

I. Brief History

The Korea-U.S. Free Trade Agreement (KORUS) was signed by President Bush in 2007, however, the Democrat controlled-Congress did not bring it up for a vote. Thus, KORUS was shelved and the document has been collecting dust in the halls of Washington. Since the 2007 signing, South Korea (Korea) has signed FTAs with the EU, India, ASEAN, Chile, and Peru. In June 2010, President Obama began renegotiating the terms of the FTA and KORUS is now ready to be voted on by Congress. The main changes negotiators made from the 2007 agreement are tariff phase-out schedules, new rules in regards to transparency, and rule-making procedure. In an economic sense the new deal is almost as good but in political terms it is much better.¹

II. Congressional Debate

Passage of the FTA became more likely after the 2010 mid-term elections in which Republicans, who usually side with free trade, won control of the House and more seats in the Senate. Also, the changes made in 2010 won approval from many Democrats, who were against KORUS, and the United Auto Workers Union. In May 2011, the Administration began technical discussions with Congress.

Republicans wanted all three pending FTAs, South Korea, Colombia, and Panama, to be voted upon as an omnibus bill. However, the USTR disagreed and will send the three FTAs separately rather than as a package, contrary to what Republicans want. President Obama indicated in May he would make the FTA passage part of a broader trade package. The Administration wanted to include in the trade package: expansion of the Trade Adjustment Assistant (TAA) program, normalization of trade relations with Russia, renewal of the Generalized System of Preferences, and Andean Trade Preferences Act (ATPA). Once

¹ Peterson Institute for International Economics. (December 10, 2010). The US-Korea Trade Pact: Assessing the Impact. Interviews on Current Topics. Jeffery Schott

submitted, under the Trade Promotion Authority, Congress is required to give expedited procedures to trade agreements which are not subject to amendment.

Eventually, President Obama announced he would send the three FTAs to Congress for a vote once it renewed the TAA extension program, which ended in February 2011. Thus, the TAA became an obstacle. Most House Democrats, 41 Senate Democrats, and 25 governors urged the President for the TAA renewal. Representative Brady (R), head of trade subcommittee on Ways and Means, declared a straight reauthorization of the 2009 TAA is not doable for Republicans due to budget constraints and compromise would be necessary. The 2009 version expanded benefits to the service sector and increased healthcare benefits both which greatly added costs to the program. The program costs \$1bn annually but Republicans are questioning its costs and effectiveness.

South Korea warned the U.S. in June on consequences of not passing KORUS by the end of summer. The Korean National Assembly will vote on the FTA after U.S. approval. Thus, Congress' failure to pass KORUS by August could push the Korean vote into the 2012. Any vote after summer is too close to the 2012 Korean elections and domestic politics will push the authorization into May. The minority party in Korea's parliament, the Democratic Party, is opposed to the deal while the Grand National Party (GNP), the majority, supports it. There are concerns GNP could lose its majority in the April 2012 elections if the powerful farm lobby, which is opposed to KORUS, is successful in its grassroots campaign.

The Obama Administration's position is that the 2009 TAA extension is important for job training program and healthcare benefits for people who have lost jobs due to trade. However, the Republicans question the costs and effectiveness of the program and the budget deficit problem makes an agreement on spending increases even harder. Republicans are not

necessarily opposed to TAA but rather the expansion of the program that was created in the 2009 stimulus bill. However, both sides are nearing consensus and more Republicans are backing the deal. The earliest the Ways and Means Committee can begin action on KORUS is July. The delay will make it more difficult for the House and Senate to vote on the deal before the August recess.

III. The EU-Korea FTA Effect

On July 1, 2011, the FTA between the EU and Korea entered into force. This FTA is the second largest in FTA history after NAFTA. Korea is the EU's fourth largest trading partner with two way trade totaling over €66 in 2010. In addition, EU exports to Korea experienced a yearly growth rate of 7.5% from 2004-2008 and has a trade surplus in services. The EU places a higher tariff rate on Korean imports than the U.S. so tariff elimination will help Korean exporters even more than KORUS. The benefits the US could get from KORUS will be reduced when the EU gets to Korea first. In fact, the EU's competitive advantages and top exports to South Korea overlap some with the U.S. and California.² The degree to which the U.S. loses market share depends on how soon Congress can pass KORUS. If passage does not occur before the August 8th recess the losses will become more deeply entrenched. If KORUS is passed quickly then California will be able to bounce back and regain the losses.

