

Static and Dynamic Consequences of a **KORUS FTA**



Korea Economic Institute
25th Anniversary 1982-2007

CONTENTS

Preface

Part I: The Economic Effects of a Korea-U.S. FTA

Conclusions and Implications for Further Research and Policy
Excerpt from *Economic Effects of a Korea-U.S. Free Trade Agreement**
Kozo Kiyota and Robert M. Stern 1

Comments on the Kiyota-Stern Study
Jeffrey J. Schott 5

Implications of the U.S.-Korea Free Trade Agreement: A General
Equilibrium Approach
Renan Zhuang and Won W. Koo 7

Part II: Dynamic Effects of an FTA

The Payoff to South Korea From Globalization
Gary Hufbauer and Agustín Cornejo 29

How Financial Multilateralism Can Increase Sustainable Output, Employment, and
Income in the Pacific Region
Douglas H. Brooks and David Roland-Holst 51

Part III: Scope for Dynamic Effects in Korea's Economy

Dynamic Consequences of a Korea-U.S. Free Trade Agreement: Foreign Direct
Investment
Arthur Alexander 73

Is A Free Trade Agreement a Royal Road to Prosperity? Demystifying Trade
Regionalism
Sungjoon Cho 89

Regional Integration and a Free Trade Agreement Among China, Japan, and Korea
Hee-joon Kang 109

Comment: Scope for Dynamic Effects in Korea's Economy
Choi Nakgyoon 123

Part IV: Conference Discussion and Conclusions

Summary of Proceedings
Bernard K. Gordon 129

* Volume 4 in KEI Special Studies Series, published by Korea Economic Institute of America

IS A FREE TRADE AGREEMENT A ROYAL ROAD TO PROSPERITY? DEMYSTIFYING TRADE REGIONALISM

** Sungjoon Cho*

CONTENTS

- I. Introduction
- II. A Multilateralist Critique of the Regionalization of International Trade
- III. KORUS FTA as a Building Block: Multilateralizing Trade Regionalism
- IV. Implementing KORUS FTA: Challenges Ahead
- V. Conclusion

**Sungjoon Cho is Assistant Professor of Law, Chicago-Kent College of Law, Illinois Institute of Technology, Chicago. The author extends his gratitude to Fred Bergsten, Jeffrey Schott, Gary Hufbauer, Claude Barfield, Choi Nakgyoon, Bernard Gordon, and participants in the KEI-PIIE KORUS FTA conference on 1 May 2007 for their valuable comments on an earlier draft.*

I. Introduction

Korea and the United States have finally sealed their 10-month negotiation on the biggest bilateral trade deal ever. The scope and impact of the U.S.-Korea Free Trade Agreement (KORUS FTA) by two major trading nations, the United States being the largest economy and Korea the 11th-largest economy in the world, will undeniably be gigantic. Yet the KORUS FTA needs to be put into a broader perspective. The global trading system has recently been inundated by a sea of regional trade agreements (RTAs), which are also called free trade agreements (FTAs). Out of 300 RTAs extant as of October 2004, 176 RTAs were created since the launch of the World Trade Organization (1994a) in 1995 (Sutherland et al. 2004, 21).

It can be conceded that regionalism has certain merits, such as speed and flexibility in trade liberalization. Yet some of these merits are often exaggerated, while the demerits of FTAs are clouded by political agendas expedient to short-term interests. Internationally, FTAs tend to seriously fragment global trade and thus give rise to various transaction costs impacting global businesspeople. Domestically, FTAs may deliver limited blessings to economic welfare because they can be designed to inhibit, not promote, market competition.

Against this backdrop, this article calls for a sobering reassessment of regionalism's balance sheet vis-à-vis multilateralism. Too much emphasis on FTAs might blind us to the demerits and at the same time eclipse the merits of more principled approaches such as multilateralism or even unilateral liberalization. In terms of the KORUS FTA, this article argues that both the United States and Korea should multilateralize their bilateral market-opening commitments not only for themselves but also to offer a catalyst to the currently comatose Doha Development Agenda. Debates and discussions over the KORUS FTA should be refocused away from short-term mercantilist calculations and onto long-term progressive economic strategies. Without a grand consensus on the nation's economic future, which involves not only trade policies but also other economic and social policies such as labor and wealth redistribution, any market-opening projects, including the KORUS FTA, will not be free from the current atrophying dynamics in both countries.

II. A Multilateralist Critique of the Regionalization of International Trade

An Economic Perspective: Trade Diversion and Embedded Mercantilism

The most salient structural drawback of RTAs is "trade diversion" arising from their preferential nature as an exception to the most-favored-nation (MFN) principle. More efficient producers from nonmember countries lose market access to less efficient

producers who nonetheless enjoy such tariff preferences. Under the Vinerian test (Viner 1950, 44–45), an RTA may be justified if it “can gain in the long-run only as the result of the general diffusion of the increased prosperity” of the RTA. This trade-creating effect has been put to test by empirical studies. Economists generally believe that RTAs are inherently inferior in trade creation compared with a multilateral trading system (Cho S. 2006a, 62–68). Moreover, rent-seeking domestic constituencies that prefer protection to competition continue to entrench an operational dimension of trade regionalism. This “embedded mercantilism” (Beeson 2003) is evidenced by most RTAs’ complicated rules of origin—which are often called a “spaghetti bowl” (Bhagwati 1998, 290)—as well as the number of waivers and derogations attached to them (Choi 2003, 52).

One might attempt to justify RTAs in East Asia or more broadly in the Asia-Pacific region in the name of “competitive regionalism” (Hilaire and Yang 2004, 608). Fred Bergsten (2002, 13) vindicates the current U.S. bilateral and regional drive under this title by suggesting that such an aggressive stance “place[s] pressure on non-members of individual free trade agreements to join the group itself earlier or to conclude broader agreements.” Although this proposal sounds quite ideal at first glance, it risks depriving nonmembers of the incentives and resources to promote the multilateral trading system. In particular, trading nations are likely to strategize their trade liberalization in a way that delays certain liberalization plans, wanting to keep them as bargaining chips in preparation for future bilateral or regional trade deals (Scollay 2004, 4). Alternatively, this competition may pit one bloc against another and precipitate economic balkanization (J. Frankel 1997, 210). Even if we accept this proposal as it stands, it would be very difficult to implement. According to one study, 210 FTAs would be required to encompass all the bilateral trading relationships between the 21 APEC economies (Scollay 2004, 8; Cho S. 2006b). After all, the devil is in the details.

