

Korea-U.S. FTA: A Path to Sustainable Growth*

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It's a real pleasure for me to be able to meet with the Institute for Global Economics this morning. I heard great things about this organization even before I left Washington to move to Seoul. So my thanks go to Dr. Sakong Il for offering me this opportunity to speak with you today.

As you all know, less than two weeks ago U.S. Trade Representative Rob Portman and Korean Trade Minister Kim Hyun-Chong announced the launch of Free Trade Agreement negotiations between the United States and Korea. That event marked a major milestone in the history of bilateral relations between our two countries. It also represented a milestone in the development of deeper economic links across the Pacific Ocean between North America and Northeast Asia.

Today I would like to focus primarily on the relationship between trade liberalization and economic growth. More specifically, the relationship between the U.S.-Korea FTA and responses to some of the key economic development challenges facing Korea at this important juncture in its economic history.

Today is also a very important day, certainly for Americans. It is Valentine's Day. That means I need to remember to get flowers for my wife Lisa. It also means it's a good day to talk about deepening relationships, whether those are trade and investment relationships, or romantic relationships.

I was surprised to learn that Valentine's Day actually dates back to pre-Christian Rome and the annual feast of Lubercus. Every February during that feast, the names of young maidens were put in a box. Boys would draw out names to decide who would be their girlfriend for the next year, which began in March. The couple would then stay together for a year, until the following March.

It's not an exact parallel, obviously. If we agree on the terms of a Free Trade Agreement, the new economic relationship between Korea and the United States will last much longer than March 2007. But March 2007 is important as it is our rough deadline for completing the negotiations. And our Chief Negotiators -- one a boy and the other a girl, by the way -- will be dating frequently over the coming twelve months.

Trust me, however, that the selection process for choosing partner nations for the U.S.-Korea FTA negotiation was more scientific than drawing names out of a box.

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Attractions for the United States

So, why is Korea an attractive FTA partner for the United States? Let me cite four of the most important reasons.

First of all, Korea has a large and advanced economy. In fact, Korea is the United States' seventh-largest trading partner, with two-way goods trade in 2004 valued at \$73 billion. This makes the U.S.-Korea FTA our most ambitious FTA undertaking since we began negotiations with Canada and Mexico 15 years ago. So just from a commercial perspective, this is a very big opportunity for both sides.

The overwhelming benefits of a U.S.-Korea FTA justify the effort. The latest Korean government research predicts that a U.S.-Korea FTA would increase Korea's real GDP by as much as 2%, boost exports to the United States by 15%, and raise manufacturing employment by 6.5%. For the United States, the economic impact is also expected to be significant, around 0.2% of GDP, which is a lot for our \$11 trillion economy.

Beyond economics, the second reason why these FTA talks are such a good idea is because Korea is an important ally of the United States, and a key geo-strategic partner in the Northeast Asian region. Let me read to you from a statement by President Bush issued on February 3. The President said:

"The United States and the Republic of Korea have a strong alliance and are bound together by common values and a deep desire to expand freedom, peace, and prosperity throughout Asia and the world... A Free Trade Agreement with the Republic of Korea will provide important economic, political, and strategic benefits to both countries and build on America's engagement in Asia."

Completing a Free Trade Agreement can only make the bilateral U.S.-Korea relationship even stronger.

Third, there is an important regional dynamic to a U.S.-Korea FTA. This FTA will help cement trans-Pacific economic ties, and add balance to regional economic relations. More than some other Asian nations, perhaps, Korea seems to have a clear understanding of the importance of Asian nations reaching across the Pacific to forge strong economic ties with North America.

From the American perspective, we hope that the U.S.-Korea FTA will further strengthen Korea's leadership role in Northeast Asia. We hope that the increased trade and investment between Korea and the United States resulting from this FTA will help inspire Japan, China and others to accelerate their own market opening and economic reform.

Fourth, and finally, looking at Korea's internal economic structure, we hope that a U.S.-Korea FTA will help Korea's reform-minded economic leaders to continue to strengthen the Korean economy, through further market opening and economic policy

reform. Since the 1997 Asian financial crisis, under strong leadership, Korea has taken a series of important steps to open and reform its economy, which have continued to this day. We hope that the FTA talks will provide an important opportunity to lock in and build on these reforms.

Attractions for Korea

I would like to spend some more time today discussing this final point -- the benefits of the U.S.-Korea FTA in helping to promote economic reform and economic growth in the Republic of Korea. As indicated by the title of my address today, I believe that the U.S.-Korea Free Trade Agreement will help significantly in promoting sustainable economic growth here in South Korea.