IV. California's Advantages in KORUS

Elimination of tariffs and non-technical barriers to trade (NTB) will increase U.S. exports by \$11 bn annually. Ten years ago the U.S. was the top exporter to South Korea and provided 20% of the country's imports.³ However, the U.S. is now in third place and holds less than a 10% market share. Intra-Asian trade pacts have increased in the past decade thus offsetting U.S.

² Transportation equipment, machinery, agriculture, chemicals

³ International Trade Administration. (February 2011) Benefits from the U.S.-Korea Trade Agreement. www.trade.gov/KORUS

economic influence in the region and discriminating against American exports. Consequently, an Asian trading bloc is being created that excludes the U.S. thus drawing a line down the Pacific. However, KORUS can help reverse this trend.

Almost 95% of Korea's tariffs in U.S. merchandise will be eliminated within three years of effect. The current Korean tariff on U.S. exports is twice as high as the U.S. rate. Thus, American exporters will experience greater rewards from the trade agreement than Korean exporters. Exporters in services and agriculture will be the major beneficiaries of KORUS.⁴

The agriculture industry in California will profit greatly from the increased market access. Two-thirds of tariffs on agriculture products will be eliminated immediately. The U.S. is Korea's top supplier of agriculture with California by itself being the fifth. Out of South Korea's top five agriculture importers, the country only has an FTA with two: EU and ASEAN. If KORUS is extensively stalled California farmers and ranchers will not sustain deep, long-lasting losses. Even with high tariff rates California agriculture is still able to penetrate the Korean market at a lower price. Also, the country has a rising per capita income and the Korean diet is changing with increased consumption for dairy and meat which California can meet. Given these factors California's agriculture industry has much to gain through KORUS.

Korean farmers will be the losers in KORUS. In fact, this is one reason some Korean politicians oppose the trade agreement. Korean agriculture has no potential to expand its tiny agricultural exports to the United States and has been losing its competitiveness over the years.⁵ In addition, increased California agriculture exports would divert trade from other exporters to Korea, such as Chile, Australia, New Zealand and China.⁶

⁴ Top U.S. services to benefit: financial, insurance, telecommunications, air express, deliveries

⁵ California Farm Bureau Federation (January 2007). Free Trade Agreement: What it would mean for California Agriculture.

⁶ Ibid

California is a major supplier of many fruit, vegetable, and tree nut products to Korea. Specifically, “citrus products, tree nuts, dairy products, beef, grapes and grape products, stone fruits, strawberries, fresh and processed vegetables, flowers and ornamental horticulture, processed tomato products, olives, hides and skins, cotton, hay and rice”⁷ will see the biggest increases in demand. Korea has practically no domestic supply for tree nuts and the U.S. is virtually the sole supplier. In addition, Korea has a cost disadvantage in dairy production that is only sustained by government subsidies. The biggest challenge facing the U.S. agriculture industry will be beef. In 2003, Seoul imposed a ban on U.S. beef due to mad cow disease. Since then, Australia and New Zealand have filled the U.S. absence with their beef products. Also, China is the dominant supplier of vegetables. Elimination of tariffs and over time it is possible to overcome these hurdles.

The U.S. has a trade surplus of over \$6 bn in services to South Korea. The U.S. service industries that will reap significant economic benefits are finance, legal, accounting, insurance, telecommunications, health care, and education. Areas of specialization and knowledge intensity that the U.S. excels in underpin our economic growth more broadly which is why services will be the biggest driver in growth from KORUS.⁸ Korea has a \$580 bn service markets making it the world’s seventh largest market.⁹ Seoul has instituted numerous NTBs for trade in services but KORUS will eliminate these. The agreement will end industry-specific restrictions that inhibit investment and joint ventures.¹⁰ Also, Korea is becoming an entertainment center in East Asia which will greatly benefit the California film and entertainment service industries.