Suppose that Korea signed yet another FTA with China. One might think that Korean exporters would be granted another big export market (China) in addition to the United States. However, this theoretical possibility does not necessarily materialize in Korean exporters’ favor. China may sign additional FTAs with other trading partners, such as ASEAN. If it were to do this, labor-intensive or assembly-oriented Korean exported goods, such as textiles and clothing, would soon lose their price competitiveness originating from preferential tariffs in the Chinese market. If China were to sign a similar bilateral trade deal with Japan, Korean exporters of capital (technology)-oriented goods, such as semiconductors or liquid crystal displays (LCDs), would soon be deprived of their short-lived competitive edges as well.

Some Korean manufacturers may contemplate building factories in China and producing products cheaply there and shipping them to the U.S. market. However, it is likely that the KORUS FTA prohibits such trade deflection using complicated rules of origin.

Those goods may be regarded as made in China, not made in Korea, especially when labor constitutes a substantial value in them. China will lose Korean investment to the extent that potential Korean producers would refrain from having their products assembled in China for fear of higher tariffs that the United States would impose on items made in China. Obviously, this scenario is likely to militate against the constructive U.S.-China relationship. This kind of problem can easily be avoided if all three countries (Korea, China, and the United States) multilateralize their bilateral commitments under the WTO MFN principle.

In sum, RTAs and FTAs tend to incur certain welfare costs from the standpoint of the multilateral trading system. Perhaps this is why most APEC members have rightly been lukewarm toward the idea of a Free Trade Area of the Asia Pacific (FTAAP) (Aritake 2007). If an East Asian bloc should emerge and thus split the global trading system into three major blocs—a European bloc and a Free Trade Agreement of Americas (FTAA) bloc would be the others—that would be one of the worst scenarios for the multilateral trading system, as Paul Krugman has observed (Scollay and Gilbert 2001, 6).

A Legal Perspective: Legal Tensions with WTO Norms

Article XXIV of GATT and the new WTO understanding. RTAs are structured under the stricture of the multilateral trading system, that is, GATT Article XXIV (1947), lest they should revive all the old mercantilist evils and thus rekindle the prewar pandemonium of economic balkanization. RTAs, as a kind of de-multilateralization, are an exception, not the norm.

From this historical lesson, the chief architect of GATT 1947, the United States, staved off demands from its allies such as the United Kingdom and France to maintain the prewar preferential system based on Commonwealth or colonial rule. To the United States, RTAs would be pernicious to the ultimate goal of the GATT—free trade—mainly because of their inherent preferential, discriminatory structure. Although the United States acknowledged a practical need to sustain trade regionalism to a certain degree, particularly in terms of rebuilding war-torn Europe via community building, the United States believed that such a need should be carried out within the multilateral trading system not as the norm but, instead, as an exception.

Hence, GATT Article XXIV stipulates rather draconian requirements for legalizing free trade areas or customs unions (CUs). For any RTA, be it an FTA or a CU, to be justified under the article it has to pass three tests: internal, external, and procedural. First, intra-RTA trade in goods should be liberalized substantially, encompassing most products that are traded (GATT 1947, para. 8). Second, the creation of an RTA should not increase in general the trade restrictions vis-à-vis nonmembers (GATT 1947, para.

5). Third, members should notify the WTO of their RTA-building process (GATT 1947, para. 7). In this sense, every RTA existing is a provisional entity whose legality needs to be confirmed and thus may be rejected through the GATT Article XXIV test, at least from a legal standpoint. Unfortunately, however, this legal stricture has seldom been imposed. Not a single RTA has ever been rejected for violating the article. The record demonstrates debates and arguments but not firm decisions, which may be characterized as “legal vacuums” in this area (Cho S. 2001, 436–37).

However, the new WTO system remedied this legal vacuum. The Understanding on the Interpretation of Article XXIV of the GATT (WTO 1994b) reclaimed legal discipline in this murky field of international trade. The understanding provided clear answers to traditionally controversial issues as well as bolstered procedural rules in monitoring and reviewing questionable aspects of regional trade deals. In particular, paragraph 12 of the understanding made it clear that a WTO member can sue another member over any legal issues involving Article XXIV.¹ This is a sea change considering that an old GATT panel had refused to adjudicate on this issue.²

Under this new legal regime on trade regionalism, the WTO Appellate Body (AB) in its 22 October 1999 report, “Turkey—Restrictions on Imports of Textile and Clothing Products” (WT/DS34/AB/R), struck down a Turkish quantitative restriction against Indian textile products that emulated the EC’s textile quota system as Turkey formed a customs union with the EC. Markedly, the AB rejected Turkey’s recourse to Article XXIV on the ground that it could have pursued a reasonably available alternative, such as a certificate of origin, which is consistent with WTO norms. This decision reaffirmed the principle of “complementarity” over RTAs: RTAs are legal under the WTO only when they follow WTO rules such as the prohibition of quantitative restrictions under GATT Article XI. The decision is paradigmatic in the sense that it demonstrated legal possibilities under which third parties (nonmembers) can challenge certain trade restrictions that an RTA may unjustifiably generate. RTA members can no longer take refuge in the legal vacuum that Article XXIV had unintentionally created.

WTO-plus: Price of bilateralism. The United States has watered down its multilateral commitment to the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) by increasing the protection of intellectual property rights in

1. “The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to *any* matters arising from the application of those provisions of Article XXIV relating to customs unions, free-trade areas or interim agreements leading to the formation of a customs union or free-trade area” (WTO 1994b, para. 12, emphasis added).

