Static and Dynamic Consequences of a KORUS FTA

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Conclusions and Implications for Further Research and Policy

[Excerpt from Economic Effects of a Korea-U.S. FTA]

* Kozo Kiyota and Robert M. Stern

We have noted that the United States and Korea have a variety of economic and political motivations in pursuing an FTA. In this connection, the present study has been designed to assess the economic effects involved in such an agreement. The Korea-U.S. FTA negotiations were initiated in May 2006 and are ongoing. It is hoped to conclude the negotiations and sign the agreement prior to the expiration of the president's negotiating authority in mid-2007.

The computational analysis presented has been based on the Michigan Model of World Production and Trade, which is a multicountry, multisector computable general equilibrium (CGE) model that has been used for more than three decades to provide estimates of the economic effects of multilateral, regional, and bilateral trade negotiations and other aspects of changes in trade policies of the United States and other major trading countries or regions. The version of the model used covers 27 economic sectors, including agriculture, manufactures, and services, in each of 30 countries or regions. The distinguishing feature of the Michigan Model is that it incorporates elements of the New Trade Theory, including increasing returns to scale, monopolistic competition, and product variety. The data for the model are based on version 6.0 of the GTAP database for 2001 together with data derived from other sources.

The United States uses a common framework covering the issues to be negotiated in each of its bilateral FTA negotiations. This framework, which is patterned after NAFTA, negotiated in 1992–93, has been updated and adapted for the new FTAs. The main negotiating issues in the FTAs cover bilateral removal of tariffs and other barriers to trade in agricultural products, manufactures, and services; rules of origin; intellectual property rights; worker rights; environmental standards; investment; government procurement; customs administration and trade facilitation; trade remedies; and dispute settlement procedures. The actual negotiations are adapted to reflect the particular conditions and interests of the United States and partner countries.

* Kozo Kiyota is Associate Professor of International Economics in the Faculty of Business Administration, Yokohama National University and Visiting Associate Professor in the Gerald R. Ford School of Public Policy, University of Michigan. Robert Stern is Professor of Economics and Public Policy (Emeritus) in the Department of Economics and Gerald R. Ford School of Public Policy, University of Michigan. We had occasion to review a number of previous studies that reviewed the important bilateral issues of concern to the two countries in the FTA negotiations and to assess the economic effects involved. The economic assessments in these studies were based on the GTAP modeling framework in which it is assumed that there is perfect competition, constant returns to scale, and that products are distinguished by country of production (Armington assumption). We had some reservations with the GTAP framework that related in particular to the use and interpretation of the Armington assumption and the handling of employment changes.

In using the Michigan Model, our focus has been on the effects of the bilateral removal of trade barriers, which lend themselves most readily to quantification. The nontrade aspects of the FTAs may also be important, but they are intrinsically more difficult to incorporate into a modeling framework. Although we have made some allowance for possible increases in FDI that may be induced over time as the consequence of the Korea-U.S. FTA, no allowance has been made for improvements in productivity that could result from the FTA. Because of the foregoing limitations, the computational results presented for the bilateral FTAs are therefore best interpreted as providing a lower bound for the potential benefits involved. Because these benefits are shown mostly to be rather small for Korea and the United States in both absolute and relative terms, the nontrade and other benefits of the Korea-U.S. FTA are unlikely to alter these results significantly.

Although the bilateral FTA removal of trade barriers would be phased in annually for some products and sectors, it is assumed for modeling purposes that all of the barriers are removed at the same time and entered as inputs into the model for the policy changes involved. The model is then solved computationally to represent the percent changes in the variables of interest and to calculate the absolute changes in employment by sector. Because full employment is assumed, the employment results presented indicate the shifts in sectoral employment that will occur with bilateral liberalization. Some sectors will have increases in employment, others will have decreases, and there is no change in employment overall.

The Korea-U.S. FTA is shown to increase Korea's economic welfare by \$9.28 billion (1.26 percent of GDP), with \$4.48 billion coming from the bilateral removal of manufactures barriers and \$5.46 billion from bilateral removal of the services barriers. U.S. economic welfare is increased by \$25.12 billion (0.14 percent of GDP), with \$7.27 billion coming from elimination of manufactures tariffs and \$19.20 billion from elimination of services barriers. Global economic welfare rises by \$41.04 billion. There is evidence of trade diversion for nonmember countries, but the welfare reductions are small. U.S. employment is increased in its agricultural sectors and food, beverages, and tobacco and is reduced in textiles and wearing apparel, metal products, transportation equipment, and services. But these employment changes are relatively

small in percentage terms based on the initial employment levels. Korea's employment increases are concentrated in rice, livestock, textiles, wearing apparel, leather and leather products, and transportation equipment. Its employment declines are noteworthy in a number of the other agricultural sectors, manufactures, and services. Some of the employment changes are fairly large in percentage terms and indicate that there may significant adjustment problems in the Korean labor market, depending on how rapidly the bilateral removal of the trade barriers would take place.

To provide some perspective on the results of the FTAs, the model was also used to calculate the effects of unilateral tariff removal by Korea and the United States. Unilateral free trade would result in much larger increases in economic welfare for Korea and the United States than the bilateral FTAs. Finally, the effects of global (multilateral) free trade were calculated and shown to be far greater for Korea and the United States compared with the bilateral FTAs. It is possible that there may be some significant benefits to Korea and the United States from the negotiation of the trade and nontrade aspects of the Korea-U.S. FTA that are not captured by the modeling framework. Nonetheless, the computational results of unilateral and multilateral trade liberalization suggest that much greater increases in economic welfare could be gained from more broadly based trade liberalization than from the bilateral Korea-U.S. FTA.

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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



