South Korea-U.S. Economic Relations

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Summary

South Korea is a major economic partner for the United States. In 2006, trade between the two countries surpassed $75 billion, making South Korea the United States' seventh-largest trading partner—ahead of France and Italy—and its seventh-largest export market. In 2006, the U.S. was Korea's third-largest trading partner, second-largest export market, and its second-largest supplier of foreign direct investment (FDI).

Bilateral economic relations have advanced to the point that the two sides in February 2006 announced their intention to negotiate a bilateral free trade agreement (FTA), which they hope to complete in 2007. If an agreement is reached, it would be the United States' largest FTA since the completion of the North American Free Trade Agreement. To go into effect, FTAs must be approved by Congress and the Korean National Assembly. The FTA negotiation and ratification processes are likely to politicize bilateral trade disputes and produce spillovers between the economic and strategic aspects of the relationship, particularly if there are dramatic developments in the crisis over North Korea's nuclear weapons program.

Increased U.S.-South Korean economic interaction has been accompanied by numerous disagreements over trade and economic policies. The intensity of the disputes has diminished considerably since the late 1980s and early 1990s, in part because South Korea has enacted a set of sweeping market-oriented reforms as a *quid pro quo* for receiving a $58 billion package from the International Monetary Fund (IMF) following the near collapse of the South Korean economy in 1997. In recent years, the United States and South Korea appear to have become more adept at managing their trade disputes, so that they tend to be less acrimonious than they were in the 1980s and 1990s. This is due in part to the quarterly, working-level bilateral trade meetings that have been held since early 2001. Strategic factors, including South Korea's increased economic integration with North Korea, have become issues on the bilateral U.S.-South Korea economic front. In the FTA talks, South Korean officials are attempting to secure preferential tariff treatment for goods made by South Korean firms in the Kaesong industrial zone, located inside North Korea. In 2003, China surpassed the United States as South Korea's largest trading partner. Many South Korean exports to China are believed to be intermediate goods that are incorporated into products sent to the United States.

This report summarizes the main issues in U.S.-South Korean economic relations, including South Korea's economic prospects and economic reforms, and major bilateral economic disputes. Details of the Korea-U.S. Free Trade Agreement (KORUS FTA) talks are left to CRS Report RL33435, *The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)*, by William Cooper and Mark Manyin.

This report will be updated periodically.

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The United States and South Korea (known formally as the Republic of Korea, or ROK) have been allies since the United States intervened on the Korean Peninsula in 1950 and fought to repel a North Korean takeover of South Korea. Over 33,000 U.S. troops were killed and over 100,000 were wounded during the three-year conflict. In 1954, a year after the parties to the conflict signed an armistice agreement, the United States and South Korea signed a Mutual Defense Treaty, which provides that if either party is attacked by a third country, the other party will act to meet the common danger. The United States maintains about 34,000 troops in the ROK to supplement the 650,000-strong South Korean armed forces.[1] In recent years, strategic differences between Washington and Seoul—particularly over the optimal policies toward North Korea—have caused some in the United States to question the benefits of the alliance.

Beginning in the 1960s, rapid economic growth in South Korea propelled it into the ranks of the world's largest industrialized countries. For over a decade, South Korea has been one of the United States' largest trading partners. Economic growth also has helped transform the ROK into a mid-level regional power that can influence U.S. policy in Northeast Asia, particularly the United States' approach toward North Korea.

South Korea at a Glance

Head of State: President Roh Moo-hyun

Population: 48.8 million

Size: slightly larger than Indiana

Arable Land: 19%

Life Expectancy: 77 years (U.S. = 78 yrs.)

Infant Mortality: 6.16 deaths/1,000 live births (U.S. = 6.43)

Fertility Rate: 1.27 children born/woman (U.S. = 2.09)

Literacy Rate: 98%

Ethnicity: 100% Korean

Nominal GDP: $769 billion (2006); world's 12th largest economy

GDP Per Capita (Purchasing Power Parity): $24,200 (2006)

Exports: $326 billion (2006)

Imports: $309 billion (2006)

Source: CIA, *The World Factbook*, February 18, 2007; trade figures are from the ROK Ministry of Commerce, Industry and Energy

Overview of U.S.-South Korean Economic Relations

Relative Economic Importance

Since 2000, South Korea has been the United States' seventh-largest trading partner, ahead of Western European countries like France and Italy. Trade flows in 2006 exceeded $75 billion, an all-time high for U.S.-Korea bilateral trade; South Korea was the United States' seventh largest export market and its seventh largest source of imports. (See **Table 1** and **Table 2**.) For some western states and U.S. sectors, the South Korean market is even more important. Major U.S. exports to South Korea include semiconductors, machinery (particularly semiconductor

[1] In October 2004, the U.S. and South Korea agreed to a phased withdrawal of 12,500 U.S. troops in South Korea, reducing U.S. in-country troop strength from 37,000 to about 24,000 by September 2008.

production machinery), aircraft, and agricultural products. South Korea is among United States' largest markets for agricultural products and beef. U.S. exports for 2006 registered an all-time high, over $30 billion, in part due to the weakening value of the U.S. dollar, which fell by over 5% against the Korean *won* in 2006. The export growth occurred despite the continued South Korean ban on U.S. beef shipments.

Table 1. Annual U.S.-South Korea Merchandise Trade

(Billions of U.S. Dollars)

Year	U.S. Exports	U.S. Imports	Trade balance	Total trade
1990	14.40	18.49	-4.09	32.89
1995	25.38	24.18	1.20	49.56
2000	26.30	39.83	-13.53	66.13
2003	22.52	36.93	-14.41	59.45
2004	24.99	45.06	-20.07	70.05
2005	26.21	43.15	-16.94	69.36
2006	30.79	44.71	-13.92	75.50
Major U.S. Export Items	Semiconductor circuits; aircraft & aircraft parts; chemical vapor deposition (cvd) equipment; corn			
Major U.S. Import Items	Cars & motor vehicle parts; cellular phones; semiconductor circuits and products; petroleum products			

Sources: 1990 & 1995 data from Global Trade Information Services. 2000-2006 data from U.S. International Trade Commission.

South Korea is far more dependent economically on the United States than the United States is on South Korea. In 2006, the United States was Korea's third-largest trading partner, second-largest export market, third-largest source of imports, and its second-largest supplier of foreign direct investment.

However, the United States' relative economic importance to South Korea is decreasing. In 2003, China for the first time displaced the United States from its perennial place as South Korea's number one trading partner. In 2005, Japan overtook the United States to become South Korea's second-largest trade partner.

Table 2. Asymmetrical Economic Interdependence (2005)

	Total Trade	Export Market	Source of Imports	Source of FDI
For U.S., ROK ranks	#7	#7	#7	#28 (2004)
For ROK, U.S. ranks	#3	#2	#3	#2

In 2003, China surpassed the U.S. as the ROK's largest trading partner. In 2005, Japan surpassed the U.S. to become the ROK's second-largest trading partner.

Diminishing Friction over Trade Disputes

The bilateral economic relationship has been accompanied by numerous disagreements over trade policies. The intensity of the disputes has diminished considerably since the late 1980s and early 1990s, in large measure because South Korea has enacted a set of sweeping market-oriented reforms as a *quid pro quo* for receiving a $58 billion package from the International Monetary Fund (IMF) following the near collapse of the South Korean economy in 1997. In particular, as a result of the reforms, South Korea has opened its doors to foreign investors, ushering in billions of dollars of foreign portfolio and foreign direct investment (FDI). The result is that foreign companies, including U.S. firms, now are significant shareholders in many prominent industrial conglomerates (*chaebol*), own an estimated 40% of the value of the shares traded on South Korea's stock exchange, and at one point owned about one-third of the Korean banking industry. After his election to one five-year term in 2002, South Korean President Roh Moo-hyun said that more extensive reforms were needed to help accomplish his goals of raising per capita gross domestic product (GDP) to $20,000 and of transforming South Korea into a major economic hub in Northeast Asia. In essence, for nearly a decade, most U.S. trade-related complaints are echoed by voices within the South Korean establishment.

The United States and South Korea appear to have become more adept at managing their trade disputes, so that they tend to be less acrimonious than they were in the 1980s and 1990s. This may be partly due to the quarterly, working-level "trade action agenda" trade meetings that were initiated in early 2001. Both sides credit the meetings, which appear to be unique to the U.S.-South Korean trade relationship, with creating a more constructive dialogue by serving as "action-forcing" events.

The KORUS FTA Negotiations[2]

U.S.-ROK economic relations advanced to the point that the two sides on February 2, 2006, announced their intent to launch negotiations to form a bilateral free trade agreement (FTA). South Korea and the United States have completed six rounds of negotiations and were, as of February 12, in the midst of the seventh round, which began in Washington on February 11 and was scheduled to end on February 14, 2007. The two sides have reported progress in some areas such as industrial tariffs, customs administration, anti-corruption measures, and foreign investment, but sharp differences remain over trade in autos, pharmaceuticals, and agricultural products and over antidumping procedures. Both sides are still aiming to complete the negotiation before the end of March to comply with TPA deadlines.

[2] For more on the FTA, see CRS Report RL33435, *The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)*, by William Cooper and Mark Manyin.

If an agreement is reached, it would be the United States' largest FTA since the North American Free Trade Agreement (NAFTA). To go into effect, FTAs must be approved by Congress. The U.S.-South Korea FTA (KORUS FTA) negotiations are being conducted under the trade promotion authority (TPA) that the Congress granted to the President under the Bipartisan Trade Promotion Act (TPA) of 2002 (P.L. 107-210). The President's TPA is scheduled to expire on July 1, 2007; that is, an agreement must be signed before July 1, 2007, if it is to receive expedited congressional consideration under that authority. In addition, the TPA requires a 90-day presidential notification to Congress of *intent* to sign the agreement; therefore, the KORUS FTA would have to be completed before April 2, 2007.[3]

The decision to launch the FTA is regarded by some as a high-risk, high reward move by both governments. The economic side of the U.S.-ROK relationship has been a source of strength and stability in recent years, even as the diplomatic and military sides have been frayed by differences between Seoul and Washington over how best to deal with North Korea and how to adapt the U.S. troop presence in Korea. The launch of the FTA talks has brought to the surface a number of long-standing, deep-seated differences in trade and investment relations that remained below the surface for years. If South Korean and U.S. negotiators can successfully address them, the relationship would strengthen. If not, and the negotiations fail, the bilateral relationship could be seriously harmed for some time as failure may be a sign of the lack of trust.