2. In EC-Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region (260L/5776 [unadopted, dated 7 February 1985], paras. 4.15–16), the panel held that “it should, in the absence of a specific mandate by the Council to the contrary, follow this practice also in the case before it and therefore abstain from an overall examination of the bilateral agreements.”

the plethora of recent bilateral trade talks. Paul Hunt, the UN human rights rapporteur, recently warned that the U.S. bilateral trade talks with Andean countries might dilute the international obligations of the United States under the new TRIPS amendment. The United States would thus be keeping drug prices unaffordably high for its bilateral trading partners (ICTSD 2004b). The UN even raised the possibility that human rights violations were being committed in those countries that engaged in bilateral trade negotiations that failed to provide millions with access to basic drugs owing to their high royalties. The criticism against the United States was intensified when Thailand hosted the 15th International AIDS Conference in July 2004. It was reported that the recent U.S.-Thailand bilateral trade negotiations threatened to disband the Thai AIDS program in favor of a stricter intellectual property rights protection program that would be tantamount to a “TRIPS-plus.” President Jacques Chirac of France even labeled such bilateral pressure as “blackmail” (BBC 2004).

The KORUS FTA is not an exception to this trend. The United States insisted successfully on applying its FTA template on pharmaceutical products to the KORUS FTA in a way that effectively suppresses competition between brand-name and generic drugs. First, the KORUS FTA delivers to big pharmaceutical companies five years of protection from generic-drug competition by banning producers of generics from using pre-existing clinical testing data and instead requires them to conduct costly tests themselves before getting approval. Second, it de facto extends the patent term of pharmaceutical products by compensating the period for regulatory approval (usually two years). Third, it suspends an approval process on generic drugs when brand-name companies file infringement suits against those producers of generics. This stay may potentially “evergreen” original patents by enabling brand-name companies to block producers of generics from marketing generic drugs via certain judicial remedies.

From a multilateral standpoint, these provisions appear highly problematic (Garrison 2006, 59–60). Article 30 of TRIPS explicitly recognized the so-called regulatory review exceptions under which governments can foster competition between brand-name and generic industries by limiting patent terms of pharmaceutical products under certain circumstances as a matter of public policy, such as protecting the interests of consumers (S. Frankel 2006, 395–96; Drahos 2004, 60). A WTO case (Canada-Pharmaceutical Patents) in 2000 also confirmed this rule. In this case, the panel upheld the Canadian government’s regulations that enabled companies that make generic drugs to use patented inventions even during the patent terms to facilitate their approval process. However, drug provisions of the U.S. FTA template tend to run afoul of the letter and the spirit of the aforementioned WTO rules because they stifle competition from generic drugs to serve the interests of big multinational pharmaceutical companies.

This U.S. FTA template on drugs is even at odds with the U.S. domestic rules in this field. Under the Hatch-Waxman Act of 1984, which was enacted to override the

Bolar decision, companies making generic drugs should be free to use preexisting clinical testing data to facilitate the approval process of generic products. However, most U.S.-concerned FTAs including KORUS FTA explicitly reject this possibility. It is a dumbed-down version of the Hatch-Waxman Act although it still preserves those provisions in the act that serve the interests of brand-name companies, such as the automatic stay of a generic approval process upon the launch of patent infringement suits by those companies (Weiss et al. 2004).

Another WTO-plus feature frequently seen in the recent bilateral trade deals with the United States is the investor-state dispute settlement mechanism (ISD), which has been patterned after Chapter 11 of the North American Free Trade Agreement (NAFTA). Some critics argue that this mechanism tends to overprotect the interests of multinational (U.S.) investors at the expense of the regulatory sovereignty of the host country (Korea) (Cho J. 2007). On the one hand, this fear is rather exaggerated because this legal regime has been around for quite a long time under the International Center for Settlement of Investment Disputes (ICSID) regime and many bilateral investment treaties (Haigh 2000, 129–30). Nonetheless, there does exist a risk that the host country's legitimate regulatory policies may be strained by abusive and overstretched claims made by powerful investors armed with great resources, now that this regime has been incorporated in a free trade agreement and thus gained a new dimension of salience. NAFTA's own experiences offer cases in point.

In an earlier NAFTA Chapter 11 case (*Pope and Talbot*), an arbitral tribunal ruled against a host country (Canada), as it took a broad view on the "full protection and security" of investors under NAFTA Chapter 11. It found that a mere rejection by Canada of the claimant's request to move the site of verification would violate the minimum international standard of "fair and equitable treatment" under Article 1105 (Arbitral Tribunal 2001, paras. 171, 172, 181). The Free Trade Commission (FTC), NAFTA's supreme decision-making organ, later had to override this decision by rendering an official interpretation that the minimum standard under Article 1105 should follow customary international law that recognizes breaches of this minimum standard only in egregious types of wrongful acts committed by the host government (FTC 2001).

In another case (*Azinian*), an unsuccessful investor attempted to take advantage of this mechanism by arguing that the annulment of its contract by the Mexican court was an "expropriation" under Article 1110. Although the tribunal blatantly rejected the claim in this case as it implied that the contract was nearly fraudulent (ICSID 1999, paras. 30, 31, 124), the ISD is inherently vulnerable to this type of exploitive suit by investors who may aim to recoup their failed investments through any settlement with the host country. Korea as a host country should be alarmed and prepared for this experimental legal atmosphere, which the incorporation of ISD in the FTA may create.

A Political Perspective: New Regionalism in East Asia and Its Discontents

The Past: Weak regionalism. East Asia is traditionally known to have very few RTAs. Except for the Association of Southeast Asian Nations (ASEAN), no salient RTA existed in this region until very recently. This institutional deficiency is attributable to a number of factors, mostly historical and political. First, after the Western imperialist powers marched into East Asia armed with superior technology provided by the Industrial Revolution, the region was transformed into a forum for power struggles and marred by various wars, large and small, and hot and cold. The accumulation of colonial experiences, deep-rooted resentment from numerous wars, and existence of diverse cultures arising from different ethnicities and languages testify to the scarcity of formal arrangements in this region (Evans 2000, 451–58). Thus, as Robert Scalapino (1988, 178) observed earlier, an “Asianization” process has not yet been fulfilled.³

Another important aspect that should be factored into an explanation of the weak regionalism is a close bilateral economic partnership between the United States and East Asian countries. As a main architect of the postwar international economic order and a champion of Western capitalism during the Cold War, the United States was steadfastly committed to East Asian countries. The United States provided major export markets for Japan and the newly industrializing economies (NIEs). It even bent trade rules for these countries, as was seen in the Generalized System of Preferences. The economic reliance of major East Asian countries on the United States may have obviated any need to form a regional bloc among East Asian countries.

