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## Conclusions

As the Bush administration reviews its foreign policy objectives in early 2001, one of its key priorities will be strengthening US relations with Korea. The 50-year partnership has benefited both countries; deepening bilateral ties can contribute to the security and economic prosperity of Northeast Asia and the United States. Promoting closer trade relations, including possibly the negotiation of a free trade agreement, should be on the bilateral agenda and considered seriously as part of the broader evaluation of the US-Korean relationship.

This monograph has examined the benefits and challenges of proceeding with a Korea-US FTA. There is no simple answer to the fundamental question posed by this study: Is an FTA worth pursuing? The economic issues raised by prospective talks are broad ranging and involve competing political interests. Opposition to important trade reforms is deep-rooted in both countries. Nonetheless, many Korean reforms that an FTA would require will need to be implemented in any event to help restructure the economy and provide a firmer foundation for sustained economic growth.

Negotiators have substantial flexibility in crafting the terms of a bilateral free trade pact. The following summarizes the economic and political considerations that should be taken into account if negotiations go forward.

First, the bilateral trade relationship is already robust but replete with troublesome barriers:

- Korea-US trade in goods and services in 1999 reached \$65 billion. The United States accounts for more than 20 percent of total Korean trade; Korea accounts for about 3 percent of total US trade.

- Trade disputes involving antidumping and countervailing duties, as well as WTO cases covering other alleged violations of global trading rules, affect about \$5 billion in Korea-US merchandise trade. In addition, almost \$400 million in Korean exports are subject to very high US tariffs. Resolving these problems and eliminating the tariffs would contribute to strong growth in bilateral trade.
- The stock of US foreign direct investment (FDI) in Korea, by contrast, is relatively modest at \$8 billion, or less than 1 percent of total US FDI abroad. Removing long-standing restrictions to entry into the Korean market, in conjunction with other domestic economic reforms and prospective FTA provisions, would generate substantial new inflows of US investment in Korea.

Second, both countries gain from the formation of a preferential free trade area. For the United States, the potential welfare gain is very small in relation to its \$10 trillion economy. For Korea, the potential income gain is more significant, ranging from 0.4 percent of GDP to more than 2 percent of GDP in the most favorable scenario. Most of the US gains come from improvements in its terms of trade (related to the preferential aspect of trade liberalization); most of Korea's gains come from increased efficiency of its industries induced by the trade reforms rather than by preferential access to the US market. This finding suggests that unilateral reforms may be a better option for Korea than a preferential trading arrangement with the United States.

However, we found two clouds in this silver lining. First, a Korea-US FTA would generate substantial trade diversion in the Asia-Pacific region, resulting in net welfare losses for the major trading partners of both countries. Japan and China would be hit the hardest. Second, the potential welfare gains from an FTA would be substantially diluted if the pact excludes politically sensitive sectors such as agriculture. Indeed, we found that the welfare gains are less than half if agriculture is excluded from the agreement.

Simply put, the deal is not worth doing unless it covers "substantially all" sectors, including agriculture, as required by WTO rules. Negotiators will need to use their imagination and flexibility to craft a pact that meets WTO requirements, mitigates domestic opposition, and assuages concerns among other trading partners that the pact would complicate achievement of the APEC goal of free trade and investment in the region. Three issues merit special emphasis:

- The FTA would require liberalization of farm trade barriers, including rice, and high tariffs, including textiles and footwear. However, the implementation period of the trade reforms could be protracted (e.g., NAFTA provides a 15-year phaseout for the most sensitive farm trade

barriers between the United States and Mexico) and temporary protection could be continued, where required, under tariff-rate quotas.

- Special rules could be included in the pact, à la NAFTA, to afford preferential treatment under national trade remedy laws (e.g., safeguards cases) or discriminatory rules of origin. However, both options undercut the value of the agreement and set troubling precedents that would complicate the conduct of regional and WTO negotiations. Moreover, Korea has recently contested NAFTA's special safeguards rules in a WTO dispute settlement case.
- The scope for antidumping reform is very limited and more feasible in the context of WTO than FTA negotiations. Both Canada and Mexico concluded that the benefits of an FTA outweighed their failure to reduce their exposure to US antidumping actions through new FTA obligations. Korea would have to reach the same conclusion for the FTA talks to be initiated.

The political ramifications of a Korea-US FTA are also complex. Concluding a bilateral free trade pact would further reinforce the strong ties that already bind the two countries together. An FTA would be a signal of the firm US economic commitment to a prosperous Korea and its political commitment to ensure that resources are available to promote peace and stability on the Korean peninsula. The more a bilateral FTA supports Korean economic development, the more likely that North Korea will maintain a less belligerent posture toward its neighbors. Other APEC countries, especially Japan and China, would benefit if the Korea-US pact contributed in this way to reduced political tensions in the region.

To be sure, a Korea-US FTA could complicate trade relations among the East Asian countries and between each of them and the United States. Given the potential for trade diversion, a Korea-US pact could spur other countries in the Asia-Pacific region to pursue their own discriminatory trading arrangements to offset the adverse effects of the trade diverted by the Korea-US FTA. In short order, Korea could face ardent FTA suitors from Japan and Taiwan and possibly a call for trilateral negotiations among those three countries. At the same time, Taiwan also would probably demand treatment in the US market similar to that accorded to Korea. In contrast, Japan would probably not seek a bilateral free trade deal with the United States. For such a deal to be credible with the US public, it would have to extensively cover Japanese regulatory policies that are at the root of many US-Japan trade disputes but are politically sensitive in Japan.

Of course, the extent to which any of these pacts actually cause trade diversion would depend importantly on the progress, if any, made in multilateral negotiations in the WTO. Simply put, WTO liberalization

dilutes the value of FTA preferences and thus reduces the scope for potential trade diversion.

To avoid trade frictions within the APEC community, the United States and Korea would have to balance their FTA with other trade initiatives in the WTO and in the region. To that end, both countries would have to manage their bilateral talks in a way that helps jump-start the next stage of free trade reform within APEC and supports the successful conclusion of WTO reforms as well. In other words, the objective should be to promote Korea-US talks in a way that spurs competitive liberalization among countries in the Asia-Pacific region rather than the formation of competing but defensive blocs. The sequencing of bilateral, regional, and multilateral negotiations will to a significant extent influence the economic and political fallout from discriminatory bilateral FTAs.

In sum, if the United States and Korea want to maximize both welfare gains and political comity in the Asia-Pacific region, the preferred trade strategy should be to concurrently pursue trade reforms bilaterally, in APEC, and in WTO negotiations. If efforts in those larger forums continue to drift however the two countries should nonetheless continue their bilateral free trade talks. However, in the spirit of "open regionalism," the FTA negotiators should include an accession clause in the pact that affords the opportunity for other APEC members to participate in the free trade area, effectively broadening the bilateral initiative into the regional free trade regime envisioned by APEC leaders in their 1994 Bogor Declaration.