeck and William H. Cooper.



## Appendix C. Top 10 U.S. Exports to and Imports from South Korea, 2006

(Billions of U.S. Dollars)

U.S. Exports		U.S. Imports	
<b>Total</b>	<b>32.5</b>	<b>Total</b>	<b>45.8</b>
Electrical Machinery	7.5	Electrical Machinery	12.6
Non-electrical Machinery	5.3	Vehicles	10.8
Aircraft	3.5	Non-electrical Machinery	7.5
Optical equipment	2.4	Mineral Fuels	2.3
Organic chemicals	1.6	Iron and steel	1.4
Plastic	1.0	Iron and steel products	1.2
Cereals	0.9	Plastic	1.1
Mineral Fuels	0.9	Rubber	1.0
Vehicles	0.8	Organic chemicals	0.7
Inorganic chemicals	0.5	Optical equipment	0.6

**Source:** Two-digit HS categories. U.S. Department of Commerce data compiled by Global Trade Information Systems, Inc.