Markedly, the lack of formal regional institutions has led East Asian countries to integrate themselves into the global market more vigorously. A weak trade regionalism has been funneled into a strong commitment to the multilateral trading system such as the old GATT 1947 and the WTO (Lawrence 1996). The NIEs, for example, Singapore, Korea, Hong Kong, and Taiwan, could prosper by adopting an outward-looking, export-oriented development strategy, in stark contrast with the inward-looking, import-substitution strategies adopted by Latin American countries during the “First Regionalism” of the 1960s (Bhagwati 1991).

The Present: New regionalism. In stark contrast with the past, heads of East Asian economies have recently been busy announcing ambitious blueprints for bilateral or subregional trade agreements. Some of these agreements have been negotiated seriously and have already borne fruit.⁴ Even Japan and Korea, which used to be

3. Scalapino defines “Asianization” as a “widening and deepening network of ties between and among Asian states of diverse political and cultural nature.”

4. For an overview of the current developments on RTAs and FTAs in East Asia and the Asia Pacific, see “Free Trade Agreements and Regional Trade Agreements” on the APEC Web site: www.apec.org/apec/apec_groups/other_apec_groups/FTA_RT.html.

known as “Friends of GATT Article I (MFN)” (Scollay and Gilbert 2001, 4), departed from their long-standing tradition of having no RTAs; Japan signed an FTA with Singapore on 13 January 2002 (Jagan 2002) and Korea signed one with Chile on 15 February 2003 (OAS 2003). Some describe the recent proliferation of RTAs in the region as a “domino effect” (Scollay 2004, 7).

ASEAN has also been active in creating subregional trade agreements with Northeast Asian trading partners (ASEAN + 3) as well as with Australia and New Zealand (ASEAN-AUS/NZ) and with China (ASEAN-China) (ICTSD 2004a). These moves may be translated as desperate efforts from within to revive the long-lost liberalization momentum in ASEAN; Secretary General Rodolfo Severino of ASEAN recently warned that ASEAN would be left behind without expeditious economic liberalization (Reyes 2000). After it proved incapable of addressing the financial crisis, ASEAN seems “sadly dated, often emasculated and out of touch with the times” (Reyes 2000). Perhaps this sorry status quo is an inevitable flaw of the “First Regionalism” that prioritized political values over economic ones, as Jagdish Bhagwati (1991, note 40) has observed. In this context, ASEAN might want to find “dying ASEAN’s new lifeline” in a new subregional trade regionalism such as ASEAN + 3 (Reyes 2000, note 47). ASEAN also announced that it would form a free trade area with Australia and New Zealand within a decade, aiming to double trade and investment between the two regions by 2010 (AFP 2004). Moreover, ASEAN will establish an FTA with China within the next decade, aiming to become the largest free trade area in the world (Choi 2003, 50–51).

New regionalism in East Asia may be analyzed in the context of two remarkable recent developments: the ascent of China and the departure of the United States from the multilateral trading system (Robertson 2002). China has transformed its economy from an old Cold War hermit to a new globalizer. Ever since it adopted its new open-door policy in the late 1970s, it has dramatically integrated its ever-expanding economy to the mainstream of the global market system and eventually was admitted to the WTO (Abbott 1998, 4). For the past decade, China’s increasing presence in East Asia and in the world and its growing prowess as a trading powerhouse have been nothing short of phenomenal. Its size and volume, both as an exporter and an importer in the region, are unsurpassed. China’s rise has been both welcomed and feared by neighboring East Asian countries—depending on the perspectives those countries hold. Some worry about China’s dominance in the region while others want to gain preferential access to China’s huge market ahead of others, utilizing the first-mover advantage. These various calculations and motivations lead different countries to choose different partners in their commitments to RTAs.

Also, in the posthegemonic era the United States has continuously adopted protectionist-cum-unilateralist trade policies that have negatively affected East Asian countries on

many occasions. Furthermore, the recent aggressive U.S. bilateral-regional drive worldwide tends to put East Asian trading partners in a defensive position. These countries are left few other options but to follow suit—without considering the long-term costs and benefits—to merely avoid getting left behind. This “reactionary regionalism” (Beeson 2003, note 5)⁵ among East Asian trading nations is reminiscent of a futile proposal in the early 1990s by Prime Minister Mahatir Mohamad of Malaysia to create an East Asia Economic Grouping or an East Asia Economic Caucus (Cho S. 2004, 17).⁶

The Future: A Clash of Titans?

It is likely that China will emerge as an economic hegemon in the East Asia region. China and ASEAN members will form the world’s biggest free trade area by 2015. This plan has become more feasible and visible since these two parties signed a critical deal liberalizing key service sectors such as banking, health, real estate, education, and construction and thus created a single service market between China’s 1.2 billion and ASEAN’s 500 million people (Landingin and Burton 2007). A dense web of well-established Chinese business networks in this region⁷ as well as reactionary sentiments among East Asian economies against the recent U.S. regionalist penchants may also reinforce this possibility.

Interestingly, China’s rising hegemony in East Asia is silhouetted against the recent China bashing on the part of the United States. The George W. Bush administration has been diligently responding to the mounting anti-China sentiment in Congress over the record-high bilateral trade deficits as well as the frustration over the slow pace of revaluation of renminbi. Last year, the United States Trade Representative announced a comprehensive action plan to deal with China’s trade policies and hinted that it would use more aggressive options such as the WTO dispute settlement system (USTR 2006). Perhaps the Bush administration wanted to appease members of Congress and, more broadly, their constituencies by going tough on China.