South Korea's Economy

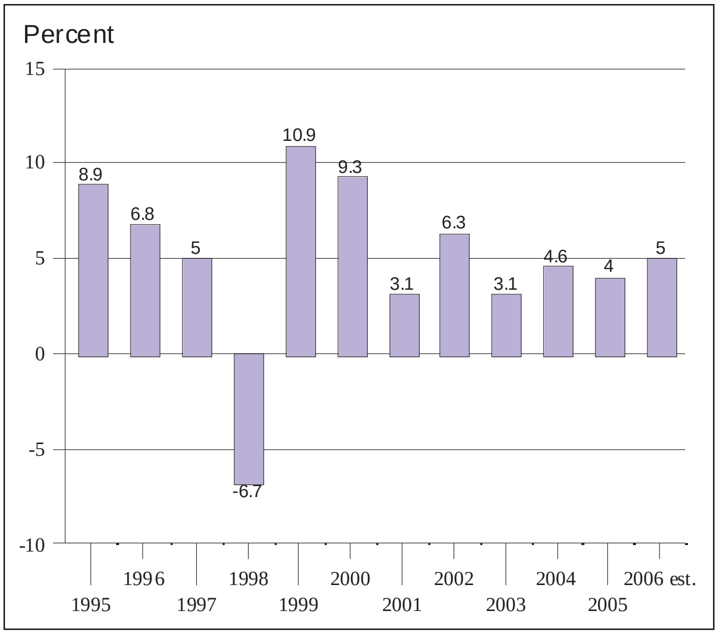
The 1997 Financial Crisis and IMF-Directed Reforms

South Korea's 1997 financial crisis was a seminal event in the country's history. During the autumn of 1997—spurred in part by the bankruptcy of six of the country's top thirty industrial conglomerates (*chaebol*) and a sharp increase in repayments required on short-term foreign debt—investors lost confidence in the economy and capital fled the country. The Korean *won* lost half its value in the space of a few days, tumbling from 900 to 1900 *won* to the dollar. In a futile attempt to prop up the currency, the government's foreign currency reserves dropped to $4 billion, an amount insufficient to carry the country through another day. In December 1997, barely a year after joining the Organization for Economic Cooperation and Development (OECD), Seoul turned to the IMF for economic assistance. At virtually the same time, South Koreans elected longtime democracy activist Kim Dae Jung to the presidency, the first time since the early 1960s that an opposition leader had won the country's highest office.

After negotiating for weeks over the details, on December 4, 1997, South Korea and the IMF agreed to a $58 billion support package. In return, Seoul agreed to tighten its fiscal and monetary policies and engage in far-reaching, market-oriented reforms of its financial and corporate sectors and of its labor market policies. South Korea also agreed to open its economy further to foreign goods and investors. The newly-elected Kim government adopted most of the structural reforms as its own.

[3] Because the agreement would have to be translated and legally "scrubbed" before given April 2, 2007, the negotiations would probably have to be completed as much as a month before then.

Figure 1. ROK Real GDP Growth, 1995-2005



Source: Bank of Korea.

Following the financial crisis, South Korea entered into a severe recession. In 1998, gross domestic product (GDP) contracted by 6.7% and unemployment nearly quadrupled, rising to 7.6% in 1998. The slowdown generated substantial anti-IMF and anti-American sentiment among many South Koreans.

Economic Events from 1999-2006

The economy rebounded in 1999 and 2000, growing by over 10% and 9%, respectively, and enabling the South Korean government to rapidly retire many of the debts it incurred in 1997.[4] In 2001, however, growth slowed considerably, dragged down by a combination of internal and external developments, including a decline in consumer and business confidence, the bursting of Korea's stock market bubble, rising oil prices, and a sharp falloff in exports to the United States and Japan, which entered economic downturns of their own. The government responded by lowering interest rates, unveiling an economic stimulus package, and easing the rules on the use of credit cards. These measures boosted consumer spending, which helped to double the growth rate from 3.1% in 2001 to 6.3% in 2002. Growth also was boosted by rapid economic integration with China. Domestic investment, however, remained low.

In 2003, overuse of personal credit cards led to the near-collapse of many financial firms and a sharp slowdown in economic growth, which fell back to 3.1%. Until the late 1990s, the consumer sector of the economy had been largely untapped, with Korean lenders focusing on the corporate sector. Thus, when the government liberalized financial regulations and forced Korea's giant conglomerates to curtail their borrowing in the aftermath of the 1997 crisis, banks and other financial institutions turned to consumers—at times recklessly—as a new source of profit. The

[4] In August 2001, Seoul paid off the last of the $19.5 billion it had borrowed from the IMF.

number of credit card holders behind in their payments increased sharply, with an estimated 8% of the population in default in March 2004.[5] In 2003 and 2004, all eight of Korea's specialized credit-card issuers registered massive losses that collectively were more than double their assets. In most cases, insolvency was avoided only through bailouts and takeovers by affiliated members of the companies' respective *chaebol* groupings. Most of these moves appear to have been engineered, regulatorally enabled, and/or encouraged by the government, which feared a collapse of the financial system if the firms were allowed to fail. The government responded to the household debt crisis by tightening restrictions on credit card use and issuance, and by initiating a refinancing and forgiveness program for individual debtors.

For 2004, South Korea's economy grew by 4.6%, below the 6% growth rate the government had expected.[6] Much of the growth was driven by a surge in exports—particularly to China—which rose by over 30% from 2003. A sharp rise in oil prices (South Korea imports all of its oil) and lackluster domestic demand contributed to the slower-than-expected growth rate.

In 2005, economic growth slowed to around 4%, due in part to a slowdown in export growth early in the year. The government responded by unveiling a $6.5 billion fiscal stimulus policy. Beginning in the late spring, South Korean domestic production and demand began to increase, indicating an improvement in the credit card problem; despite rising energy prices, private spending rose by 3.2% in 2005, compared to a 0.5% contraction the year before. Toward the end of the year, the South Korean stock market and the *won* sharply appreciated in value, the latter against both the U.S. dollar and the Japanese *yen*. Despite this trend, South Korean exports continued to rise, albeit at a slower rate; exports rose by just over 12% in 2005, compared with a 31% growth rate in 2004. South Korea's merchandise trade surplus in 2005 was about $23 billion.[7]

In 2006, South Korea's economic growth increased to an estimated 5%. Significantly, the rebound appeared to be more balanced than in previous years, when rising exports had been the primary driver of South Korea's economic growth; for most of 2006, private consumption continued its upward trajectory, though its rate of growth dipped in the final months of the year. While exports were up, rising energy imports caused the merchandise trade surplus to decline considerably. South Korea's soaring housing prices—particularly in the greater Seoul area, where around 40% of the population lives—became a dominant political issue in 2006, exacerbating concerns about increasing economic inequality. The issue is likely to figure prominently in the run-up to the December 2007 presidential election. The government has taken a number of steps designed to rein in real estate speculation, leading some to fear that more government action could cause the housing sector to experience a hard landing in 2007.

[5] Hye-Seung Seo, "South Korea Unveils Program To Help Ease Consumer Debt," *The Asian Wall Street Journal*, March 11, 2004.

[6] Gordon Fairclough, "South Korea Forecasts Growth Of Near 6% on Export Strength," *The Asian Wall Street Journal*, April 26, 2004.

[7] Ministry of Finance and Economy and the Korea Development Institute, *Republic of Korea Economic Bulletin*, Volume 28, No. 1, January 2006.

Economic Reforms

Financial Sector and *Chaebol* Reforms

Assessing Korea's economic reforms to date depends on one's perspective. If the point of comparison is the Korean economy in 1997, then the government's progress has been impressive. South Korea's economy today is far more transparent, open to foreign investors, and efficient than it was seven years ago. Progress has been particularly notable in opening the country to foreign direct investment (see below) and in reforming the financial sector. In the years following the crisis, the government spent about $140 billion to bail out ailing banks and mutual funds.[8] This amount is approximately 25%-30% of the country's GDP, nearly twice the level required to save Mexico's financial system during its crisis in 1995. Notably, predictions that the government would have to spend substantially more funds have not come to pass, and Korea's banking sector as a whole has returned to profitability. By the end of 2001, non-performing loans (loans which are unlikely to be repaid) had fallen to 2.4% of total loans, compared with 16.4% in 1998. (In 2001, the percentage of non-performing loans for large banks in the United States was 1.5%.)

The Roh government has accelerated South Korea's efforts to re-privatize the banks that were nationalized in the aftermath of the 1997 crisis. By 2000, the nationalization program had brought about one-third of the banking industry's assets into government hands, and state ownership of the banking sector formed the crux of a major trade dispute with the United States and European Union, in which state-owned and state-controlled banks were accused of illegally subsidizing Hynix Semiconductor Inc., the world's third-largest producer of dynamic random access memory (DRAM) semiconductor chips. By the spring of 2004, however, sales of many of formerly state-owned banks had given foreign companies collectively a major stake in South Korea's financial sector, notwithstanding occasional statements by Korean politicians expressing misgivings about excessive non-Korean ownership. By 2005, foreigners owned about one-third of the assets in the Korean banking sector, including majority stakes in four of Korea's eight nation-wide banks.[9] In March 2004, Korea's Financial Supervisory Commission approved a $1.7 billion bid from Citigroup for a controlling stake in KorAm, Korea's seventh-largest bank. Through 2006, the Korean banking sector continued to be increasingly profitable.[10]

If the yardstick used to assess South Korea's reforms is the U.S. economy, however, it becomes clear that Seoul has far to go if it is to make the economy truly responsive to market-oriented pressures and incentives. Progress has been particularly difficult in the government's attempts to pressure the *chaebol* to correct the problems revealed by the 1997 crisis, including excessively high debt levels, a heavy reliance on short-term debt, the lack of transparency, weak corporate governance, and corporate structures dominated by individual families rather than professional business managers. Although two of the largest *chaebol*—Daewoo and Hyundai—have been dismantled and debt-equity ratios for most of the top conglomerates have been reduced, corporate governance and cross-shareholdings within *chaebol* groupings remain major problems. The bailouts of struggling credit card affiliates in 2003 and 2004 seemed to many to indicate that the *chaebol* had not reformed their past practices of forcing their profitable enterprises to rescue

[8] Francesco Guerrera, et al., "Seoul Plans to Sell Most of Stake in Hana Bank," *Financial Times*, January 28, 2004.

