

# The Korea-U.S. Free Trade Agreement, the Kaesong Industrial Complex, and U.S.-Korea Relations

Suk Hi Kim

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## Introduction

A free trade agreement is one form of trading bloc, a preferential economic arrangement amongst a group of countries that reduces barriers to trade. Trading blocs have emerged as the most debated topic in world trade. While countries around the world are making efforts to harmonize interests through trading blocs, these groupings are also emblematic of difficulties associated with the current global trading system under the World Trade Organization (WTO).

The WTO has five major functions: (1) administration of its trade agreements; (2) acting as a forum for trade negotiations; (3) monitoring national trade policies; (4) offering technical assistance and training for developing countries;

and (5) cooperating with other international organizations (Kim and Kim, 2006, p. 38).

As multi-party trade negotiations promoted by the WTO travel a bumpy road, making little progress, trading blocs—particularly FTAs—have seen accelerated expansion. 120 trade agreements have been entered to date, 95 percent of them in the past five years (Byun, 2006). A total of 43 trade agreements were reported to the WTO during a roughly one-year period from January 2004 to February 2005 (Lee, 2006, p. 122).



South Korean president Roh Moo-hyun and U.S. president George Bush make a joint statement in November 2005.

South Korea and the U.S. agreed to start serious

negotiations for a free trade agreement between the two countries on February 2, 2006. During the first preliminary session held in Seoul on March 6, they agreed to begin formal negotiations on June 5. Because the U.S. president's authority to negotiate trade agreements, called the "trade promotion authority," expires on June 30, 2007, and includes a 90-day congressional review period on the final negotiation results, the deal must be concluded by late March 2007 if it is to have any prospect of ratification. One of the major sticking points is disagreement between the two countries over the inclusion of products made in the Kaesong Industrial Complex (KIC) in North Korea, the first large-scale economic project jointly undertaken by both Korean governments.

This article is organized as follows. The first section describes U.S. objectives in an FTA. The succeeding sections consider Korean objectives in this FTA as well as the Korean request for duty-free treatment for goods produced by the KIC. The final section describes the impact of the U.S. elections on the KORUS FTA.

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



Assistant U.S. Trade Representative Wendy Cutler toasts with South Korea's chief negotiator Kim Jong-hoon during a dinner in Seoul on January 16, 2007.

After signing its first FTA with Israel in 1985 and its second FTA with Canada and Mexico in 1993, the U.S. signed no other FTA until that with Jordan in early 2000. Since then, however, the U.S. has signed FTAs with at least 16 countries. Two factors have motivated the U.S. to pursue FTAs with a large number of countries. First, with mounting difficulties in preserving the current global trading system under the WTO, the U.S. both seeks to advance WTO negotiations and pursues FTAs as a fallback position in the event of the failure of the WTO system. Second, the U.S. considers free trade a primary weapon for curbing security threats, believing that economic growth stimulated by free trade will reduce social and political instability (Lee, 2006, p. 124).

The U.S. selects countries as FTA partners based two criteria. First, the partner country must demonstrate a commitment to pursue further

liberalization of restrictions on trade and investments in the domestic economy. Second, the partner country must show willingness to work with U.S. officials to achieve a successful conclusion to the Doha Round of the WTO negotiations (Schott, 2004, Chapter 13). In June 2006, the U.S. started FTA negotiations with South Korea once Korea met these conditions by liberalizing restrictions on farm trade, screen quotas, and other sectors.

The Office of the United States Trade Representative released the following facts in February 2006. First, as the U.S. market is largely open to Korean goods and services, an FTA will make duty-free treatment a two-way street. A reduction in Korea's average applied tariffs of 11.2 percent on all products, three times greater than the U.S. average of 3.7 percent, will benefit U.S. businesses, farmers, and workers. Second, a reduction of Korea's average applied tariff of 52 percent on agricultural products, four times greater than the U.S. average of 12 percent, will benefit U.S. agriculture. Third, addressing a wide variety of tariff and non-tariff barriers against U.S. goods and services will create new opportunities for U.S. exporters in sectors in which U.S. companies are highly competitive (Office of the United States Representative, 2006).

If completed, a KORUS FTA would produce substantial export gains while advancing important U.S. foreign policy objectives in

Northeast Asia. Key exports for the U.S. include (1) autos, (2) beef, and (3) pharmaceutical pricing and reimbursement issues. (1) Formal U.S. efforts to resolve bilateral trade frictions over automobiles have spanned more than a decade. (2) During 2003, Korea was the third largest foreign market for American beef. At the end of that year, however, Korea banned imports of American beef after officials confirmed the first U.S. case of "mad cow" disease. (3) The U.S. charges that Korea enacted cost containment measures that discriminate against imports by systematically undervaluing pharmaceuticals and skewing demand toward domestically produced generic drugs (Schott, Bradford, and Moll, 2006, pp. 8–11).