When the Doha Round is dying, the United States will probably reinforce its bilateralist-regionalist trade policies in the East Asia region. The United States may also want to “put the brakes” on China’s recent ascent in the region through trade deals like KORUS

5. A similar phenomenon can be located in the creation of APEC in that it could be viewed as a reaction, or a warning, to emerging regional blocs such as the EU and NAFTA at that time (Cho S. 2004, 386–87).

6. See Tay (2004, 127) who posits that this reactionary regionalism would not undermine preexisting bilateral relations between individual countries in East Asia and the United States.

7. Peng (2002) describes the informal economic integration in East Asia based on ethnic Chinese business networks and subregional economic zones.

FTA (Park 2007). Yet such strategic moves will only be countered by China, together with other East Asian economies, in the name of defensive regionalism. As a result, a fragmented world trading system run by competing trading blocs may provide a recipe for economic balkanization, as proved to be the case during the interwar period. Economic balkanization tends to create a fertile ground for political tensions. Unfortunately, both nations have enough issues, ranging from China's increasing military spending to Taiwan, to make this speculation plausible.

III. KORUS FTA as a Building Block: Multilateralizing Trade Regionalism

Saving the Doha Round by Multilateralizing the KORUS FTA

Any rosy projection for this bilateral deal cannot but be eclipsed by concerns for the Doha Round, which is hanging by a thread. Undoubtedly, a major bilateral deal like the KORUS FTA is not only a serious distraction from but also a fatal blow to a multilateral trade negotiation. This deal, I am afraid, will send a strong signal to the WTO members: Multilateralism is now being replaced by bilateralism. We are now changing the syntax and grammar of trade negotiations.

This would be a big mistake. Just recollect why we created the General Agreement on Tariffs and Trade (GATT), the WTO's predecessor, 60 years ago right after the end of World War II. In the interwar period, trading nations severely fragmented the global market through a web of bilateral deals, costing the world a 70 percent decrease of trade volume. The evils of bilateralism or regionalism did not remain economic. They brewed tensions and hostilities among different trading blocs which eventually escalated into the tragic war. The framers of GATT witnessed all this and thus created the GATT to avoid it. History will repeat itself if we refuse to learn a lesson from it.

Korea and the United States can certainly remedy the current situation. They can jump-start the currently comatose Doha Round talks by multilateralizing their bilateral market opening commitments to other members of the WTO on the condition that major members, such as the European Union (EU), Brazil, and India, match this offer by making good faith, substantial liberalization concessions on their own. The EU can persuade its farmers into tolerating a bigger market opening, such as larger tariff cuts on farm imports, by drawing their attention to yet another big export market, Korea, boasting a population of 48 million. Both Brazil and India can also substantially reduce their industrial tariffs in exchange for enhanced market access to the United States and Korea, whose tariffs on most manufacturing products will be eliminated in just three years.

Importantly, the United States and Korea will also benefit much from this multilateralization process, which is likely to successfully complete the Doha Round. First, these two advanced economies have no reasons at all to defy more and bigger export markets. Obviously, 150 markets are better than just two markets to both the United States and Korea. A truly global market—which only the WTO can offer—is unconditionally and immediately superior to any bilateral or regional market to them. Some U.S. law firms may want to have a pan-Asia legal service network by branching not only to Seoul but also to Tokyo and Taipei. Korea may want to see U.S. cars compete with Honda and Volvo in its domestic market in order for Korean customers to enjoy cheaper yet better products.

Second, by drawing a global trade map, these two countries can truly open their economies to global competition and thus make them economically healthier and more efficient. Bilateral deals, such as the KORUS FTA, are inevitably prone to specific carve-outs (exemptions) and other restrictions (for example, rules of origin) owing to more-targeted lobbies than in the global trade deal. The outcome is the so-called spaghetti-bowl effect. Both U.S. and Korean businesspeople will increasingly be experiencing an eye-popping, head-spinning web of heterogeneous trade regulations in their international transactions.

Complicated rules are themselves a kind of trade barrier, and in this sense any bilateral deal is creating, not only reducing, trade barriers. Big companies may survive these labyrinthine legal and administrative burdens, but small players cannot. Therefore, bilateral deals tend to cartelize the economies of the participants, eviscerating the vitality of their markets. This problem can be addressed by a global trade deal under the WTO, which can offer a defragmented market with unified trade rules. Only then will even small players in both countries be able to find their ways to global niches.

Finally, but not least, a global deal tends to dispense with bilateral deals. Those hefty resources dedicated to numerous bilateral deals can be saved by striking a more focused global trade deal.

It is conceded that multilateralization of the sort proposed here may be politically challenging, or politically incorrect, for both the United States and Korea. Unfortunately, both governments may have already exhausted political capital necessary for any trade deals. The public may perceive, albeit incorrectly, that costs are larger in a global deal than in bilateral deals because of the fact of more trading partners. This is why we need genuine political leadership in both countries. It happens that incumbent presidents in both the United States and Korea cannot stand for reelection. Thus, they may be better positioned in exercising such leadership. If they can help salvage the Doha Round by multilateralizing the KORUS FTA, they will certainly be rewarded by a legacy that they deserve.

APEC as a Multilateralizer

APEC's strong commitments to the multilateral trading system have been its defining trait. APEC has remained complementary to the WTO and has not tried to supplant it. When the success of the Uruguay Round negotiations and the creation of the WTO were in doubt, APEC vigorously sent a message to the audience that swayed opinion in favor of the creation of the WTO (Cho S. 2004, 413–14).

APEC, in stark contrast with an inward-looking, discriminatory regional bloc, has resulted in trade and investment liberalization whose benefits are meant to be shared by both members and nonmembers, based on the principle of open regionalism (APEC 1994b). In 1994, APEC announced its bold liberalization blueprint, called the “Bogor Declaration,” in which members committed themselves to achieve full-fledged trade and investment liberalization in the Asia Pacific region by 2020, and by 2010 for the developed countries (APEC 1994a). This ambitious trade and investment liberalization scheme certainly exceeds the current WTO level in terms of both scope and depth. This scheme has been made possible only by APEC's soft institutionalization, which is defined by its nonbinding nature and voluntarism.