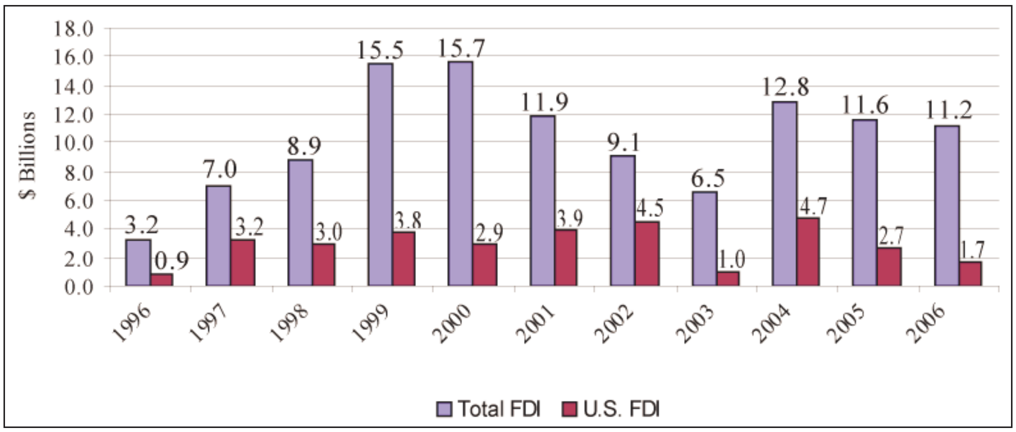
[9] Foreigners also are significant shareholders in many prominent chaebol and own an estimated 40% of the value of the shares traded on South Korea's stock exchange.

[10] Economist Intelligence Unit, *South Korea Country Report*, February 2007.

failing ones. Also in 2003, a massive accounting scandal at SK Global, the trading unit of the country's fourth-largest *chaebol*, SK Group, revealed similar structural problems.[11]

Additionally, the reckless credit card lending activities of Korean credit card firms in 2003 and 2004 exposed the continued weaknesses in risk management and due diligence by Korean financial interests. One of the government's responses has been to accelerate plans to further restructure the financial industry by passing new laws allowing the consolidation of banking, insurance, asset management, and brokerage services. Some critics, however, worry that this cross-sectoral consolidation will accentuate the problem of cross-shareholding within *chaebol* groupings. Also, bailouts of the two largest credit card companies, LG Card and Samsung Card, in 2003, have raised fears that the "too big to fail" dynamic continues to persist in South Korea.

Figure 2. Foreign Direct Investment in the ROK, 1996-2006



Source: ROK Ministry of Commerce, Industry, and Energy.

Foreign Direct Investment Reforms

As part of its commitment to the IMF in December 1997, Seoul pledged to eliminate most restrictions on foreign firms' long-term investments in local subsidiaries and controlling interests in local companies. The government of President Kim Dae Jung, who was elected during the nadir of Korea's financial crisis, moved aggressively to liberalize Korea's foreign investment regime. Partly as a response to Kim's reforms, and partly in response to the lower prices of Korean assets following the 1997 crisis, FDI flows increased markedly, soaring from $3.2 billion in 1996 to a peak of $15.7 billion in 2000. FDI fell off significantly from 2001-2003, before rising to $12.8 billion in 2004, the same year President Roh Moo-hyun's government began a policy of boosting FDI as a source of domestic growth.[12] Since the 1997 crisis, FDI commitments

[11] SK Global (now SK Networks)was found to have window-dressed its financial statements by over 7 trillion *won* (around $5.8 billion), for which several senior level executives, including SK Corp's chairman were convicted of breaching fiduciary responsibilities. The chairman served a three-month prison term. Following SK Global's restatement of its earnings, SK Corp led a rescue of its subsidiary despite the objections of most of SK Corp's foreign shareholders, led by Dubai-based Sovereign Asset Management. SK managers ultimately defeated Sovereign's efforts, and in July 2005, Sovereign sold its 15% stake in SK Corp.

[12] In a March 4, 2004 speech to the American Chamber of Commerce of Korea, Minister of Finance and Economy Lee Hun-jai announced the new policy, saying, "foreign direct investment is important not just for short-term recovery of the Korean economy, but also for supporting longer-term growth potential." Andrew Ward, "Korea Moves to Win Back Foreign Business," *Financial Times*, March 5, 2004.

by U.S. companies have totaled nearly $20 billion. (See **Figure 2**.) A number of high-profile Korean companies have been taken over by foreign interests, notably General Motors' purchase of Daewoo Motors in 2002.[13] Citigroup's $2.4 billion purchase of KorAm Bank in March 2004 was the largest foreign direct investment in Korean history and Citigroup's largest investment outside North America.

The Daewoo Motors Case

Despite the increased openness to foreign ownership, a number of high-profile acquisitions by foreign companies have been either delayed or cancelled, due to nationalistic objections to the sale, disagreements over the sales price, and/or the discovery of previously undisclosed debts owed by the target Korean company. These delaying actions often have backfired, resulting in far lower eventual sale prices. A case in point was the protracted sale of Daewoo Motors. In June 2000, Daewoo Motor's creditors, many of them government-owned or controlled, reached a tentative agreement with Ford, which bid nearly $7 billion for the company. Negotiations became difficult, and after discovering billions of dollars in previously hidden liabilities (and taking a large loss from the Firestone tire recall), Ford withdrew its offer. General Motors, which initially had bid $4 billion, remained the only viable suitor. Negotiations with creditors and the government dragged on for over a year and a half, however. Finally, in May 2002, GM and Daewoo's creditors signed an agreement, by which GM acquired a controlling stake in Daewoo Motors for $400 million.

Thus far, the GM-Daewoo partnership has been hailed as a success story. The combined company has become a global production base for GM; GM-Daewoo's sales have quadrupled since the purchase, making the affiliate one of GM's most profitable. Sales have been particularly strong in China, and GM has chosen to house its global mini and small car development teams in the Korean company.[14]

The Newbridge Capital Case

Many Koreans, however, have reacted with alarm to foreign investment and there has been growing discussion of restricting the takeover of Korean companies by foreigners. For instance, when Newbridge Capital sold its 50% stake in Korea First Bank in early 2005 at a high profit, it was accused of being a "foreign exploiter." The South Korean government attempted to limit or eliminate an investment treaty with Malaysia, Newbridge's home, that allowed the company to avoid paying Korean taxes on its gains. Newbridge bought Korea First Bank in 1999 and is credited in many circles with turning around the bank's fortunes. Part of the Korean government's apparent ambivalence to foreign investment, particularly in the financial sector, is that foreign multinationals often are more resistant to government pressure. Newbridge, for instance, reportedly resisted efforts by the South Korea's Financial Supervisory Commission to advance loans to two failing companies, Hynix and LG Credit.[15]

[13] Since then, GM Daewoo has become GM's manufacturing platform in Asia.

[14] Gina Chon, "Growth Engine: Daewoo Works Through its Woes to Give Floundering GM a Boost," *The Wall Street Journal Asia*, April 5, 2006; "As GM Daewoo Soars, Kia Crumbles," *Chosun Ilbo*, February 10, 2007; see also CRS Report RL33317, *China's Impact on the U.S. Automotive Industry*, by Stephen Cooney.

[15] Edward Graham, "South Korea Should End its Corporate Xenophobia," *Financial Times*, August 4, 2005.

The Lone Star Case

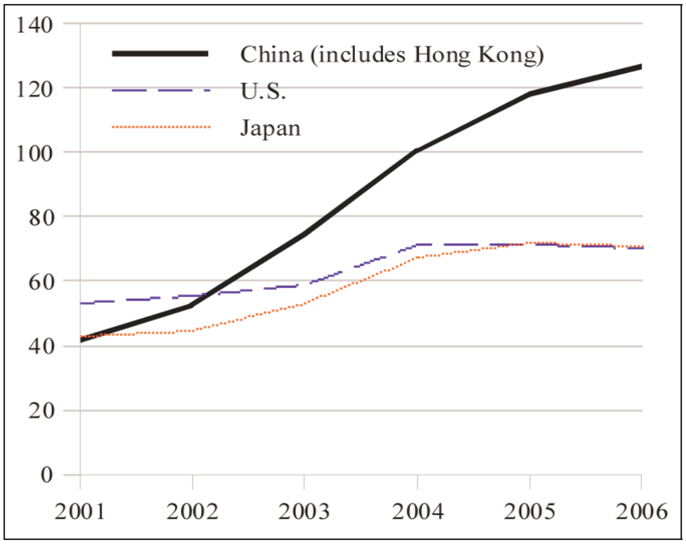
In 2006, the government's moves against Lone Star, a Texas-based private equity fund, again raised fears among foreign businesspeople that high-profile investments remain vulnerable to politically-charged investigations. Earlier in the year, Lone Star announced a preliminary agreement to sell its controlling stake in the Korea Exchange Bank (KEB), Korea's fifth largest, to the country's largest bank, Kookmin Bank, for $7.4 billion. Lone Star purchased KEB in 2003 for $1.2 billion. Shortly after the announcement, which sparked an outcry against foreign "predators" in South Korea, South Korean prosecutors launched an investigation of the 2003 purchase arguing that the sale price was set too low by KEB and the government, which managed the sale. Separately, prosecutors also have issued arrest warrants for Lone Star executives for alleged illegalities stemming from a number of Lone Star's transactions after it took control of KEB. Korean authorities reportedly are seeking the extradition from the United States of two Lone Star officials.[16] The combination of the two sets of investigations has stalled Lone Star's sale of KEB to Kookmin.

South Korea's Increased Economic Integration with China

As mentioned earlier, in 2003 China surpassed the United States as South Korea's number one trading partner (see **Figure 3**). South Korea has run trade surpluses with China for a number of years, in contrast to the increasingly large trade deficits it has run with Japan (see **Figure 4**). For several years, China has also been the number one destination for South Korean overseas direct investment, by a large margin. Many South Korean exports to China are intermediate goods used in the production of finished goods that ultimately are exported from China to other countries, including the United States. A growing number of Koreans are studying the Chinese language and traveling to China, and public opinion polls show that a growing number of Koreans have favorable views of China. These developments, combined with a sharp decline in favorable views of the United States, have led many American observers to worry that Chinese influence over South Korean policy is likely to rise in the future, at the expense of the United States.

[16] Laura Santini and Lina Yoon, "Lone Star Probe Engulfs Fund's South Korea Chief," *The Wall Street Journal Asia*, January 29, 2007.