With regard to foreign policy objectives, an FTA between the U.S. and Korea could improve their strained relationships over U.S. military redeployment and their differences over how to respond to North Korea. In addition, the FTA could deepen the already strong economic ties between the two countries and might improve Korean competitiveness in the face of the rising tide of China's economic and political strength.

### **Korean Interests and Objectives**

South Korea is a major economic partner for the United States. The total volume of two-way trade between the two countries reached

approximately \$70 billion in 2005, thus making South Korea the seventh-largest trading partner of the U.S., ahead of France and Italy. South Korea is among the largest markets of the U.S. for agricultural products. Nevertheless, South Korea is far more dependent economically on the U.S. than the U.S. is on Korea. Table 1 shows that, in 2005, the U.S. was Korea’s third-largest trading partner, second-largest export market, third-largest source of imports, and its largest supplier of foreign direct investment.

Table 1: Asymmetrical Economic Interdependence

Country	Total trade	Export market	Source of imports	Source of investment
For the U.S., Korea ranks	#7	#7	#7	#28
For Korea, the U.S. ranks	#3	#2	#3	#1

Source: Mark E. Manyin and W. H. Cooper, “The Proposed South Korea–U.S. Free Trade Agreement,” CRS Report for Congress, Congresses Research Service, the Library of Congress, May 24, 2006, p. CRS-4.

The KORUS FTA is a free trade type of agreement. This pact is expected to require the two countries to remove all tariffs for more than 90 percent of the traded goods between the two countries over 10 years, which is likely to have a significant impact on the Korean economy. According to the Korean Institute for International Economic Policy, the KORUS FTA would increase mid/long-term production by 1.94 percent (\$27 billion), employment by 0.63 percent (104,000 people), real GDP by 1.99

percent (\$13.5 billion), exports by 15.1 percent (\$7.1 billion), and imports by 39.4 percent (\$12.2 billion) (Lee, 2006, p. 122). Nevertheless, most analysts believe that the Korean benefits would derive not from the short-term reductions in U.S. trade barriers, but rather from medium- to long-term effects of improving the dynamism and efficiency of the South Korean economy.

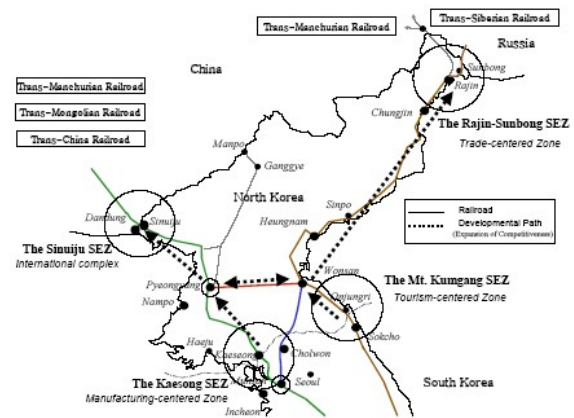
Key issues for Korea include exclusion of agricultural products from the FTA, ending U.S. steel antidumping measures, access to the U.S. visa waiver program, and coverage of production in the Kaesong Industrial Complex (Schott, Bradford, and Moll, 2006). On the political front, Koreans hope for positive spillover effects from the FTA on the broader bilateral relationship. Many Koreans expect that the FTA will have even broader strategic effects. This FTA can elevate the standing of South Korea in Northeast Asia by boosting its status as a middle-ranking power. It might conceivably help Korea to play this role not only by boosting its economic performance, but also by ensuring that the U.S. remains a strategic and economic counterbalance to China and Japan. Furthermore, Korean officials expect that the FTA will produce a better climate for pursuing North–South trade and investment on the Korean peninsula. To that end, they regard the KIC as a manifestation of that development and want its output covered by the FTA.

## The Kaesong Industrial Complex

### *Special Economic Zones as Survival Strategy of North Korea*

A potentially contentious issue in the FTA talks is the status of the Kaesong Industrial Complex (KIC), one of four special economic zones (SEZs) in North Korea. North Korea has recently begun to develop two new projects: the KIC and the Mt. Kumgang tourism project. In terms of their levels of cooperation, partners, and functions, these projects have been distinguished from the two earlier SEZs: the Rajin–Sunbong SEZ is a trade-oriented center that includes China, Russia, and Japan; the Sinuiju SEZ has focused on trade as a vehicle for cooperation with countries in the Yellow Sea rim area, including China. In contrast, the KIC is envisaged as a production-centered SEZ, to attract small- and medium-sized South Korean businesses. The Mt. Kumgang SEZ is also cooperating with the Hyundai Asan Corporation of South Korea in the development of an international tourism venture. Figure 1 presents the developmental path in linking the four SEZs; that is, the “Westward Expansion Line,” running from the Kaesong SEZ (via Pyongyang) to the Sinuiju SEZ, and the “Eastward Expansion Line,” from Mt. Kumgang (via Wonsan) to the Rajin–Sunbong SEZ (Lim and Lim, 2006).