During his New Year's address on January 18, President Roh first spoke about the U.S.-Korea FTA, saying: "We should conclude a Free Trade Agreement with the United States for the future of our economy." This strikes me as a profoundly wise statement. Notice the reason the President cites. It's not a short-term vision. President Roh was talking about making the Korean economy stronger in a lasting way.

Amplifying President Roh's view, Trade Minister Kim Hyun-Chong has frequently referred to Korea's FTA with the United States as an "invisible infrastructure." His point is that Korea invests heavily, and intelligently, in physical infrastructure. Similarly, Korea can and should invest in intangible infrastructure, such as by linking the Korean economy more closely to the largest and most advanced economy on the planet, the United States. As Minister Kim has said, Korea "will learn from the United States, compete with it in some areas, and have the opportunity to grow into a developed economy."

Challenges to Long-Term Sustainable Growth

Let's explore for a moment what are the biggest long-term growth challenges for the Korean economy. One is clearly the problem of Korea's rapidly aging labor force, and its growing retirement-age population.

Aging Population: Now, I am not a professional economist by training. And I expect that most of you in this room could explain this problem more fully than I can. But it is clear even to a layman that when it comes to the aging population, Korea faces a major dilemma.

According to some calculations, Korea is experiencing the most rapid fertility rate decline in any major country in human history. This will, of course, have a huge impact on social expenditure, the nation's long-term fiscal position, and the composition of the labor force and Korea's general industrial capability. It could even have some impact on Korean culture and society.

Basic economic growth theory says that sustained growth will be harder to achieve when the labor force is not growing -- following the simple equation of labor growth, plus capital, plus productivity growth, equals total growth. At the same time, social costs could become prohibitively expensive without growth.

What to do about this situation? It's not an original argument, but given the finite availability of domestic capital, the key solution must be productivity growth. The goal is to produce more, especially in services, using fewer people.

At the same time, the economy should endeavor to attract as much foreign capital as possible. Foreign capital is among the best capital available because, along with cash, it tends to bring and introduce new technologies, both "hard technologies" and "soft technologies" such as new business management practices.

This is where the U.S.-Korea FTA comes in. We expect that with a U.S.-Korea FTA, we will see an acceleration of Korean investment in the United States to take advantage of improved business opportunities. But an FTA will also have a profoundly positive impact on foreign investment in Korea. All previous American FTA partners have seen a sharp increase in U.S. direct investment. For example, U.S. investment in Mexico jumped from \$4.4 billion pre-NAFTA to \$13.2 billion after NAFTA. Our only other Asia-Pacific FTA partners, Singapore and Australia, also experienced increased inward foreign investment.

Polarized Economy: A second key challenge to the Korean economy in the medium and long term is the problem that is commonly referred to as the polarization of the economy.

President Roh has made this a major theme of his presidency. As he explained in his New Year's speech: "The divide between conglomerates and small and medium enterprises, and between regular and irregular employees is growing wider." Again, I think President Roh's analysis is right on the mark. It's quite apparent to most observers that a bifurcation -- or splitting in two -- of the Korean economy is becoming increasingly clear. Significantly, as President Roh said, this is happening on both the business front and the labor front.

In business terms, a relatively small group of technologically advanced manufacturing firms -- those with the capability of reaching world markets -- has enjoyed an immense export boom. That group is investing more overseas, financed by vibrant but narrow corporate bond and stock markets. Meanwhile, a second group of less technologically advanced, more domestically oriented smaller firms is struggling to stay alive, while finding it increasingly difficult to attract bank financing.

In labor terms, Korea also has an unusual situation -- where a relatively small group of workers enjoy both high wages and high job security, while others experience both lower wages and lower job security. Some unionized workers take advantage of their employment at profitable firms to demand wages, rights, benefits and job security that arguably exceed the increases in their productivity, making it hard for those firms to hire more regular employees. Meanwhile, non-union workers at smaller firms, and

irregular and temporary workers at large firms, are seeing only slow improvement, or even declines, in their real incomes.

What's to be done in such a situation? It appears to me that the key is to create new growth opportunities in new economic areas -- not necessarily manufacturing -- but in areas where better investment and employment opportunities can be generated to try to bridge the gap.