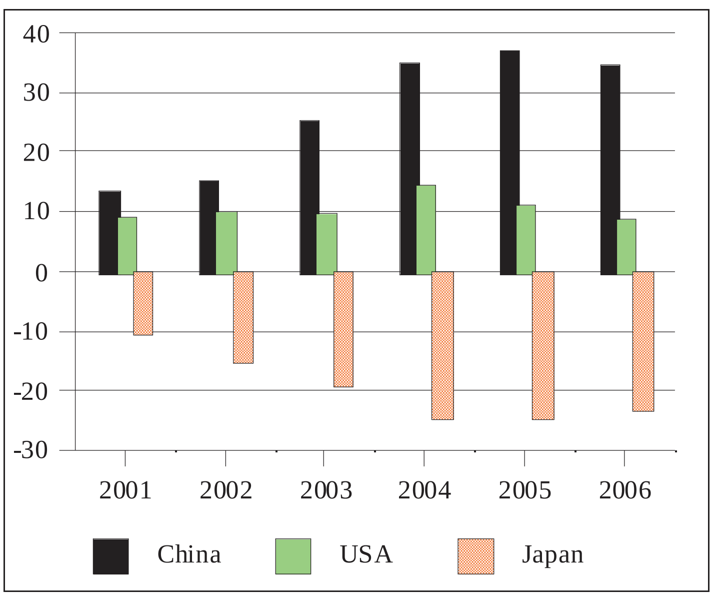
Figure 3. ROK Trade with China, U.S., and Japan 2001-2006



Source: Korea Customs Service.

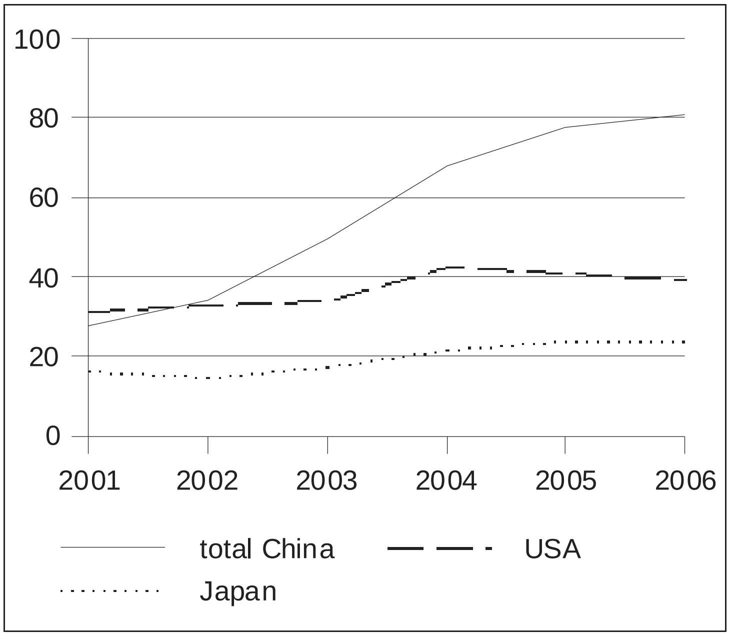
Many South Koreans, however, have ambivalent views of China's growing economic importance. Increased imports from China has increased competitive pressure on South Korean farmers and manufacturers. The increased competitiveness of many Chinese manufacturers has caused some consternation in some South Korean firms, pushing them to search overseas for lower-cost production bases. There are also concerns that jobs, particularly in the manufacturing sector, will be lost to Chinese workers as South Korean foreign direct investment in China increases.

Figure 4. ROK Trade Balances with Major Partners



Source: Bank of Korea.

Figure 5. South Korean Exports to China, U.S., Japan, 2001-2006



Improved Inter-Korean Economic Relations

In the past three years, South Korea has emerged as North Korea's second-most important economic partner, after China. Inter-Korean trade has more than doubled since 2000, to over $1.3 billion in 2006 (see **Figure 5**).[17] For the past two years, about 40% of this trade (approximately $550 million in 2006) was conducted on a commercial basis. The rest is associated with inter-Korean cooperation projects ($370 million, or 27% of bilateral trade, in 2006) and non-commercial transactions such as humanitarian assistance projects (about $420 million, or 30%, in 2006). Overall, South Korea runs a trade surplus with North Korea, though if only commercial transactions are considered, Seoul runs a deficit.[18]

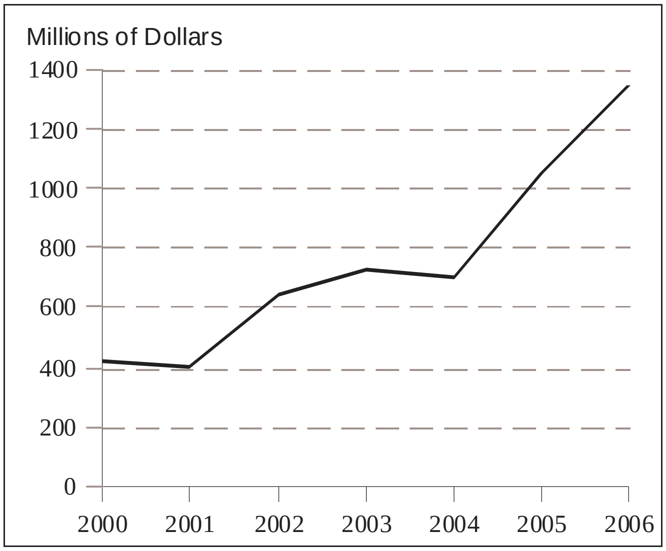
From 1994-2006, Korea provided over $3 billion worth of economic and humanitarian aid to North Korea, most of which has come since the June 2000 summit between North Korean leader Kim Jong-il and then-South Korean President Kim Dae Jung. Since the summit, the two Koreas have reconnected inter-Korean roads, are close to reconnecting two rail lines, have expanded a tourism site in Mt. Kumgang (North Korea), and have completed construction of a pilot industrial zone in Kaesong (North Korea) for South Korean companies to erect factories using North Korean labor. Kaesong is 40 miles north of Seoul, just across the demilitarized zone separating the two countries. By the end of 2006, a pilot site at the Kaesong industrial complex (KIC) had expanded to include 15 South Korean firms employing over 10,000 North Korean workers. Following North Korea's missile tests in July 2006 and nuclear test in October 2006, the South Korean government announced some restrictions on its economic cooperation projects with the North, including the suspension of new applications from South Korean firms seeking to invest in the second phase of the KIC. In January 2007, the South Korean Unification Minister announced that an additional 40 firms, which had been selected prior to the suspension, would open

[17] South Korean National Statistical Office; Korean Ministry of Unification.

[18] South Korean National Statistical Office; Korean Ministry of Unification.

operations in Kaesong in 2007. Additionally, as part of the six-party talks on North Korea's nuclear weapons programs, Seoul has proposed sending large amounts of electricity to North Korea, in exchange for concessions from Pyongyang.

Figure 6. North-South Korea Trade



Source: Unification Ministry.

Some analysts worry that improved inter-Korean economic relations are undermining the Bush Administration's policy of constricting the inflows of foreign currency that are thought to go to the North Korean elite, providing a critical base of support for North Korean leader Kim Jong-il. Alternatively, coordinated U.S. and South Korean policies could use economic leverage to pressure North Korea. In broad terms, the Bush Administration has stated that it supports South Korea's economic engagement with North Korea, including the Kaesong industrial zone.[19] In 2004 and 2005, the United States approved several export controls clearances that were required by U.S. law for South Korean firms to bring items—such as computer and telecommunications equipment—to Kaesong.[20]

Since the KIC opened, it has been South Korean policy to request that its FTA partners allow exports from Kaesong to be considered as "Made in Korea" (meaning South Korea), thereby enabling these products to receive the preferential status conferred by the FTA. The United States has refused to consider Kaesong as part of the KORUS FTA. Two important issues for the United States in considering South Korea's demand are the conditions for North Korean workers and the income the KIC provides for the North Korean government. Some U.S. labor and human rights advocates have argued that North Korean workers in Kaesong are being exploited. South Korean officials, as well as other analysts, counter by saying that conditions—including wage conditions—at Kaesong are far better than those in the rest of North Korea.

[19] See, for instance, Joint Declaration on the ROK-U.S. Alliance and Peace on the Korean Peninsula, White House Office of the Press Secretary, November 17, 2005.

[20] U.S. Embassy in Korea, "Questions and Answers from Economic Press Roundtable with Embassy Official," February 8, 2006; January and February 2006 conversations with officials familiar with the Kaesong export control discussions.

The North Korean government derives hard currency from several sources in the KIC project, including leasing fees and surcharges levied on North Korean workers' wages, which are paid to an arm of the North Korean government agency before being passed on to employees (in the form of North Korean *won*).[21] To date, according to information provided by the South Korean government, these streams likely total less than $20 million in hard currency. However, if the South Korean government realizes its most ambitious goals for the Kaesong project, by the middle of the next decade the North Korean government would likely derive hundreds of millions of dollars annually from tax revenues and its slice of North Korean workers' wages, assuming the KIC's current tax and wage structures remain in place.[22] Some South Koreans caution that the uncertainties over the future course of the KIC project make such projections highly speculative.

Major U.S. Trade Disputes with South Korea

Given the disparities in size and economic dependence, it is not surprising that the United States typically sets the agenda of U.S.-ROK trade talks. Since the 1997 financial crisis, these complaints have tended to be directed at regulations promulgated by "domestic" ministries, such as the Ministry of Health and Welfare, the Korean Food and Drug Administration, and the Ministry of Environment, that traditionally have had little contact with foreign governments or firms. One element of the U.S. strategy toward Korea appears to be attempting to raise the pressure on these ministries by pushing for the Korean Cabinet to focus on the issue.

In general, U.S. exporters and trade negotiators identify the lack of transparency of Korea's trading and regulatory systems as the most significant barriers to trade with Korea, in almost every major product sector. In 2004, the transparency issue became a stand-alone item in the quarterly trade action agenda meetings. Many U.S. government officials also complain that Seoul continues to use government regulations and standard-setting powers to discriminate against foreign firms in politically sensitive industries, such as automobiles and telecommunications. Another major cross-sectoral complaint is that restrictions in the Korean labor market, such as mandatory severance pay, raise the cost of investing and doing business. Finally, the United States and other countries have pressed South Korea to open further its agricultural market, which is among the most closed in the OECD.[23]

Below are brief descriptions of several major sector-specific disputes between the U.S. and South Korea. In cases where an issue is a significant subject of the KORUS FTA talks, that fact is mentioned, but more detailed discussion is left to CRS Report RL33435, *The Proposed South Korea-U.S. Free Trade Agreement*.