Figure 1. The Developmental Path of the North Korean SEZs



These two new projects have been an advance toward economic cooperation and interaction between the two Koreas. They have not only contributed to economic exchange, but have also demonstrated the possibility of advancing the two Koreas’ political relations. South–North economic cooperation is important in promoting reciprocal economic development, the development of the industrial infrastructure, and the building of an integrated industrial structure between the two Koreas. Proponents hold that changes in the economic sector could contribute to the political and military stability of the entire Korean peninsula.



## Construction of the Kaesong Industrial Complex

The SEZs are regions that guarantee the rights of foreign companies, with independent legislative, judicial, and executive branches, free from central government interference. North Korea welcomes foreign investment and trade because it generates the transfer of technology and skills; increases national employment and domestic wages; contributes to tax revenues; develops import substitute products; and helps to increase exports.

The Kaesong project is the first large-scale economic project jointly undertaken by both Korean governments. The symbolic meaning of Kaesong rests on the fact that during the Korean War, the soldiers of North and South Korea confronted one another there, close to the demilitarized zone (DMZ).

Seoul and Kaesong are only 60 km apart—it is only a one-hour car ride between the two cities. Kaesong is now a rapidly growing industrial site with the construction of the KIC. During the three years of preparation, the North and South Korean governments worked to ensure free passage across the DMZ, and to establish tax, accounting, banking, and labor laws to be applied there. A groundbreaking ceremony was held in Kaesong to officially inaugurate the KIC in June 2003.



Groundbreaking ceremony for the KIC

The KIC is the centerpiece of North–South economic cooperation under the peace and prosperity policy of South Korean President Roh Moo-Hyun. At present, several dozen South Korean firms operate in the industrial park, with a total of 6,000 North Korean workers. The project is to be carried out in three stages over 10 years between 2003 and 2012. In April 2006, the Ministry of Unification of the Republic of Korea projected that the KIC would grow to over 16,000 acres, employ 700,000 North Korean workers, and have 2,000 companies at the end of 2012 (see Table 2). The U.S. officially supports the KIC. In 2004 and 2005, the U.S. approved several export controls clearances that were required by U.S. law in order for South Korean firms to bring items such as computer and telecommunications equipment to Kaesong (Manyin and Cooper, 2006, p. CRS-18).

Table 2: The development of KIC by stages

		Stage 1	Stage 2	Stage 3	Extended area	Kaeseong Urban area	Total
Area (acres)	Industrial zone	817	1,225	2,859	1,634	-	6,536
	Supporting zone	-	817	1,634	4,085	3,268	9,805
Tenant Firms		300	700	1,000	-	-	2,000
Employees (thousands)		70	130	150	350		700
Development schedule		2003-2007	2006-2009	2008-2012			

Source: The Ministry of Unification of the Republic of Korea, "Introduction to and Implications of Kaeseong Industrial Complex Project," [www.keia.org](http://www.keia.org) on July 14, 2006.

*KIC as the Major Obstacle to a KORUS FTA*

South Korean products made in the joint-Korean KIC are expected to become the greatest obstacle to the \$20 billion free trade agreement between the U.S. and Korea. Surveys conducted in 2006 and 2007 by Potomac Associates (PA), a nonpartisan research organization, make clear the difficulties of achieving agreement on the question of duty-free treatment for products made in Kaesong (Watts, 2006). Counting on the free trade deal to help attract local and overseas companies to the industrial park, South Korea prioritizes inclusion of goods made at KIC in the free trade deal with the U.S., despite Washington’s apparent opposition. 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,” thereby enabling these products to receive the preferential status conferred by the FTA. Korea’s agreements with Singapore, the European Free Trade Association, and the Association of South East Asian Nations contain such a provision. In the case of the KORUS FTA, however, the

situation is a little more complicated. Realistically, the volume of exports stemming from Kaesong will likely remain trivial for some time. Nonetheless, the South Korean side may well insist on its inclusion as a way of ensuring stability on the Korean peninsula and of easing the presumed costs of an eventual Korean reunification.