These unique institutional features of APEC can facilitate the multilateralization of KORUS FTA. Both Korea and the United States can rehearse their multilateralization of bilateral market opening commitments in APEC before they eventually take them to the WTO level. One of China's vice ministers, Long Yongtu, once stated, “The WTO is like a lovely banquet, and APEC is the kitchen where the food is prepared” (Fried 1998, 186). This flexibility also tends to diffuse any political backlash against this unilateral liberalization initiative.

This multilateralization effort under APEC will also be aided by certain procedural requirements that APEC has recently established to better serve its mandate of open regionalism. Under APEC's new “reporting template,” APEC requires both Korea and the United States to share information on the KORUS FTA with other APEC members (APEC 2004). This reporting template is also geared toward open regionalism in that it requires both Korea and the United States to describe how the KORUS FTA complements their efforts in the WTO and when to notify the WTO of this bilateral trade agreement (APEC 2004).

IV. Implementing KORUS FTA: Challenges Ahead

Policy Challenges: Beefing Up Regulatory Capacity

The FTA with the United States will inevitably bring Korea new regulatory challenges. For example, Korea will have to formulate new and more effective competition policies

to check any anticompetitive behaviors by dominant U.S. companies. In financial services, the Korean government also has to come up with various prudential regulations to prevent any exploitive measures taken by big U.S. financial institutions, which may be eager to take advantage of loopholes in the current Korean financial regulations.

In responding to these new regulatory demands, the Korean government should actively co-opt various regulatory benchmarks or best practices endorsed and recommended by international organizations such as the Organization for Economic Cooperation and Development (OECD). This regulatory co-optation will bring the Korean government three concrete benefits in the regulatory area. First, it will ensure that regulatory challenges that Korea is facing are addressed in an effective way. As a club of the world's most advanced economies, the OECD holds an enormous repository of members' best practices in various regulatory areas, ranging from tax to anticompetition.⁸ Studying and consulting these regulatory standards will enable the Korean regulators to formulate the best policy options in light of its regulatory context.

Second, by tapping into global regulatory standards, the Korean government will face lesser regulatory resistance and fewer negative trade consequences from foreign exporters and service providers. Nowadays, economic interdependence has increasingly turned hitherto purely domestic regulatory issues into potential nontrade barriers. Harmonization through these global standards will prevent these adverse consequences. Third, regulatory co-optation is a different name for regulatory cooperation. Networking among regulators from different jurisdictions under the auspices of international organizations, such as the OECD and the APEC, itself constitutes an invaluable public good from a global standpoint. This transgovernmental regulatory network tends to address many cross-border, collective problems before they evolve into full-blown disputes (Slaughter 2000, 178). Human connections, especially among working-level officials, can disarm unnecessary confrontations between different jurisdictions.

In sum, the Korean government should map out comprehensive market opening-cum-regulatory reform policies as it has initiated trade liberalization such as the KORUS FTA. This comprehensive strategy is beyond *ex post* stopgaps or any other symptomatic responses: it denotes an *ex ante*, long-term, systematic blueprint taking into account different areas of policies such as (re-)distribution and social regulations. Except for these essential, prudential regulations, the Korean government should boldly deregulate to facilitate structural reforms of domestic players facing ever-intensifying liberalization.

8. Topics are listed on an OECD Web page: www.oecd.org/maintopic/0,2626,en_2649_201185_1_1_1_1_1,00.html.

Political Challenges: Democratizing Trade Liberalization

Any economic policy, including trade liberalization, cannot satisfy every person affected by the policy, even though it aims to create in general positive changes from the status quo. It is an inevitable outcome as long as what the policy pursues is not an idealistic Pareto optimality but a more modest Kaldor-Hicks efficiency. Yet, in a democracy, those who are negatively affected by trade liberalization, even though they are a minority, are entitled to fight against this generally beneficial policy. Election and free speech tend to provide these minorities with powerful tools to advocate their own interests. Certain manufacturers might lobby against liberalizing trade in competitive products for the fear of losing domestic market share to new cheap imports. Certain groups of farmers might also oppose the cheap grains and fruits brought in via market opening.

As a result, any economic policy tends to create social conflicts within the society to varying extents. In an insightful observation, Robert Scalapino (1988, 177) located paradoxes in the contemporary international economic dynamics: Greater interdependence and market integration lead to increased nationalistic and protectionist private lobbies that invoke the name of democracy. Managing and resolving these conflicts are critical prerequisites to a successful economic policy. An FTA is not an exception to this rule.

Critically, the conflict resolution between those who are negatively affected by market opening and those who benefit from it may not be feasible if it is based on any substantive rationality of the policy. When calculating costs and benefits of market opening, different interest groups are organized around different assumptions, discount rates, and considerations. If noneconomic aspects such as security (for example, solidification of foreign relations via enhanced trade relations) and sociopolitical issues (for example, social unrest caused by massive unemployment or sudden industrial restructuring) are factored into this calculation, it is likely that each group (proponents and opponents) will reinforce its original positions that have already been polarized. Furthermore, various cognitive errors, such as the status quo bias, social cascades, and availability heuristics, tend to aggrandize the cost of trade liberalization vis-à-vis its potential benefit (Kemp 2007). In sum, the conflict resolution in this area might not come from the substantive rationality of the policy (trade liberalization) itself.

Therefore, conflict resolution or conflict management commissioned by trade liberalization should locate its foundation in procedural virtues, such as deliberation. Vibrant communications and feedback among policymakers and various interest groups can “bridge” diverging social capital originating from sector-specific pressure groups and construct a broader identity or social consensus based on “generalized reciprocity” (Putnam 2000, 22, 22–24, 134, 363). In this sense, the Korean government has achieved

a limited success in building a domestic coalition with certain societal actors, such as farmers and labor unions (Putnam 1988). Ironically, the current administration has failed to garner political support from these societal actors who have been relatively loyal to it.