⁷ Ibid

⁸ Brookings Institute. (December 8, 2010). A Closer Look at the Korea-U.S. Free Trade Agreement. Joshua Meltzer

⁹ Third Way. (April 2011) The Korea Trade Agreement: A Good Deal for America. Gerwin, Ed and Ryan McConaghy

¹⁰ Ibid

Manufactured goods account for approximately 80% of U.S. exports to South Korea.¹¹ Gains in manufactured goods will be smaller and more limited compared to services and agriculture. Products expected to increase exports are: medical equipment, pharmaceuticals, information technology, green technology, aerospace/aviation, transportation equipment, and electrical equipment. U.S. exports in some of these areas are relatively small, ie medical devices and pharmaceuticals, but are very competitive in the Korean market. Within three years the following will gain duty-free access: aerospace equipment, automotive parts, electrical goods, scientific equipment, and transportation equipment. U.S. capital intensive machinery stands to be the biggest sectoral gainer from KORUS.

Considering these factors, California businesses should not equate potential Korean market growth with success. There are difficulties, costs, and risks associated with doing business in a new market. These barriers are namely in the form of cultural and geographic distance. Fortunately, Los Angeles is home to the largest Korean community in North America. This cultural linkage provides a great advantage to California. This connection will also provide an additional advantage to KORUS over the EU-Korea FTA. Geographic distance will be an obstacle when California firms compete against China, Japan, and Taiwan. But the West Coast is closer to Korea's ports than Europe so transportation costs will be lower for U.S. goods. These "distances" must be incorporated into any foreign trade and investment plan as the environment and atmosphere adds to the costs of doing business abroad.

V. Investment

Direct investment between the U.S. and South Korea is underdeveloped.¹² Bilateral investment in 2007 was \$38 bn while bilateral trade was \$81 bn.¹³ KORUS provisions regarding

¹¹ Ibid

¹² Brookings Institute. A Closer Look at the Korea-U.S. Free Trade Agreement

protections, regulations, and disputes will improve the investment climate.¹⁴ However, there is still the question of mode of entry: joint venture or subsidiaries? The choice of entry is influenced by cultural differences and firm experience.¹⁵ Most likely, there will be an increase in joint ventures between the U.S. and Korea rather than subsidiaries. In addition, IPR provisions and investment protections improve the climate for a joint-venture. However, considering California's cultural linkage to Korea and its experience in trade to the region may not make it as difficult to establish a direct presence in the country.

VI. Intra-Industry Trade

Intra-industry trade (IIT) is trade in which a country both imports and exports products in the same industry. The IIT index is measured from 0 to 1. If the measure is 0 it means the country only imports or exports the good in question and if 1 then both the imports and exports are equal. IIT between the U.S. and South Korea is high with seven of the top fourteen U.S. exports to Korea having an IIT index above 0.5. One reason for the cause of the high IIT indices is product differentiation. This is especially true in electronics and automobiles. Typically, industries that are most likely to have high IIT are those with capital-intensive manufactured goods with production is characterized by economies of scale.

A result of a high IIT means there will be more competition when there is free trade. Specifically, Detroit and Silicon Valley will face a more competition from its Korean counterparts. Business will not have to worry about production shifting to another country due to cheaper costs. IIT involves trade in goods and services that use similar factor intensities (capital and labor). Korea is a developed economy and specializes in capital intensive goods

¹³ Ibid

¹⁴ Ibid

¹⁵ Kogut, Bruce and Harbir Singh. (1988) The Effect of National Culture on the Choice of Entry Mode. *Journal of International Business*. Fall 1988

which is similar to the U.S. economy. What this means is that American workers don't have to worry about jobs being shipped overseas to Korea due to KORUS. A lower IIT means production will shift to the country with a trade surplus in that industry. Thus, Korea will lose agricultural jobs to the U.S. However, U.S. firms may lose out in electrical appliances.

VII. Conclusion

KORUS will provide a major boost for international trade to East Asia for California and Los Angeles businesses. The agreement greatly affects your short-term interests as the FTA could be implemented within weeks. KORUS is no longer an idea that is far off but an almost present day reality. Republicans in Congress will most likely make concessions before the August recess. Any changes to TAA would be minimal at most. Identifying how your business can capitalize on the FTA must be done quickly in order to establish a foothold and beat out European competitors. Los Angeles must utilize its Korean cultural linkage if it wishes to gain the most from the new trade agreement. Overall, California stands to be one of the biggest beneficiaries of KORUS in the U.S.