Here, again, I believe there is an important role for the U.S.-Korea FTA to play in helping build Korea's "invisible infrastructure." Increased foreign investment can play an important role in helping fill gaps in the Korean economy. But the FTA will also help by promoting service sector deregulation, particularly in financial services, but also in other key service sectors. More sophisticated financial services methodologies introduced as the result of deregulation will inevitably help spur the development of venture capital and start-ups, creating new growth opportunities. In addition, the regulatory transparency provisions of the FTA should help accelerate deregulation of the real (non-financial) economy as well, creating even more avenues for investment and job creation.

To some extent, the "polarization" disparities now evident in the Korean economy are the inevitable result of the rapid growth and structural reforms that have already taken place. Some parts of an economy always grow faster than others, and some workers and businesses adjust more quickly than others to changing circumstances. But polarization remains a problem to be addressed, and it's a similar problem, frankly, to what we face in the United States. Rather than trying to force high-performing capital into new segments of the economy, it needs to be lured into those segments. Investment in the gaps of the economy must be attracted -- it cannot be dictated. Certainly, no measures should be taken to restrict investment in some areas in order to try to force investment into others. It is also not wise for the government to act as a major financial intermediary.

Fortunately, it is clear that the Roh Administration understands that reform and growth are the ways to deal with the polarization and aging society dilemmas. The United States is highly pleased and excited that we have been invited to participate in this vision, through the pursuit of a U.S.-Korea Free Trade Agreement.

The Strategic Context: 이 "Completing U.S.-Korea Relations" 이

Finally, let me discuss just a bit more the strategic context of the U.S.-Korea FTA talks.

Last week, Vice Foreign Minister Yu Myung-hwan called the FTA talks "a bold move to complete Korea's strategic alliance with the United States." I couldn't agree with him more.

Sometimes when things happen gradually, they don't get noticed. But what has gradually happened in the history of U.S.-Korea relations is that a plain military

alliance that was established to protect South Korea from North Korea's declared aim of reunifying the peninsula under communist rule by force has step-by-step expanded and graduated, and emerged into an important global partnership.

During their Gyeongju summit meeting in November, President Bush and President Roh agreed to launch a high-level strategic dialogue called the Strategic Consultation for Allied Partnership, reflecting Korea's increasing international standing and its growing role on the world stage. In January I attended the first of these consultations in Washington and I am happy to report that we had an excellent discussion on bilateral, regional, multilateral and global issues.

Our alliance really has taken on a global dimension. The United States and the Republic of Korea are working side-by-side to rebuild Iraq and Afghanistan as part of the international effort to bring freedom, peace and democracy to those nations. We appreciate that Korea recently extended the mission of its troops in Iraq for an additional year.

Alongside countries from across the globe, the Republic of Korea has also sent humanitarian assistance to regions hit hard by natural disasters, such as the tsunami in Southeast Asia, the earthquake in South Asia, and the hurricanes in the United States. It is a measure of Korea's stature in the world today that the ROK contributed \$30 million to aid the victims of Hurricane Katrina. That assistance will help Americans who suffered from one of the worst natural disasters in our history, and we are grateful.

Here in Northeast Asia, our bilateral efforts to increase international cooperation and ensure stability are evident in our work together in the Six Party Talks. As President Bush and President Roh said at Gyeongju, we are committed to the peaceful resolution of the North Korean nuclear issue through diplomatic methods, but we will not tolerate a nuclear-armed North Korea. I hope that talks will resume soon. It is in the interests of all countries and peoples, but most especially it is in the interests of the North Koreans themselves that the DPRK shed the albatross of its nuclear programs and join the international community.

Collective prosperity also depends on the health of each nation's people. One issue that urgently requires international attention is the threat that avian influenza could lead to a human pandemic. When the weather turns cold, we are all to some extent thinking about catching colds and flu, but the dangers posed by an influenza pandemic are quantitatively different, as the 1918 case graphically shows. Preventing a pandemic and minimizing the damage if one emerges will uniquely require international cooperation. Washington and Seoul are working together on this important issue. Both our countries are founding members of the International Partnership on Avian and Pandemic Influenza launched by President Bush at the United Nations this fall.

Another measure of the strength of our alliance is the numbers of people-to-people exchanges. The U.S. Embassy processed over 400,000 visas in our fiscal year that ended in September 2005, and we hope to process as many as 500,000 in the 2006 fiscal year. The U.S. Embassy issues more than 65,000 student visas, making Korea

the third largest source of foreign students in the U.S. Since the terror attacks on September 11, we have been required to institute additional security procedures, but wherever we can we have worked to streamline the process. In the Gyeongju summit, President Bush said that the United States will work with the ROK to “develop a Visa Waiver Program roadmap to assist Korea in meeting the requirements for membership in the program.” I personally am committed to this issue, because as you know our alliance is not just between governments but between our two peoples, and I want to ensure that as many Koreans as possible have the opportunity to visit the United States.