To facilitate the bridging of social capital, the formulation of trade policies needs to be changed from the current esoteric, top-down approach to an open, bottom-up approach that fully represents the general welfare of citizens and the domestic economy in its entirety. This bottom-up approach can be implemented by a wide range of public participation in various forms such as public hearings, town meetings, seminars, public debates, and polls. This procedural democratic virtue can avoid vices of representative democracy in trade policymaking, such as capture, and enlighten the public on costs of protectionism. As renowned economist Anne Krueger has observed, "If citizens could easily identify and directly vote on the magnitudes of gains and losses from protection," trade policies would be different from what they are now (Krueger 1995, 3).

V. Conclusion

Now that the KORUS FTA has become a *fait accompli*, it should be ratified and implemented in due course. Any failure or undue delay of ratification will cause grave political and reputational costs to both governments. Yet the KORUS FTA should be a stepping-stone to further liberalization, not a final destination. In implementing it, both governments should endeavor to multilateralize their market-opening commitments on the basis of the spirit of open regionalism. APEC can be instrumental to this multilateralization.

In addition, future trade policies in major trading nations, such as the United States and Korea, should be shifted from a regionalist dogma to the fundamental cause of trade liberalization itself. Although the new regionalism in East Asia is politically tempting for various reasons discussed above, political appeal should not outshine the practical demerits embedded in trade regionalism.

Nor should regressive regional isolationism, which insulates East Asia from North America, be contemplated: It would be disastrous not only for economic but also for geopolitical reasons. Major trading nations in East Asia, such as Korea, China, and Japan, should play a more constructive role in the multilateral arena, such as APEC and WTO, rather than indulge themselves in bilateralism or regionalism.

In conclusion, we should manage and contain FTAs rather than promote them. Under certain circumstances, they may be a catalyst for trade liberalization. Nonetheless, they cannot and should not become ends in themselves.

REFERENCES

- Abbott, Frederick M. 1998. Reflection Paper on China in the World Trading System: Defining the Principles of Engagement. In *China in the World Trading System: Defining the Principles of Engagement*, ed. Frederick M. Abbott. Boston: Kluwer Law International.
- AFP (Agence France-Presse). 2004. Leaders of ASEAN, Australia, New Zealand Agree to Free-Trade Talks. www.aseansec.org/afp/90.htm.
- APEC (Asia-Pacific Economic Cooperation). 1994a. APEC Economic Leaders' Declaration of Common Resolve, Bogor, Indonesia, 15 November 1994, www.apecsec.org.sg/apec/leaders__declarations/1994.html.
- . 1994b. Sixth APEC Ministerial Meeting, Jakarta, Indonesia, 11–12 November 1994, Joint Statement. www.apecsec.org.sg/content/apec/ministerial__statements/annual_ministerial/1994_6th_apec_ministerial.html.
- . 2004. APEC Ministers Agree to Strengthen the Contribution of RTAs/FTAs to Achieving APEC's Goals. Media Release. 19 November. www.apec.org/apec/news__media/2004_media_releases/191104_strgthnrtaftacontribapegoals.html.
- Arbitral Tribunal. 2001. In the Matter of an Arbitration under Chapter 11 of the North American Agreement between Pope & Talbot Inc. and the Government of Canada, Award on the Merits Phase Two. 10 April. www.international.gc.ca/tna-nac/documents/Award_Merits-e.pdf.
- Aritake, Toshio. 2007. Proposed APEC FTA Still Drawing Limited Support from Key Nations. *International Trade Reporter* 24, no. 12 (22 March): 421.
- BBC (British Broadcasting Corporation). 2004. France Raps 'US Aids Blackmail,' BBC News, 13 July. <http://news.bbc.co.uk/2/hi/health/3891385.stm>.
- Beeson, Mark. 2003. "ASEAN plus Three and the Rise of Reactionary Regionalism." Working paper, University of Queensland, Brisbane, Australia. <http://eprint.uq.edu.au/archive/00000496/01/mbasean03.pdf>.
- Bergsten, Fred. 2002. "A Competitive Approach to Free Trade." *Financial Times*, 5 December.
- Bhagwati, Jagdish. 1991. *The World Trading System at Risk*. Princeton: Princeton University Press.
- . 1998. *A Stream of Windows: Unsettling Reflections on Trade, Immigration and Democracy*. Cambridge: MIT Press.
- Cho Jin-seo. 2007. Poisonous Clauses Cast Dark Cloud Over FTA. *Korea Times*, 4 April.
- Cho, Sungjoon. 2001. Breaking the Barrier between Regionalism and Multilateralism: A New Perspective on Trade Regionalism. *Harvard International Law Journal* 42:419.

- . 2004. Rethinking APEC: A New Experiment for a Post-Modern Institutional Arrangement. In *New Perspectives on the World Trading System: WTO and East Asia*, ed. Mitsuo Matushita and Dukgeun Ahn. London: Cameron May.
- . 2006a. Defragmenting World Trade. *Northwestern Journal of International Law and Business* 27:39.
- . 2006b. “‘Plan B’ Is Always Inferior to ‘Plan A.’” *Financial Times*, 22 August.
- Choi Won-mok. 2003. “Regional Economic Integration in East Asia: Prospect and Jurisprudence.” *Journal of International Economic Law* 6:49.
- Drahos, Peter. 2004. Securing the Future of Intellectual Property: Intellectual Property Owners and Their Nodally Coordinated Enforcement Pyramid. *Case Western Reserve Journal of International Law* 36:53.
- Evans, Paul M. 2000. Regional Institutions, Regional Identities. In *Eastern Asia: An Introductory History*. 3rd. ed. Melbourne: Longman Cheshire.
- Frankel, Jeffrey A. 1997. *Regional Trading Blocs in the World Economic System*. With Ernesto Stein and Shang-jin Wei. Washington, D.C.: Institute for International Economics.
- Frankel, Susy. 2006. WTO Application of “the Customary Rules of Interpretation of Public International Law” to Intellectual Property. *Virginia Journal of International Law* 46:365.
- Fried, Jonathan T. 1998. APEC as the Asia-Pacific Model for Regional Economic Cooperation. In *China in the World Trading System: Defining the Principles of Engagement*, ed. Frederick M. Abbott. Boston: Kluwer Law International.
- FTC (Free Trade Commission). 2001. Notes of Interpretation of Certain Chapter 11 Provisions. 31 July. www.state.gov/documents/organization/38790.pdf.
- Garrison, Christopher. 2006. *Exceptions to Patent Rights in Developing Countries*. Geneva: ICTSD; Geneva: UNCTAD.
- GATT (General Agreement on Tariffs and Trade). 1947. Article XXIV: Territorial Application—Frontier Traffic—Customs Union and Free-trade Areas. 30 October. www.wto.org/english/docs_e/legal_e/gatt47_02_e.htm
- Haigh, David R. 2000. The Management and Resolution of Cross Border Disputes as Canada/ U.S. Enter the 21st Century: Chapter 11—Private Party vs. Governments, Investor-State Dispute Settlement: Frankenstein or Safety Valve? *Canada-United States Law Journal* 26:115.
- Hilaire, Alvin, and Yongzheng Yang. 2004. The United States and the New Regionalism/Bilateralism. *Journal of World Trade* 38:603–26.