[21] North Korean workers in Kaesong receive a base monthly salary of $50 for a 48-hour work week. In 2005, the average workweek (including overtime) at Kaesong was 55 hours, bringing the average gross monthly salary to $67 per month. South Korean officials say they are unsure of precisely how much is taken by the North Korean government, but from conversations with workers and other sources, they estimate the government takes an estimated 30% "social services fee" from the wages to pay for housing and other services that are to be provided the North Korean state. If these figures are correct, the average Kaesong worker's take-home monthly pay in 2005 was just under $37, paid in North Korean *won*. Presumably, payments are made at the official rate of exchange, which is much lower than black market rates. The North Korean government also levies a 15% social insurance surcharge, which is paid by the South Korean employer, to pay for unemployment and occupational hazards.

[22] Moon Ihlwan, "Bridging the Korean Economic Divide," *Business Week*, Mar 8, 2006.

[23] OECD, *Economic Survey - Korea 2004.*

Major Agriculture Issues

Despite South Korea's place as one of the top destinations for U.S. agricultural exports, U.S. government and agricultural industry officials contend that Seoul retains a number of tariff and non-tariff barriers that have stunted U.S. bilateral exports. South Korean agricultural tariffs are particularly high compared to the United States and most OECD members; according to USTR, South Korea's average applied agricultural tariffs are 52%, more than four times the U.S.'s average.[24] The completion of a comprehensive FTA therefore is to dramatically expand U.S. agricultural exporters' access to the Korean market; by one estimate, U.S. agricultural exports will increase by more than 200% within four years after a hypothetical FTA is implemented.[25] South Korea's farmers, while shrinking in terms of population and contribution to GDP, remain a politically powerful force in South Korea. At the February 2006 launch of the FTA, ROK Hyun-chong Kim said Seoul plans to spend over $100 million in adjustment assistance to South Korean farmers over the coming decade. At one point during the FTA talks, Korea reportedly requested that a total of 284 agricultural tariff lines be excluded from market access commitments.[26]

In recent years, the number and intensity of agricultural disputes on the U.S. trade agenda with South Korea appear to have diminished, as manufacturing and service sector issues have been emphasized. Two of the most contentious agricultural trade disputes over the past two years have involved beef and rice.

South Korea's Beef Ban

A major political trade issue on the bilateral agenda is South Korea's ban on imports of U.S. beef, which the South Korean government essentially re-imposed in late December 2006 after partially lifting it earlier that year. The issue originated in December 2003, when South Korea (along with Japan and other countries) banned all U.S. beef imports after the United States reported the discovery of a cow with bovine spongiform encephalopathy (BSE or "mad cow disease"). South Korea formerly was the third-largest foreign buyer of U.S. beef; the United States exported nearly $800 million worth of beef to South Korea in 2003.[27] Throughout 2004, USTR official said that FTA negotiations were unlikely to begin with South Korea while the ban was in place. During bilateral talks in January 2006, South Korea agreed to partially lift its ban "toward the end of March" 2006 by allowing imports of U.S. boneless beef from cattle less than 30 months old. Boneless beef constituted about half of U.S. bilateral beef exports in 2003.

Korea did not announce it would start resuming imports of boneless beef from the United States until September 2006. Then, when the first three shipments of U.S. beef arrived in South Korea in December 2006, South Korean meat inspectors prohibited the entry after they found bone fragments. A senior official from the Korean Agricultural Ministry stated that U.S. and Korean negotiators were unable to come up with a mutually acceptable definition of "boneless beef," among other issues, and therefore had failed to resolve the dispute as of February 12, 2007.[28] U.S.

[24] USTR, *FTA: United States & Republic of Korea Economic & Strategic Benefits*, February 2, 2006.

[25] United States International Trade Commission (ITC), *U.S.-Korea FTA: The Economic Impact of Establishing a Free Trade Agreement (FTA) Between the United States and the Republic of Korea*. (Washington, DC, 2001) pp. 5-1 - 5-2.

[26] "Korea Seeks Total Exclusion of Rice from Bilateral FTA," *Inside U.S. Trade*, September 22, 2006.

[27] USTR, *FTA: United States and Republic of Korea Opportunities for Agriculture,* February 2006.

[28] *Washington Trade Daily*, February 12, 2007. In December 2005, Japan lifted its ban, only to reimpose it the following month after Japanese government inspectors found bone material among the first U.S. beef shipments to (continued...)

officials and beef producers have argued that the fragments are so small as not to be a potential cause of mad cow. A number of Members of Congress have called for the suspension of the KORUS FTA negotiations until the matter is resolved or have indicated they would not approve an FTA with Korea as long as it continued to stop U.S. beef imports.

Rice

The South Korean government controls the purchase, distribution, and end-use of all imported rice. During the Uruguay Round of multilateral trade negotiations (1986-1993), South Korea was granted a 10-year grace period before opening its rice market to imports. In return for receiving this concession, South Korea agreed to allow minimum access for rice through the use of quotas. The grace period ended on the last day of 2004. Prior to that date, South Korea notified the WTO that it wished to extend the minimum access quota system rather than convert to tariffs. Under the Uruguay Round agreement, Seoul could do this only if it obtained the consent of other WTO members, which could demand concessions to expand their quota. The United States availed itself of this right, and on December 30, 2004, U.S. and South Korean officials announced an agreement, under which Korea will double the amount of rice it imports over the next 10 years, provide guaranteed access for 50,000 MT of U.S. rice each year, and make imported rice available directly to Korean consumers. In November 2005, after months of delay and acrimonious debate, the Korean National Assembly ratified the rice deal. China and Thailand, two other parties to the rice negotiations, reportedly wished to see an end of the quota system in favor of tariffication, which presumably would be more advantageous to lower-cost rice producers such as themselves. In 2006, U.S. exporters sold over 60,000 metric tons to South Korea.[29] In the KORUS FTA negotiations, the United States is pressing South Korea to open its markets on rice, a position that the South Korean negotiators have strongly resisted.[30]

Other Issues

Automotive Trade[31]

Automotive trade is perennial issue in trade talks between the United States and South Korea, the world's fourth-largest producer of automobiles. For years, U.S. officials have argued that Korean tax and "Korea unique" certification practices discriminate against imports. According to press reports and conversations with the author, throughout 2005, U.S. officials included automobiles as one of the major outstanding bilateral issues on which progress would be needed before the United States would agree to launch an FTA.[32] In announcing the intent to launch talks, Portman

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(...continued)

arrive. U.S. Secretary of Agriculture Mike Johanns expressed regret that the prohibited material had entered the shipments. After months of bilateral talks, in August 2006 Japan resumed imports of U.S. beef from cattle 20 months old or younger.

[29] U.S. Department of Commerce, U.S. Census Bureau, Foreign Trade Statistics.

[30] *Washington Trade Daily*. February 12, 2007.

[31] This section written with Stephen Cooney, CRS Industry Analyst. For more on the United States auto industry, see CRS Report RL32883, *U.S. Automotive Industry: Recent History and Issues*, by Stephen Cooney and (name red acted).

[32] Inside US Trade, "Portman Says U.S. Not Ready to Launch FTA Talks with Korea," June 10, 2005; Edward Alden, et. al., "South Korean Film Concession Paves Way for Free Trade Talks with the US," *Financial Times*, January 27, (continued...)

alluded to the South Korean Ministry of the Environment's decision in the fall of 2005 to grant auto makers with a low share of the Korean market an exemption, until 2009, from Korea's regulations on ultra-low emissions. Previously, the regulations would have applied in January 2007. South Korean government officials say that changes made in the auto sector were unrelated to the negotiations over launching an FTA.

South Korean imports of foreign automobiles totaled around 37,000 in 2006—including about 6,500 U.S. vehicles—just over 4% of the South Korean market, up from less than 0.5% five years earlier (see **Table 3**). Most of the foreign cars sold in South Korea are luxury models, though in 2006 Japanese manufacturer Honda began to have some success marketing its Accord and CR-V models. In contrast, South Korean auto manufacturers sold nearly 750,000 cars to the United States in 2006, capturing over 4% of the U.S. market. Almost all of these vehicles were produced by Hyundai Motors, including vehicles produced by its subsidiary Kia, formerly Korea's second-largest independent manufacturer. One significant change in 2006 was that over one-quarter of the "Korean" cars sold in the United States were produced at Hyundai's plant in Montgomery, Alabama (see **Table 4**).

Table 3. Reciprocal U.S.-ROK Automotive Sales

Vehicular Units, including Light Trucks

	2000	2001	2002	2003	2004	2005	2006
Korean Auto Companies' Sales in the United States[a]	473,400	618,300	650,300	637,700	688,670	730,863[a]	749,821[a]
Market Share	*2.7%*	*3.6%*	*3.9%*	*3.8%*	*4.1%*	*4.3%*	*4.6%*
Total Foreign Auto Companies' Sales in Korea[b]	4,400	7,700	16,100	19,500	23,345	30,901	36,962[c]
Market Share	*0.3%*	*0.5%*	*1.3%*	*1.9%*	*2.1%*	*3.3%*	*4.2%*[c]
Sales of "U.S. Brands" in Korea[d]	1,700	2,000	4,700	4,100	5,415	5,795	6,576[c]
Market Share	*0.1%*	*0.1%*	*0.4%*	*0.4%*	*0.5%*	*0.7%*	*0.8%*[c]

Source: U.S. Department of Commerce.

a. Figures include vehicles manufactured in Hyundai's plant in Montgomery, Alabama (see **Table 4**).

b. Figures for foreign and U.S. companies' sales in South Korea do not include the sales of GM Daewoo Automotive Technologies, which has captured between 12% and 13% (104,000-128,000) of the Korean market since GM took over Daewoo in 2002.

c. January - November 2006.

d. "U.S. brands" includes Cadillac, Chrysler, Ford, Jaguar, Land Rover, Saab and Volvo.

In 2006, the United States ran a trade deficit with South Korea in auto parts shipments of over $1.7 billion, up from a deficit of nearly $1.4 billion in 2005. Between those two years, U.S. parts exports essentially remained stagnant, registering $515 million to $517 million in 2005 and 2006, respectively.[33]

(...continued)

2006; conversations with U.S. officials in June 2005, September 2005, and December 2005.

[33] U.S. Commerce Department.