As I mentioned earlier, we are working closely with the Korean government to modernize our defense alliance to better meet our shared goals and better serve our peoples. We plan to consolidate and relocate several bases away from population centers, return some bases such as Yongsan Garrison to the Korean people, and transfer more missions and authority to Korea’s armed forces. Over the next few years, we plan to spend \$11 billion to upgrade U.S. forces in the region to improve our ability deal with any contingency on the Peninsula or beyond. By moving our troops out of places like the heart of Seoul, we will lay the groundwork for keeping our alliance strong for decades to come; and by improving the quality of our forces; we will ensure the effectiveness of our deterrent for decades to come.

In short, U.S.-Korea relations are advancing in a positive way on several fronts. Today, on Valentine’s Day, we are lucky enough to be able to meet and discuss how conclusion of a U.S.-Korea Free Trade Agreement will help complete our alliance, and raise U.S-Korea relations to next level.

Thanks again for the opportunity to address the benefits of a U.S.-Korea FTA, and now I look forward to your questions and comments.

Questions & Answers

[Q] As you may know, five Korean major economic organizations advertise largely in local newspapers explaining the benefits of FTA, which with the U.S. supports successful negotiation and conclusion of this FTA agreement. My question is, are there any U.S. economic organizations or interest groups in favor of FTA with Korea, and what are the reasons for their support? And are there any interest groups that are not in favor of the FTA, and what are the reasons for their opposition? Lastly, don’t you think there should be a general rule that should allow some exceptions to this agreement for mutual benefits that will keep away objections of some interest groups of both countries?

[A] On the first question, a number of U.S. business and trade organizations have indeed come out quite strongly in favor of an FTA, including the American Chamber of Commerce here in Korea, the U.S. Chamber of Commerce, and the U.S.-Korea Business Council; I don't have the whole list memorized yet but I will soon. I haven't heard of any organizations that have come out against an FTA, although, some sectors of our economy may be more cautious, waiting to see what the results will be for their industries. But I think everyone in America is persuaded that this will be a major boost to our economy, and to Korea's economy. I think it's a very classic win-win situation.

To your second question, as a matter of principle, we have always negotiated comprehensive FTAs that cover the full spectrum of goods and services, and that's what we aim to do in this FTA. Obviously some sectors will be more sensitive when it comes to negotiating concrete provisions, and there may be somewhat different treatment between one area and the next. But of course I don't want to anticipate the actual negotiations and we think market opening is the best solution. So we hope we will find a balanced approach that doesn't make exceptions, but that comes up with mutually acceptable formulae for the sensitive issues.

[Q] Thank you for sharing your assessment of the significance of the FTA to Korea and our economy. As a Korean, I think I speak for everyone here when I say that I think we will enjoy a tremendous benefit from this FTA as far as Koreans are concerned. You basically emphasized the benefits that the FTA will bring to Korea on the macro level in terms of investment, but in order to secure broader based popular support and overcome the resistance from the farmers etc. in this country probably it would be better to supplement that with emphases on the long-term impact of this FTA on the Korean cultural industry, and my belief is that in the long-term, this FTA could be the key to sustainable development of the global economy as well as Korean cultural industry. With that as background, I believe this window of opportunity for FTA between our two countries would remain open for only several months from now, and once it's closed, it will not return to us over the next two decades and maybe never. So this is a very critical juncture. I have two questions. First, are there any chances of this FTA, once it is negotiated, being defeated in the U.S. Congress? And second, I think one unexpected stumbling block could be a disagreement on how to treat the Kaesong industrial complex in the language of this FTA. Is there any view that you can share with us on that issue as well?