- ICSID (International Centre for Settlement of Investment Disputes). 1999. Between Robert Azinian et al., Claimants, and the United Mexican States, Respondent. Case no. ARB(AF)/97/2. 1 November. www.worldbank.org/icsid/cases/robert_award.pdf.
- ICTSD (International Centre for Trade and Sustainable Development). 2004a. ASEAN Looks to Deepen Integration, Forge New Trade Ties. *BRIDGES Weekly Trade News Digest* 8, no. 29 (8 September).
- . 2004b. Concerns Raised over Access to Medicines under Trade Treaties. *BRIDGES Weekly Trade News Digest* 8, no. 25 (14 July).
- Jagan, Larry. 2002. Japan Opens Its Markets. BBC News, 14 January. <http://news.bbc.co.uk/1/hi/business/1759915.stm>.
- Kemp, Simon. 2007. Psychology and Opposition to Free Trade. *World Trade Review* 6:25.
- Krueger, Anne O. 1995. *American Trade Policy: A Tragedy in the Making*. Washington, D.C.: AEI Press.
- Landingin, Roel, and John Burton. 2007. China in Key Deal with ASEAN on Service. *Financial Times*, 14 January.
- Lawrence, Robert Z. 1996. *Regionalism, Multilateralism, and Deeper Integration*. Washington, D.C.: Brookings Institution.
- OAS (Organization of American States). 2003. Chile-Korea Free Trade Agreement. OAS, SICE. 15 February. www.sice.oas.org/Trade/Chi-SKorea_e/ChiKoreaind_e.asp.
- Park Yoon-bae. 2007. FTA to Redraw Economic Map in Asia. *Korea Times*, 8 April.
- Peng Dajin. 2002. Invisible Linkages: A Regional Perspective of East Asian Political Economy. *International Studies Quarterly* 46:423.
- Putnam, Robert D. 1988. Diplomacy and Domestic Politics: The Logic of Two-Level Games. *International Organization* 42:427.
- . 2000. *Bowling Alone: The Collapse and Revival of American Community*. New York: Simon & Schuster.
- Reyes, Alejandro. 2000. Southeast Asia Adrift. *Asiaweek*, 1 September. www.asiaweek.com/asiaweek/magazine/2000/0901/asean.sea.html.
- Robertson, Jeffrey. 2002. ASEAN Plus Three: Towards the World's Largest Free Trade Agreement? Research Note no. 19, 12 November. Parliament of Australia, Parliamentary Library. www.aph.gov.au/library/Pubs/RN/2002-03/03rn19.htm.
- Scalapino, Robert A. 1988. Regionalism in the Pacific: Prospects and Problems for the Pacific Basin. *Atlantic Community Quarterly* 26:174.
- Scollay, Robert, and John P. Gilbert. 2001. *New Regional Trading Arrangements in the Asia Pacific?* Washington, D.C.: Institute for International Economics.

- . 2004. "Preliminary Assessment of the Proposal for a Free Trade Area of the Asia-Pacific (FTAAP): An Issues Paper for the APEC Business Advisory Council (ABAC)." PECC Trade Forum. 10 November. www.apec.org.au/docs/koreapapers2/SX-RS-Paper.pdf.
- Slaughter, Anne-Marie. 2000. Governing the Global Economy through Government Networks. In *The Role of Law in International Politics: Essays in International Relations and International Law*, ed. Michael Byers. New York: Oxford University Press.
- Sutherland, Peter, et al. 2004. *The Future of the WTO: Addressing Institutional Challenges in the New Millennium*. Geneva: WTO. www.wto.org/english/thewto_e/10anniv_e/future_wto_e.pdf.
- Tay, Simon S. C. 2004. Asia and the United States after 9/11: Primacy and Partnership in the Pacific. *Fletcher Forum of World Affairs* 28:113. <http://fletcher.tufts.edu/forum/archives/pdfs/28-1pdfs/Tay.pdf>.
- USTR (United States Trade Representative). 2006. U.S.-China Trade Relations: Entering a New Phase of Greater Accountability and Enforcement. February. www.ustr.gov/assets/Document_Library/Reports_Publications/2006/asset_upload_file921_8938.pdf.
- Viner, Jacob. 1950. *The Customs Union Issue*. New York: Carnegie Endowment for International Peace.
- Weiss, Linda, et al. 2004. US Australia FTA: Bitter Pill for an Appendage State. On Line Opinion, 7 September, <http://www.onlineopinion.com.au/view.asp?article=2526>.
- WTO (World Trade Organization). 1994a. Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations. Geneva: WTO. 15 April. www.wto.org/English/docs_e/legal_e/03-fa.pdf.
- . 1994b. Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994. Geneva: WTO. www.wto.org/english/tratop_e/region_e/regatt_e.htm.

KORUS FTA Conference Cosponsored By:

The Korea Economic Institute
The Peterson Institute for International Economics

In Conjunction With:
The Korea-America Economic Association



May 1, 2007

Korea Economic Institute of America
1201 F Street NW, Suite 910, Washington D.C. 20004
Ph: 202.464.1982 Fx: 202.464.1987 www.keia.org