Table 4. Increased Sales from Hyundai's Alabama Plant

	2005	2006
Total Hyundai Sales in U.S.	455,012	455,521
- Of which, Hyundai Alabama Production	65,747	195,361
% of Hyundai's U.S. Sales	*14.4%*	*42.9%*
% of Total Sales of Korean Autos in U.S.	***9.0%***	***26.1%***
- Of which, Hyundai Imports	389,265	260,159
% of Hyundai's U.S. Sales	*85.6%*	*57.1%*
Kia Sales (Imports)	275,851	294,301
Total Sales of Korean Autos in U.S.	**730,863**	**749,821**

Source: U.S. Department of Commerce.

For years, USTR has pushed South Korea to lower its 8% tariff, which is more than three times the U.S. level of 2.5% on imported cars. Moreover, the United States continues to protest that South Korea's tariff, tax and regulatory structure unfairly penalize automobiles with larger-sized engines. Specifically, the Bush Administration has called on Korea to move from engine displacement taxation to a value-based taxation system, because the former assesses higher taxes on larger vehicles.[34] Periodically, some Members of Congress have introduced legislation calling on South Korea to end the practices that impede foreign market access and requesting various U.S. executive agencies to monitor Korea's progress on this issue. Two initiatives were H.Con.Res. 144 and S.Con.Res. 43, introduced in the 107th Congress, in May 2001.

For much of the post-Korean War era, South Korea's market was closed to the import of automobiles. It banned all automobile imports prior to 1989, and the ban on importation of automobiles from Japan was eliminated only in 1999. Gradually, the industry has opened up to foreign investment, though almost all cars sold in Korea are still locally produced.

In its October 1997 Super 301 report to Congress, the Clinton Administration designated Korea as a "Priority Foreign Country" for its barriers to foreign motor vehicles.[35] USTR subsequently initiated an investigation under Section 301 of the U.S. Trade Act of 1974, as amended, and issued a call for bilateral consultations to provide fair market access for foreign autos in Korea.[36] In 1998, the United States and South Korea signed a Memorandum of Understanding (MOU) on foreign access to Korea's auto market, which led the USTR to terminate the Section 301 investigation. Under the MOU, Seoul agreed to reduce its tariffs on motor vehicles from 80% to 8%, proactively address instances of anti-import activity in Korea, lower or eliminate many

[34] USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers*, p. 313.

[35] Super 301 (Section 310 of the 1974 Trade Act) requires the USTR to report to congress on "priority foreign countries" that practice unfair trade and "priority practices" that have the greatest effect on restricting U.S. exports. If agreement is not reached on the priority practices, the USTR is required to initiate a Section 301 case (see the following footnote). For more information, see CRS Report 98-454, *Section 301 of The Trade Act of 1974, As Amended: Its Operation and Issues Involving its Use by the United States*, by (name redacted).

[36] Section 301 (sections 301-309 of the Trade Act of 1974) authorize the USTR to initiate investigations of foreign trade practices that allegedly discriminate against U.S. commerce. If a settlement with the foreign country is not reached following the initiation of the investigation, the USTR decides whether or not to retaliate, usually in the form of 100% tariffs on selected imports from the offending country. See CRS Report 98-454, *Section 301 of The Trade Act of 1974, As Amended: Its Operation and Issues Involving its Use by the United States*, by (name redacted).

automobile taxes, create a new financing system to make it easier to purchase automobiles, and streamline its standards and certification procedures. Many of these steps—including lowering tariffs—have been implemented.

Furthermore, Seoul has largely abandoned its policy of allowing only Korean-owned auto companies to operate in South Korea. With Hyundai's purchase of Kia, Korea's second-largest producer, there is now only one Korean-owned motor vehicle manufacturer left, although it is dominant in the home market. In 2002, General Motors purchased the Daewoo Motor Company from the bankrupt Daewoo conglomerate. Two other smaller vehicle producers, Samsung and Ssangyong, have also come under the control of foreign investors.

Meanwhile, Korea's top automotive manufacturer has renewed an earlier effort to build cars in North America, as well as to import them. In May 2005, Hyundai Motors opened a new $1.1 billion plant in Montgomery, Alabama. In 2006, the new plant produced nearly 200,000 cars that were sold in the United States, over 40% of Hyundai's total sales in this country. (See **Table 4**.) The facility is expected to produce 300,000 vehicles annually and will employ approximately 2,000 workers. The plant's suppliers are expected to employ approximately 5,500 workers.[37] In Korea, Hyundai Motor experienced significant legal and labor troubles in 2006. In January 2007, South Korean regulators levied a $24 million fine on the company for violating competition rules. Its chairman, Chung Mong-koo, is on bail facing corruption charges. And, in 2006, Hyundai Motor union members staged walkouts on 32 days last year, incurring production losses of 115,683 units.[38] Hyundai's legal troubles have cast a cloud over the construction of a new plant in West Point, Georgia, by Kia Motors. Groundbreaking on the plant was held in October 2006. Production is due to begin in 2009.

Pharmaceuticals

Pharmaceutical trade has been one of the most contentious issues in the KORUS FTA talks. Korea is ranked in the world's top 15 pharmaceutical markets, with annual sales in the $4 billion range. In 2001, imports comprised approximately 30% of the total market, compared with an average of 50%-70% for other countries that do not have a significant research-based domestic industry. Korea's expenditures on pharmaceutical products is about $115 per person per year, less than half the $240 average for OECD countries.[39] The country has a nationalized health insurance system, which began to experience a negative cash flow in 1995. For years, the U.S. government has complained that a number of Korea's pharmaceutical policies are designed to protect the domestic Korean industry, which predominantly produces generic drugs.

Criticisms have mounted since 2001, when the Korean government implemented a series of emergency measures to fill the national health insurance fund's mounting deficit, estimated at the time to be over 4 trillion *won* ($3.3 billion). Recent complaints include the lack of transparency of the Korean Ministry of Health and Welfare, particularly the Ministry's allegedly poor record on consulting with and notifying companies about regulatory changes; the reimbursement scheme of the health insurance system, which allegedly gives price incentives for doctors to prescribe and patients to use Korean-made products; poor protection of intellectual property rights for medical

[37] May 20, 2005 letter from Hyundai Motor Co.'s Washington, DC, office.

[38] Kyong-Ae Choi, "Korean Car Sales Increase," *The Wall Street Journal Asia*, January 3, 2007.

[39] American Chamber of Commerce in Korea, *Improving Korea's Business Climate 2002*, p. 148.

patents; and the discriminatory nature of Seoul's requirements that foreign drugs must be retested on Koreans living in Korea, rather than on other ethnic Asians, as the United States has insisted. In a sign of pharmaceuticals' growing importance on the bilateral trade agenda, in January 2002, the two sides established a bilateral private sector health care reform working group.

Both sides cited progress in 2005 in managing some of the most persistent disagreements—for instance, South Korea agreed to consult with the multinational pharmaceutical industry (as well as the domestic industry) in setting up an independent mechanism under which pricing and reimbursement decisions could be appealed—though there are conflicting reports about details of some of the negotiations.[40] According to press reports and conversations with the author, throughout 2005, U.S. officials included pharmaceutical regulations as one of the major outstanding bilateral issues on which progress would be needed before the United States would agree to launch an FTA.[41] South Korean government officials say that changes made in the pharmaceuticals sector were unrelated to the negotiations over launching an FTA.

South Korea's "Screen Quotas"

Since 1966, South Korea has sought to protect its domestic film industry by mandating that movie theaters devote at least 146 days per year (or 40% of the calendar year) to showing domestic films. The issue was a major reason the United States and South Korea were unable to finalize negotiations over a bilateral investment treaty (BIT), which were initiated in the late 1990s but were suspended in 1999.[42] Each country's motion picture industry has significant political clout; during South Korea's 2002 presidential elections, Roh was backed by several prominent South Korean actors. Nonetheless, for years Roh's administration pledged that it would reduce, if not eliminate, the quotas. For U.S. trade officials, the issue became a symbol of the Roh government's ability and capacity to make the difficult political concessions that would also come in FTA negotiations. On January 26, 2006, the day after the beef ban was partially lifted, South Korea's Prime Minister announced that the screen quotas would be cut in half, to 73 days a year. The following week, the two countries announced their intent to launch FTA talks. The growing popularity—both in South Korea and abroad—of South Korean films undoubtedly made Roh's concession more palatable.

South Korea's Alleged Currency Manipulation

In recent years, South Korea has been criticized for intervening in foreign currency markets by purchasing U.S. dollar assets to artificially lower the value of the Korean *won* against the U.S. dollar in order to boost exports. As of the end of November 2006, South Korea was the fourth

[40] For instance, in describing the proceedings of the October 2005 quarterly trade meeting, USTR's annual report states that the Korean government "assured the United States that it has no immediate plans" to implement proposals that would change the calculation methodology of its triennial re-pricing mechanism. However, the USTR's NTE reports that the Korean government said it would "take a 'cautious' approach toward this matter."

[41] Inside US Trade, "Portman Says U.S. Not Ready to Launch FTA Talks with Korea," June 10, 2005; Edward Alden, et. al., "South Korean Film Concession Paves Way for Free Trade Talks with the US," *Financial Times*, January 27, 2006; conversations with U.S. officials in June 2005, September 2005, and December 2005.

[42] BITs are designed to improve the climate for foreign investors—typically by committing the signatories to prohibit discrimination against foreign investors—by establishing dispute settlement procedures and by protecting foreign investors from performance requirements, restrictions on transferring funds, and arbitrary expropriation. The United States has signed over 30 BITs, primarily with countries undergoing significant economic reforms.

largest foreign holder of U.S. treasury securities, holding $67.7 billion, an amount that essentially is unchanged from 2005.[43] As **Figure 4** shows, the *won* generally has been appreciating against the dollar since 2001. The *won's* rise was particularly marked in late 2005 and early 2006, when it reached levels not seen since before the 1997 financial crisis. During the same period, the *won* has risen even more precipitously against the Japanese *yen*. This is particularly worrisome to many Korean exporters because they compete directly against more Japanese than U.S. companies and because many Korean manufacturers rely upon imports of intermediate goods from Japan.