Workers in a factory at the KIC

The U.S. is reluctant to include Kaesong in its negotiations with South Korea, because of a number of thorny issues. Some labor and human rights advocates have argued that the North Korean regime exploits its workers in Kaesong. South Korean officials and some other analysts respond by saying that conditions in Kaesong are far better than those in the rest of North Korea. However, North Korea does not meet internationally recognized core labor standards; rights to associate, organize, and bargain collectively are absent entirely. In addition, the North Korean government retains a large share of the \$57.50 per month paid to each North

Korean worker; in fact, Schott, Bradford, and Moll (2006) claim that North Korean workers net less than \$3 per month.



Protest outside negotiations of the U.S.–Korea FTA, Seattle, September 2006.

These labor and human rights concerns add to the considerable list of U.S. problems with North Korea, including North Korean nuclear proliferation, drug trafficking, and U.S. currency counterfeiting. These factors pose serious political impediments to extension of the FTA to products from Kaesong. The Kaesong issue could well undermine the prospects for concluding the FTA.

The KIC has become the centerpiece of South Korea's "sunshine policy" of engaging North Korea. The Roh administration views the complex as a way of maintaining stability on the

Korean peninsula and of easing the enormous costs of an eventual Korean reunification, by introducing South Korean economic standards to North Korea and linking North Korea to the global economy. Access to cheap North Korean labor could also make it easier for small South Korean firms to compete with lower-cost Chinese firms in South Korea and elsewhere. Many South Koreans believe that the U.S. position on Kaesong in the FTA negotiations is the litmus test for the U.S. approach toward South Korea's entire sunshine policy.

### U.S. Elections and Trade Policy

In the November 6, 2006, U.S. elections, the Democrats narrowly gained control of both the House and the Senate. U.S. trade policy will be one source of friction between the Democrats and Republicans. The Democrats' stance against free trade contributed to the party's success at the polls and could tip the balance on trade matters. The new dynamic could put a definitive end to the already troubled efforts around the WTO's Doha Round of negotiations to reduce tariffs and open markets. It could also jeopardize lesser deals, such as those that the U.S. has crafted with Vietnam, Colombia, and other countries (Hitt and King, 2006).

The Democrats will try to attach protection for labor rights, the environment, and food safety to



the Bush administration's request for renewal of the fast track trade negotiating authority. In fact, some trade experts say that the Democrats may try to extract concessions from President Bush that would render a fast track deal virtually impossible. In addition, the Democrats are unlikely to approve a number of trade deals that the Bush administration has successfully negotiated. Legislation to normalize trade relations with Vietnam was defeated in the House on November 13, 2006, just four days before President Bush was scheduled to make his first visit to the only country ever to defeat the U.S. in a major war. The measure failed to win the necessary two-thirds majority needed to pass under a procedure that the House Republicans adopted in an effort to rush it through with limited debate. Republican leaders pledged to bring the measure up again under normal procedures, which will require only a majority for passage. However, the prospects for congressional approval of several free trade bills by the administration were cast into doubt on November 14, when House Republican leaders abruptly withdrew the bill aimed at Vietnam, even though the Republicans had enough votes for its approval. The failure of the Vietnam bill brought an end to the president's hope that its passage would signify a milestone in the improvement of relations with a country in which tens of thousands of Americans died more than 30 years ago. This and other signs point to the difficulty awaiting the U.S.-Korea FTA.

Nevertheless, both Republicans and Democrats have publicly encouraged a Korea-U.S. free trade agreement throughout the negotiations since early 2006. Thus, if the U.S. and South Korea can reach a FTA agreement in the first half of 2007, the possibility remains that Congress will approve it. The U.S. trade deal with South Korea is different in one notable way from all other U.S. free trade agreements, because of its broad implications for the Korea-U.S. bilateral relationship that go far beyond economic benefits. Not only is the KORUS FTA essential for strengthening the U.S.-ROK military alliance, it also has important implications for North Korea. The readjustment of the Korea-U.S. alliance that is currently in progress embraces bilateral agreements on important issues such as U.S. force repositioning, command relocation, reduction of the size of the military force, and strategic flexibility (Lee, 2006, p. 127).

Both countries consider the FTA a vehicle for the advancement of important foreign policy objectives, particularly the strengthening of cooperation on North Korea. Reaching agreement on policies toward North Korea will be contentious and will require skillful management. From a U.S. perspective, it is difficult to see how the FTA could grant advantages to North Korean production so long as North Korea continues to test nuclear weapons. Schott, Bradford, and Moll (2006, p. 15) correctly state that "the prudent course would be

to exclude North Korean-produced goods and services from the FTA until compliance with the pact's rights and obligations can be adequately monitored and enforced." However, it also makes sense to support the South Korean vision for Korean reunification by setting out procedures in the FTA itself for updating the pact if and when that process moves forward.

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