[A] On your general point on the impact on the rural economy, it's clear that there are members of the farm sector that are worried about the impact of the FTA, and this will be a sensitive part of our negotiations. But I think this is also an opportunity for

reforming the agricultural sector, and we're pleased to see the government has already announced measures that will be undertaken over the next ten years to conduct such reforms to redirect some of the less-profitable, less-economically competitive areas of production into other areas where they may be more sustainable in the long-term. So I think that's the positive way to look at the potential impact of the FTA: to use it as the framework for conducting necessary reforms that will ultimately benefit not only the rural sector but the wider economy by promoting a more rational use of resources. And of course these kinds of decisions will have to be made on the American side too. So regarding the possibility of rejection by the U.S. Congress, of course it is possible. Trade Agreements are always controversial in American debate, and the ones that have been approved have been approved by very slim majorities. So it will be important, as we conduct these negotiations, to be sensitive to the issues of the other party and to be sure that we come up with a result that can pass scrutiny by the Korean National Assembly and the U.S. Congress. That is certainly our objective.

Regarding the Kaesong industrial complex, I would say, first of all, that the U.S. has supported South Korea's efforts to engage North Korea commercially through projects like the Kaesong industrial complex, and we have even made the effort to provide necessary licenses for the transfer of certain technologies for use in Kaesong. That being said, how Kaesong is treated under the FTA is going to be a complex issue. The starting point is that an FTA applies to goods originating in the U.S. and the Republic of Korea. But there will be negotiation, and I think it best not to anticipate what will take place in the negotiation through the media.

[Q] I fully share your views of the beneficial impact of the U.S.–Korea FTA. As you said it should be very comprehensive. You said that the Korea–U.S. FTA should end by March next year. Considering that they should be comprehensive, you also mentioned they should touch on perspective of the industry, where negotiation may take longer than the deadline you set of March next year. If we fail to reach a conclusion by that deadline, can we work towards a medium quality FTA leaving the sensitive issues aside?

[A] It's true that this is not only the biggest FTA that we've negotiated in 15 years, but it also has to be the fastest FTA that we've ever negotiated. However, we're optimistic that it can be done. We don't start from a blank sheet of paper, we have been discussing these issues with our Korean partners for several years, and we have already had preliminary discussions on what are to be the key issues to be discussed in the FTA. So when formal negotiations begin in May, I think we'll be ready to get off to a quick start with text on the table. I think that deadlines tend to focus peoples' minds, and if you don't have much time, you're forced to focus on what is really important. With the political will that is clearly present on both sides, we should be able to meet the deadline. I don't think we can count on Trade Promotion Authority

being renewed beyond July 1, 2007, so we really need to get this done, and adopt the model of some of our astronauts of the past, when I say that "failure is not an option."

And as far as high quality versus medium quality, I think we should maintain a high level of ambition at this stage. There will have to be flexibility on both sides as we go through this negotiation, but if we settle for a medium quality FTA, that may be harder to sell to our parliaments. So I think it better to go for the big prize that I think is attainable.

[Q] How closely are FTA policies related to other security issues or policies in the process of negotiation? In other words, are there other factors that might affect the negotiations?

[A] As I said in my remarks, we view the FTA as an important way to strengthen the foundation of our wider strategic partnership, and I think that will in and of itself make it easier for us to find common ground on different issues whether it is how to deal with future security challenges in Northeast Asia, or how to find ways to cooperate against proliferation. But I don't think the FTA negotiations will be directly affected by our work in these other areas. It will affect the larger strategic context for our partnership. Perhaps Congress will be favorably influenced by the fact that our overall political and security relationship is strong, and hopefully that will make them look at the FTA in a more positive frame of mind, but of course they will ultimately be judging it on its economic impact. That's why we are aiming to achieve the best possible result for both countries -- the high quality FTA that we are striving for.

[Q] I first have a couple comments on previous questions. First on the possibility of having medium quality FTA, I think we have to be very careful there. It raises the question of having a comprehensive regional trading agreement, but I think it's important to have a very high quality and comprehensive package of course, and in terms of timing, I think our countries have enough time, and as you know Koreans are very good at doing things quickly. But my question is on the regional impact, especially on Japan. When I wrote a book on this issue four years ago, I remember writing a sentence saying, "a successful U.S.-Korea FTA would trigger Japan's reaction to consider possible Japan-U.S. FTA in the near future, perhaps immediately following the U.S.-Korea FTA". What is your assessment of this.

[A] I would agree that our success in reaching a U.S.-Korea FTA will have a very strong impact on other countries in the region and will encourage them to open their

markets, if only because they will be worried about losing in the competition. Whether this leads to interest in an actual FTA, I cannot say, but it is quite possible. But for now we are focused on the immediate task of translating the theory into the practice of a U.S.-Korea FTA, and if we succeed, I think it will have an inspirational effect on the rest of the region, which can only be to the good of everyone's economies.