Since the *won* began its gradual ascent in 2001, South Korean authorities have intervened episodically to slow the *won's* rise, though the scale of the intervention has been far less than Japan and China's. The United States made currency intervention a major issue at the Asia Pacific Economic Cooperation (APEC) Finance Ministers and G-7 Finance Ministers meetings in September 2003. Shortly thereafter, South Korea appeared to ease off large-scale interventionist policies; South Korean government officials say that since early 2004, they have engaged in only minor intervention to "smooth" excessive currency volatility.[44] In response to the *won*'s spike since late 2005, although some Korean officials have said that their currency is overvalued, they did not appear to intervene in currency markets in a large-scale way until late 2006. Indeed, in February 2006, South Korean Finance Ministry officials said they would like to loosen restrictions on *won*-denominated transactions overseas in order to make the *won* more widely traded.[45] By December of the same year, however, there were signs that the Bank of Korea resumed its intervention, and a deputy finance minister, Kim Sung-jin, reportedly stated that "to stabilise the economy, it is essential to maintain the currency at a certain level and the government will make its best efforts to achieve that ... if the government consults with the central bank and intervenes in the currency market, our resources are unlimited."[46]

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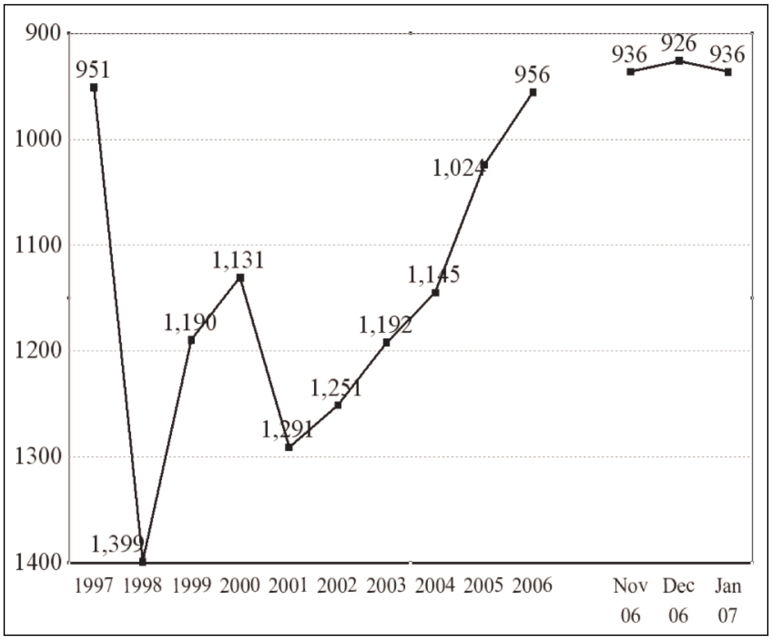
[43] Department of the Treasury and the Federal Reserve Board, "Major Foreign Holders of Treasury Securities," http://www.ustreas.gov/tic/mfh.txt. Japan held $683 billion in U.S. treasury securities, China $250 billion, and the United Kingdom $223billion.

[44] Charles Roth, "South Korea to Use Reserves For Local Asset Management," *The Asian Wall Street Journal*, February 14, 2005.

[45] Laura Santini, "Won Bulls see Korean Currency as a Proxy for Asia's Growth," *The Asian Wall Street Journal*, February 7, 2006.

[46] Anna Fifield, "Seoul Will Use 'Unlimited Resources' to Stem Won Rise," *Financial Times*, December 23, 2006.

Figure 7. *Won*-Dollar Exchange Rate, 1997-2007



Source: Bank of Korea, average basic rate.

Note: Y-axis is inverted.

In the future, the U.S. dollar and the market for U.S. Treasury securities could be affected by the South Korean government's launch of the Korean Investment Corporation (KIC) to manage a portion of South Korea's foreign exchange reserves, in July 2005. The KIC initially is managing $20 billion, and is expected to eventually manage $100 billion by 2012. The stated goals of the program are to invest South Korean foreign currency holdings more effectively. The program also aims to boost President Roh Moo-hyun's efforts to turn Korea into a major financial and commercial hub in Northeast Asia by helping boost Korea's asset management industry.

Some members of Congress have criticized Korea's currency policy. A "Fair Currency Act" (Lieberman) was introduced in Senate the last two Congresses (S. 377 in the 109th Congress and S. 1592 in the 108th Congress). If passed, they would require the U.S. government to monitor and take action against specific countries, including South Korea, that are "engaged most egregiously in currency manipulation."

Intellectual Property Rights Issues

Bilateral tensions often have arisen over U.S. allegations that Korea does not sufficiently protect intellectual property rights (IPRs). Since becoming a signatory to the World Trade Organization (WTO) Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) in 1994, USTR has moved Korea back and forth between the Special 301 "priority watch list" and the "watch list."[47] In 2005, USTR downgraded Korea to the "watch list" because of "significant

[47] "Special 301" refers to Section 182 of the Trade Act of 1974. Since the start of the Special 301 provision in 1989, the USTR has issued annually a three-tier list of countries judged to have inadequate regimes for IPR protection, or to deny access: 1) *priority foreign countries* are deemed to be the worst violators, and are subject to Section 301 investigations and possible trade sanctions; 2) *priority watch list countries* are considered to have major deficiencies in their IPR (continued...)

steps" Seoul had taken to strengthen its IPR regime. USTR has cited South Korea's increased protection for recordings transmitted over the internet and the launch in May 2004 of a "Pan-Government Comprehensive Plan For IPR Protection" headed by a Han Duk-soo, a prominent official who has a Cabinet portfolio to promote the initiative. In 2006, USTR kept Korea on the "watch list," though it commended Korea's established of a Copyright Protection Center, as well as a Standing Inspection Team to increase enforcement against the institutions using illegal software. USTR also lists several items, such as copyright protection and DVD piracy, on which it would like to see Korea make additional progress.[48]

Telecommunications

In recent years, telecommunications has emerged as one of the most contentious trade issues between the United States and South Korea. With one of the world's highest rates of Internet usage, South Korea is often used as a market for telecommunications companies to test cutting-edge wireless products and technologies. The Roh government has designated next-generation mobile communications as one of ten "new growth engines" that will help Korea reach President Roh's 2003 goal of nearly doubling per capita GDP to $20,000 by the end of the decade. Perhaps to this end, the Korean government has attempted to set mandatory, single-technology standards for wireless telecommunications services. These efforts led USTR in April 2004 to name South Korea as a "key country of concern" in its annual report under Section 1377, which requires USTR to assess U.S. trading partners' compliance with international telecommunication agreements.

Specifically, for two years, USTR negotiated with the South Korean government over the Ministry of Information and Communication's (MoIC) plan to require all cell phone services to use only the so-called wireless Internet platform for interoperability (WIPI) for downloading information from the Internet. WIPI is a new platform developed by a Korean association funded by Electronics and Telecommunications Research Institute (ETRI), a government-funded institute. The requirement would have excluded users and developers of other operability platforms, such as the platform developed by San Diego-based Qualcomm, which is used by a leading Korean cellular service provider. In April 2004, Seoul and Washington announced they had reached a compromise that allows MoIC to implement WIPI, but also permits cellular phones to be made compatible with other standards.[49]

A similar dispute is over MoIC's issuance of a mandatory standard—to be located in the 2.3 gigahertz (GHz) bandwidth spectrum—for a new portable broadband Internet system used to transmit information from the Internet to laptops and other wireless equipment. USTR and U.S. companies charged that, under the influence of ETRI, the original, domestically-designed standard was designed to deliberately exclude foreign companies in favor of Samsung.[50] In June 2004, the Korean government announced that all license holders would have to use one of the

(...continued)

regime, but do not currently warrant a Section 301 investigation; and 3) *watch list countries*, which maintain IPR practices that are of particular concern, but do not yet warrant higher level designations. See Wayne Morrison, *Section 301 of the Trade Act of 1974*, CRS Report 98-454, *Section 301 of The Trade Act of 1974, As Amended: Its Operation and Issues Involving its Use by the United States*, by (name redacted).

[48] USTR, *2006 Special 301 Report*, April 28, 2006.

[49] "U.S., Korea Reach Deal on Single Standard for Cell Phone Technology," *Inside US Trade*, April 30, 2004.

[50] USTR, "Results of 2004 Section 1377 Review of Telecommunications Trade Agreements," p. 5.

several technologies compatible with a standard designed by the International Institute of Electrical and Electronics Engineers. USTR has criticized the decision as excluding companies that have developed other systems. USTR also has asked the Korean government to revise its restrictions on foreign ownership in the telecommunications sector.[51]

Steel[52]

From 1998 through 2003, South Korean steel exports to the United States were one of the most politically charged items on the bilateral economic agenda, particularly since the 1997 Asian financial crisis. From 1997 to 1998, Korean shipments of steel to the U.S. nearly doubled, vaulting South Korea into the top five U.S. sources of steel imports. In 2003, imports from South Korea declined below pre-crisis levels, helping to defuse the issue. In the preceding five years, a number of anti-dumping cases were initiated against South Korean exporters, and Presidents Clinton and Bush each granted safeguard relief (under Section 201 of the Trade Act of 1974) for U.S. steel producers.[53] Korea and other countries challenged both Section 201 actions at the World Trade Organization, which ultimately ruled that the actions were inconsistent with global trading rules. In December 2003, President Bush terminated the safeguard tariffs he had established in March 2002.[54] In 2000, Korea also won a major WTO case involving anti-dumping duties the United States imposed against Korean exports of stainless steel plate in coils and stainless steel sheet and strip. Korea remains one of the leading exporters of steel to the United States by volume, at about 1.5 million metric tons annually in 2004-2005, but is now well behind the three leading Western Hemisphere suppliers (Canada, Mexico, Brazil), as well as China. The rise in steel prices since 2003 has to some extent defused this issue.

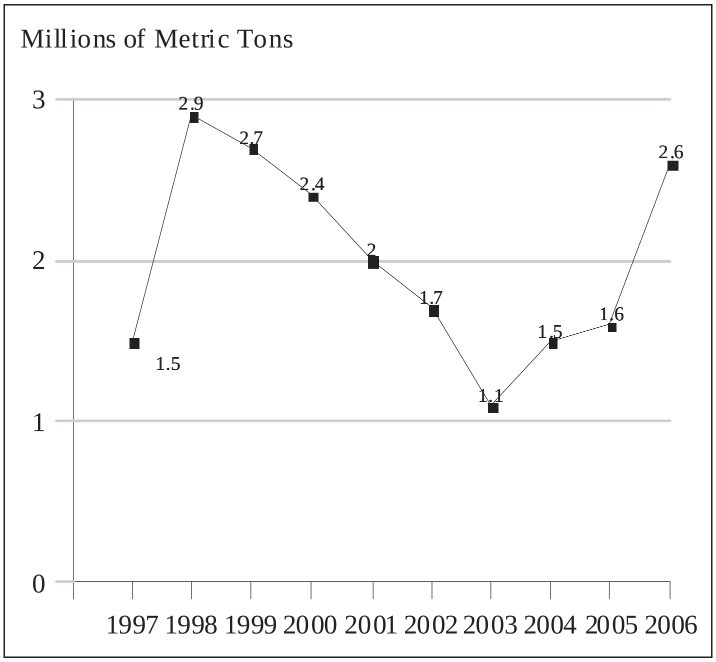
[51] USTR, *2005 National Trade Estimate Report on Foreign Trade Barriers (NTE)*, p. 394-95.

