

# The KEI Exchange

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## Moving the KORUS FTA Forward in a Time of Economic Uncertainty

*by Troy Stangarone*

Despite the clear benefits of KORUS FTA for the United States and 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 U.S. beef have largely been resolved, the onset of the financial crisis and the ensuing economic recession in the United States have only 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 in the United States than any specific provisions in the agreement itself. The current financial crisis has pushed the U.S. auto industry to the brink of collapse, reinforcing the industry's 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 United States 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 the United States' ability to sell cars exported to Korea. However, the United States is not the only country that has failed to crack the Korean market, as imports account for only around five percent of all of the 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 a testament to the barriers that have been in place, it does not demonstrate that the KORUS FTA does not adequately address these barriers. More importantly, the nature of the disparities in auto sales between Korea and the United States is much more complex than it might seem at first glance.

While Korea sold nearly 775,000 cars in the United States in 2007, it is often cited that the United States 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, sales of autos in the United States were around 16.5 million, while sales in Korea were only around 1 million. The significant gap in size of the Korean and U.S. markets means that there will always be a disparity in the sales totals.

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 United States had an equivalent market share in Korea, its sales would rise to around 50,000 units. Even if the United States gained 20 percent of the Korean market, it would sell around 200,000 vehicles.

However, one should be skeptical of claims that the United States 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 United States 12.8% 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 United States include 250,000 that were made at the Hyundai plant in Alabama. In the long run, the number of vehicles Korea sells that are produced in the United States will rise as Hyundai brings its Kia factor in Georgia on-line, increasing Korea's total production capacity in the United States to 600,000 units per year.

These differences matter, as historically the United States has moved production to the area of sale rather than exporting from the United States. This means that U.S. sales in Korea can increase without significantly reducing the autos trade deficit or creating jobs in the United States.

This structure of trade is likely to continue in the future. Korea currently has one of the most aggressive FTA policies in the world. In addition to

the FTA with the United States, 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 of its considered partners, including the United States, 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.

### **The Global Financial And Economic Crisis**

The current global crisis has changed the politics of the KORUS FTA. The U.S. Congress has never knowingly approved an FTA during a recession. With the recent announcement that the United States 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 is 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 United States still maintains a significant tariff schedule. The pending FTAs with Panama and Colombia could fit this profile, as they are currently recipients of U.S. preferences, while Korea and the United States still maintain a wide range of tariffs. However, once the FTA is implemented 95 percent of tariffs will be eliminated after three years.

The crisis has also hit the U.S. auto industry hard. As the economy has worsened and the financial crisis set in, it has seen sales collapse in the United States 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 United States at 6.7 percent and the possibility that it could rise as high as 9 or 10 percent in the next year, Congress will likely act soon on some form of bailout or restructuring program for the U.S. auto industry. If Con-

gress failed 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 only 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 December 2, Ford and GM identified 2011 and 2012 as the respective estimates for when they would potentially become profitable again. Even with a bailout, the U.S. industry could face a turbulent future. Industry sales are expected to trend down slightly next year and, according to the Financial Times, could ultimately 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 United States, 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, and, should that restructuring be 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 would not be permanent, and would need to be structured with clear guidelines on what signs of health in the U.S. industry would trigger resump-

tion of the provisions. These could be a period of 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 for the possibility that the U.S. auto industry is unable to meet those metrics 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 U.S. 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 United States worked with Korea to find a politically acceptable way to relieve the crisis. Now the United States is facing a potentially much more critical crisis, and Korea could strengthen the alliance by showing similar flexibility in the United States' time of need.

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Layout Editor: Arthur N. Taylor

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