Static and Dynamic Consequences of a KORUS FTA

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Comments on the Kiyota-Stern Study

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The U.S.-Korea Free Trade Agreement, or KORUS FTA, is a historic agreement that should enhance bilateral economic relations and reinforce the long-standing partnership of the United States and Korea on political and security matters.

The KORUS FTA is designed to promote competition and regulatory reform so that the trade pact complements other domestic policies implemented to boost productivity and economic growth in both countries. Part of these gains is achieved through commitments to greater transparency of administrative and regulatory procedures and through joint working groups on autos and other issues. Such results, of course, confound analysts who do not know how to accommodate them in their economic models!

The KORUS FTA provides substantial new opportunities for trade and investment in goods and services. Most tariffs on bilateral trade will be removed within three years. Even in agriculture, many tariffs will be phased out over time and many quotas will be expanded; only rice will be exempted from the liberalization. The impact of these bilateral preferences will depend, of course, on what happens in the Doha Round, on how quickly the multilateral liberalization is implemented, and on the evolution of other FTAs among Asia-Pacific countries.

The analysis by Kiyota and Stern (2007) captures some of these aspects of the agreement. The authors deserve praise for advancing knowledge on how to estimate results from trade negotiations. Their current model sets out an elegant methodology that has pushed the envelope of academic research. But for the purposes of policy analysis, it still leaves much to be desired.

The authors provide a useful literature review of other studies on the potential outcome of a KORUS FTA. All those studies set forth estimates of potential changes if their simplified assumptions about the content and implementation of the pact are adopted. They are not predictions of what will happen under the terms of the deal concluded in early April 2007.

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As in any modeling exercise, the output is only as good as the input. In this regard, I am concerned about several parts of the Kiyota-Stern study. First, the sectoral results on agriculture seem way off the mark. I cannot conceive how the authors can explain an increase in Korean output and employment in rice, wheat, and livestock owing to demand factors. Rising incomes generate richer diets, but farmland in Korea will be taken out of production for use by industry and service companies. Second, there are obvious glitches in the construction of the database on services trade restrictions. Tables 11 and 13 report that U.S. barriers are higher than those in Korea for all segments of the service economy; the data are simply not reliable and that skews the overall estimates from the model. Third, the authors misunderstood and thus misrepresent the sectoral results about the welfare and employment effects of the FTA reported by Schott, Bradford, and Moll (2006). If one examines the Schott-Bradford-Moll scenario that excludes rice—as those authors recommend given modeling problems with the other scenarios that they reported—there are far fewer differences with the results of the Kiyota-Stern model.

Policymakers may learn the most from the supplementary experiments reported in Table 23. The authors test the impact of a 1 percent and 5 percent increase in Korea's base stock of capital as a surrogate for dynamic changes that could accrue in response to the KORUS FTA. Even the very conservative estimate of a 1 percent boost in the capital stock yields an additional welfare gain for Korea of $19.3 billion or 2.62 percent of GDP. This finding validates a key objective of many participants in entering into free trade pacts: that is, the most important benefits may derive from increased investment—if the trade pact is implemented in conjunction with other domestic economic reforms, especially in the services sector.

Let me conclude with a note of caution. Politicians like to have concrete numbers to show their intellectual dexterity, and they take the somewhat mushy numbers generated by these models as hard evidence. The Kiyota-Stern study is prone to such intellectual abuse. It is a valuable piece of work but provides only one piece of evidence about the potential economic implications of the KORUS FTA. Its findings should be considered in conjunction with partial equilibrium analyses of specific provisions of the pact, which can be done once the actual details are made public.

REFERENCES

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