[52] This section written with Stephen Cooney, CRS Industry Analyst. For more, see CRS Report RL31748, *The American Steel Industry: A Changing Profile*, by Stephen Cooney.

[53] Section 201 relief, often referred to as "safeguard" or "escape clause" relief, is defined in sections 201-204 of the Trade Act of 1974, as amended (19 U.S.C. 2251-2254). Safeguard relief provides for temporary duties, quotas, or other restrictions on imports that may be traded fairly, but that enter in such quantities as to cause or threaten to cause serious injury to a domestic industry. The relief is intended to give the domestic industry an opportunity to adjust to the new competition and remain competitive. Within six months after a Section 201 petition has been filed with the International Trade Commission, the ITC must conduct an investigation, determine if relief is warranted, and recommend appropriate remedial action from a specified range of options. The President then decides whether to implement the recommended measure, apply an alternative measure, or take no action at all.

[54] For more on the steel Section 201 case, see CRS Report RL32333, *Steel: Price and Policy Issues*, by Stephen Cooney.

Figure 8. Steel Imports from Korea, 1997-2006



Source: U.S. Census Bureau.

Assistance to Hynix Semiconductor

In 2001, a major trade dispute erupted between the United States and South Korea over allegations that the Seoul government was propping up Hynix Semiconductor, presently the world's third-largest producer of dynamic random access memory (DRAM) semiconductor chips. In 2001 and 2002, Hynix's leading creditors—most of which were owned by the Korean government—orchestrated a series of rescue packages that kept Hynix in business by enabling it to restructure its 8.6 trillion *won* (over $7 billion) in debt. In the United States, Micron Technology, the Idaho-based second largest producer of DRAMs, led a campaign against the support packages, arguing that they amounted to government-sponsored bailouts that allow Hynix to export at low prices and that they were a prime cause of the drastic plunge in global chip prices in 2001 and 2002. Micron, the last U.S.-based DRAM producer, eventually filed a countervailing duty case, which it won, resulting in a 44% punitive tariff being assessed against Hynix's exports to the United States. In a similar case, the European Union imposed a 34% countervailing duty against Hynix. Korea challenged both rulings in the WTO. A WTO panel was formed and in February 2005 ruled that the United States had failed to "properly demonstrate" that the Korean government had subsidized Hynix. The United States appealed in June 2005, the WTO's Appellate Body reversed the ruling, in part by using a definition of what government actions constitute a subsidy that is broader than the definition used by the panel.[55] Because Appellate Body decisions cannot be appealed, the United States' punitive tariffs will remain in place.

[55] "WTO Appellate Body Finds U.S. Can Keep Duties on Korean DRAMS," *Inside US Trade*, July 1, 2005.

Meanwhile, Hynix appears to have undergone a turnaround. It sold many of its non-semiconductor assets, introduced a program to upgrade its efficiency, completed its debt-workout program (in 2005, a year ahead of schedule), and in 2006 was the world's third-largest chipmaker by sales.[56]

South Korea's Performance in the Doha Development Agenda

In the current round of multilateral trade talks, the Doha Development Agenda, USTR officials consistently have praised South Korea for attempting to bridge the differences between the developed and developing countries, particularly on non-agricultural market access issues such as industrial tariffs and services. Seoul also has been criticized consistently for resisting agricultural liberalization in the negotiations. Korea's tariffs on agricultural products, except rice, average 66%, compared with a 7.5% average for tariffs on industrial products.[57]

Korea's Complaints Against U.S. Anti-Dumping and CVD Practices

For over a decade, South Korea has chafed at the United States' use of anti-dumping and countervailing duty (CVD) laws to raise tariffs on Korean exports. According to one study, in July 2000 the five CVD and 18 anti-dumping orders against South Korean exports covered approximately $2.5 billion, or over 7%, of U.S. imports from South Korea in 1999. Moreover, these tariff hikes have tended to be concentrated in a handful of Korean industries—semiconductors, steel, televisions, and telecommunications equipment—that have considerable political influence in Seoul.

During the Uruguay Round (1986-1993) of the General Agreement on Tariffs and Trade (GATT, the WTO's predecessor organization), Korea was one of several countries demanding revisions to global anti-dumping rules, changes the United States opposed because of concerns that they would constrain U.S. anti-dumping investigators. South Korea, joined most prominently by Japan, has taken up this issue again in the Doha Development Agenda talks, against U.S. opposition, and has made it a priority issue in the KORUS FTA talks.[58]

In recent years, Seoul has become more assertive in using the WTO to challenge United States' trade practices. In 1999 and 2000, Seoul took the U.S. to the WTO over allegedly discriminatory U.S. anti-dumping duties placed on Korean exports of steel and semiconductors. Korea won both of the steel cases it initiated.

[56] Economist Intelligence Unit, *South Korea Country Report*, February 2007.

[57] USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers*, p.290.

[58] In his address at the December 2005 Doha Development Round ministerial in Hong Kong, South Korean Trade Minister Kim said that a "tangible outcome" in anti-dumping was "indispensable" for South Korea. Statement by Mr Hyun Chong Kim Minister for Trade, World Trade Organization Ministerial Conference Sixth Session Hong Kong, WT/MIN(05)/ST/19 14 December 2005 (05-5992).

U.S. Visa Policies

South Koreans' complaints about U.S. visa policies tend to fall into two categories.[59] First, some Korean government officials, Korean businesses, the American Chamber of Commerce in Korea, and Korean-Americans have questioned why South Korea is not a participant in the U.S. Visa Waiver Permanent Program, under which foreigners traveling from certain countries are permitted to travel to the United States for up to ninety days without having the immigration documents normally required for entry.[60] Although South Korea's status in the U.S. Visa Waiver Program (VWP) is not formally part of the FTA negotiations, it is a priority the South Korean government is pursuing with the United States.[61] Any changes made by the United States in this area are likely to play a political role in selling the agreement in Seoul.

Among the statutory requirements for countries to participate in the U.S. visa waiver program is that the country must have a low nonimmigrant visa refusal rate for two years—averaging no more than 2% over both years and not exceeding 2.5% in any one year. According to State Department officials, South Korea's visa refusal rates have consistently been over this threshold. The FY2004 rate was 3.6% and according to one report, in early 2005 the rate again was below 4%.[62] Meeting the refusal rate is not the only requirement. A country's participation in the VWP must also be deemed to be in the economic, law enforcement, and security interests of the United States. Since the late 1990s, no country has been added to the VWP, an indication of the difficulty in meeting the participation requirements. For South Korea to become a participant would likely require significant attention from the White House. During his November 2005 summit with President Roh in South Korea, President Bush announced that the United States would work with Seoul to develop a "roadmap to assist Korea in meeting the requirements for membership" in the visa waiver program, a move that has been supported by a number of groups in the United States.[63] H.R. 4304, introduced in November 2005 by Representative James Moran, would designate South Korea as a program country under the VWP.

The second category of complaints is lodged against U.S. visa policies implemented since the September 2001 terrorist attacks on the United States, particularly requirements for mandatory interviews, fingerprinting, and greater scrutiny of business travelers for possible technology transfer risks. Like citizens of many other countries, Koreans particularly have objected to the fingerprinting, which some Koreans have likened to requirements imposed upon them during Japan's thirty-five-year occupation of the Korean Peninsula in the first half of the 20th Century.

[59] For more on U.S. visa policies, see CRS Report RL31512, *Visa Issuances: Policy, Issues, and Legislation*, by (name redacted).

[60] For more on the visa waiver program, see CRS Report RL32221, *Visa Waiver Program*, by (name redacted).

[61] For more on the U.S. Visa Waiver Program, see CRS Report RL32221, *Visa Waiver Program*, by (name redacted). Speech by ROK Ambassador to the United States Lee Tae-sik, "The Korea-US Alliance - A Partnership for the Future," February 7, 2006, Korea Economic Institute forum, The St. Regis Hotel, Washington, DC; Balbina Hwang, "A Bumpy Road for the U.S.—ROK Free Trade Agreement," *Heritage Foundation Executive Memorandum* No. 995, March 2, 2006. U.S. trade officials say they do not plan to include the VWP in the FTA negotiations. Spring 2006 conversations with U.S. officials. If the VWP, or any other immigration issue, is included in the FTA, those provisions could fall under the jurisdiction of the House and Senate Judiciary Committees.

[62] Balbina Hwang, "Including South Korea in the U.S. Visa Waiver Program," *Heritage Foundation Backgrounder* No. 1872, July 25, 2005.

[63] "Joint Declaration on the ROK-U.S. Alliance and Peace on the Korean Peninsula," White House Office of the Press Secretary, November 17, 2005.

South Korea also has encouraged the United States to open its domestic market to services delivered by so-called mode-4 delivery, that is by the temporary movement of South Korean service providers and their workers to the United States.[64]

Legislation in the 109th and 110th Congresses

109th Congress

S. 3830 (Stabenow). The South Korean Fair Trade Act. Declared that the duty in effect on July 31, 2006, on cars and motor vehicles imported from South Korea shall remain in effect until 15 days after the date the Secretary of Commerce certifies to Congress that at least 20% of the total number of cars and motor vehicles sold in South Korea each year are made in a country other than South Korea. Introduced August 3, 2006; referred to Senate Finance Committee.

S. 377 (Lieberman). The Fair Currency Enforcement Act of 2005. Required the U.S. government to monitor and take action against specific countries, including South Korea, that are "engaged most egregiously in currency manipulation." Introduced February 15, 2005; referred to Senate Finance Committee.

H.R. 4304 (Moran). Designated the Republic of Korea as a program country under the visa waiver program. Introduced November 10, 2005; referred to House Judiciary Subcommittee on Immigration, Border Security, and Claims.

110th Congress

No bills have been introduced in the 110th Congress.

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[64] South Korean government report to the National Assembly, "Negotiating Objectives of Korea-U.S. FTA," translation provided by the U.S. Embassy.