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Moving the KORUS FTA Forward in a Time of Economic Uncertainty

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Despite the clear benefits of the Korea-U.S. Free Trade Agreement (KORUS FTA) for the U.S. and South Korea, it has been stalled for nearly 18 months due to disputes over U.S. beef and the sale of U.S. autos in Korea. While the difficulties over beef have largely been resolved, the financial crisis and the economic recession in the U.S. have further clouded the agreement's prospects.

Prior to the current crisis, the difficulties with the auto provisions of KORUS FTA were more about the declining position of the U.S. auto industry than any specific provisions in the FTA itself. The financial crisis has pushed the U.S. auto industry to the brink of collapse, reinforcing its need to protect its position in the U.S. market, which is the world's largest.

With the prospect of the deepest recession in the United States in at least a quarter century and the uncertain prospects for the U.S. auto industry, it is time for Korea and the U.S. to consider policy solutions that reflect the changed economic and political realities. Without doing so, the KORUS FTA will continue to face an uncertain future.

The Trouble with Autos

For years the U.S. auto industry has faced a tariff, tax, and regulatory structure in Korea that has inhibited its ability to sell cars there. However, the U.S. is not the only country that has failed to crack the Korean market, as imports account for only around 5 percent of all cars sold in Korea. In contrast, imports accounted for slightly less than 30 percent of the U.S. market in 2007, according to *Automotive News*.

While the inability of any foreign auto producer to thrive as an importer in Korea is testimony to the barriers that have been in place, it does not demonstrate that the KORUS FTA fails to address these barriers. More importantly, the nature of the disparities in auto sales between Korea and the U.S. is much more complex than it might seem at first glance.

While Korea sold nearly 775,000 cars in the U.S. in 2007, it is often cited that the U.S. sold only 6,500 cars in Korea. However, the real sales and production figures are much more complex than this disparity would indicate. Prior to the current financial crisis, annual sales of autos in the U.S. were around 16.5 million, while sales in Korea were only around 1 million. The significant gap in market size means using the number of total sales can be misleading.

Even with a structural gap, the sale of 6,500 U.S. vehicles in Korea last year is still significantly smaller than one might expect. In 2007, Korea had approximately 5 percent of the U.S. market for automobiles. If the U.S. had an equivalent market share in Korea, its sales would rise to around 50,000 units; if the U.S. gained 20 percent of the Korean market, it would sell around 200,000 vehicles.

However, one should be skeptical of claims that the U.S. sold only 6,500 vehicles in Korea in 2007. U.S. companies sell cars in Korea that are produced there, as well as cars that are imported from Europe. The location of production matters, especially when considering the impact of U.S. car sales on jobs in the United States and corporate profits.

While the official import sales statistics show that the Big 3 sold only 6,500 cars in Korea last year, the figure does not include vehicles produced by GM's Korean subsidiary, GM Daewoo. Last year, it had sales of more than 125,000 vehicles. If these are included in the U.S. sales figure, sales by U.S. owned automobile companies rise to nearly 135,000, giving the U.S. 12.8 percent of the Korean market – significantly more than Korea's market share in the United States.

In contrast, the 775,000 vehicles Korea sold in the U.S. include 250,000 that were made at the Hyundai plant in Alabama. In the long run, the number of Korean vehicles that are produced in the U.S. will rise as Hyundai brings its Kia factory in Georgia on line, increasing Korea's total production capacity in the U.S. to 600,000 units per year.

These differences matter, as historically the U.S. has moved production to the area of sale rather than exporting from U.S.-based plants. This means that U.S. sales in Korea can increase without significantly reducing the autos trade deficit or creating jobs in the U.S. while Korean sales in the U.S. are likely to create new American jobs.

This structure of trade is likely to continue in the future. Korea has one of the most aggressive FTA policies in the world. In addition to the FTA with the U.S., it is close to concluding an agreement with the EU, and is likely to begin negotiations with China in the near future. Should Korea conclude agreements with all its considered partners, including the U.S., it would have FTAs with countries representing more than 90 percent of global GDP. This will make it easier to service the Korean market from the most economically viable production plant for each of the Big 3 U.S. auto companies.

The Global Financial and Economic Crisis

The economic crisis has changed the politics of the KORUS FTA. Congress has never knowingly approved an FTA during a recession. With the recent announcement that the U.S. has been in a recession for the past year, and the expectation that this could be the deepest recession in at least the last quarter century, it seems unlikely that this trend will be broken anytime soon.

If the trend is to change, it will likely be with a trading partner that already receives significant U.S. preferences, rather than a nation with which the U.S. still maintains a significant tariff schedule. The pending FTAs with Panama and Colombia fit this profile, as they are recipients of U.S. preferences, while Korea and the U.S. still maintain a wide range of tariffs. However, once the FTA is implemented 95 percent of tariffs will be eliminated after three years.

The financial crisis has hit the U.S. auto industry hard. As the economy has worsened and the crisis set in, sales have collapsed in the U.S, dropping from 16.5 million units in 2007 to an expected 13.6 million this year. Even generally strong companies such as Toyota have seen sales drop by over 30 percent in the recent monthly figures.

With unemployment in the U.S. at 6.7 percent and the possibility that it could rise as high as 9 or 10 percent next year, Congress will likely act soon on some form of bailout and restructuring program for the U.S. auto industry. If Congress fails to act and the Big 3 ceased operations, the Center for Automotive Research has estimated that it would mean the loss of 3 million jobs. Even the loss of 50 percent of the Big 3's capacity could lead to the loss of nearly 2.5 million jobs because of the integrated nature of the industry.

Flexibility would Benefit Korea and the United States

In submitting their proposals for assistance to Congress on Dec. 2, Ford and GM estimated that they would potentially become profitable again in 2011 and 2012. Even with a bailout, the U.S. industry faces a turbulent future. Industry sales are expected to trend down slightly next year and, according to the *Financial Times*, could settle at a level that will only allow for the viability of two of the Big 3 domestic auto producers.

Given the uncertainty surrounding the U.S. auto industry and its importance to the passage of the KORUS FTA in the U.S., both sides should consider ways to temporarily mitigate the impact the agreement will have on the U.S. auto sector. This would allow both countries to begin experiencing the benefits of the agreement in other sectors.

One option would be to temporarily suspend the provisions relating to trade in autos. While the FTA currently calls for a three-year phase-out of U.S. tariffs and an immediate lifting of Korean tariffs on autos, a temporary suspension would offer two benefits. First, the U.S. industry would not face *increased* competition from Korea while it undertakes a significant restructuring in its home market. Second, if the restructuring is successful, it would be in a better position to utilize the provisions in the FTA to expand its share in the Korean market.

However, any suspension of the FTA's auto provisions should not be permanent, and would need to include clear guidelines identifying the signs of health in the U.S. industry that would trigger resumption of the provisions. These could be consecutive quarters of health by the U.S. industry as a whole, or the completion of the conversion of factories to produce more fuel efficient cars. Whatever the metric, any agreement would also need to cap the suspended period given the possibility that the U.S. auto industry may be unable to meet the assigned metric in a reasonable period of time.

These are unique economic times for both the U.S. economy and the U.S. auto industry. The current recession could extend through much of 2009, while the auto industry does not expect to see its fortunes improve until perhaps 2011. Suspending the auto provisions of the FTA could provide the flexibility all sides need to move the agreement forward.

This past spring, as daily protests over U.S. beef filled the streets of Seoul, the U.S. worked with the South Korean government to find a politically acceptable way to relieve the crisis. Now the U.S. is facing a potentially much more critical crisis, and Korea could strengthen the alliance by showing similar flexibility in a time of need.