

# Executive Summary Backgrounder

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## Complaints About North Korean Imports a Smoke Screen for Trade Protectionism

*Bruce Klingner*

After years of needless delay, the South Korea–U.S. free trade agreement (KORUS FTA) is finally gathering momentum for congressional approval. Several key Members of Congress who previously opposed the FTA are now advocating its implementation. However, some die-hard opponents are making a last-ditch effort to stoke resistance to the agreement. The most egregious myth is that North Korean goods will freely enter the U.S. market via the North Korean Kaesong Industrial Complex (KIC), resulting in America’s *de facto* subsidization of Kim Jong-il’s regime.

**KORUS FTA Does Not Allow North Korean Goods into the U.S.** Goods produced in the KIC are not eligible to be imported into the United States under the agreement’s provisions, nor can North Korea receive the benefits of the FTA. Footnote 2 of Chapter 1 states clearly that “[a] natural person who is domiciled in the area north of the Military Demarcation Line on the Korean Peninsula shall not be entitled to benefits under this Agreement.” Then-U.S. Trade Representative Susan Schwab affirmed to Congress in 2007 that “goods made in the KIC are not eligible for FTA tariff preferences.”

**Rules of Origin Are Not a Loophole.** Opponents claim that KORUS FTA rules of origin would surreptitiously allow North Korean goods from Kaesong to be imported into the United States. Rules of origin are far more technical and complicated than a simplistic “100 percent minus 35 percent equals 65 percent” allowable North Korean content. Virtually

any product exported under the KORUS FTA would be far more than 35 percent South Korean in origin.

Moreover, U.S. sanctions against North Korea always trump the KORUS FTA. As long as U.S. sanctions against North Korea remain in place, the allowable percentage of Kaesong content in South Korean goods is zero. Title 31 Part 500 of the U.S. Code of Federal Regulations states that “Goods of North Korean origin may not be imported into the United States either directly or through third countries, without prior notification to and approval of the Office of Foreign Assets Control.” Executive Order 13570 similarly declares that “the importation into the United States, directly or indirectly, of any goods, services, or technology from North Korea is prohibited.”

**KORUS FTA Does Not Supersede U.S. Sanctions.** The KORUS FTA specifically allows the U.S. to maintain any existing measures against North Korean imports into the United States: “Nothing in this Agreement shall be construed... to preclude a Party from applying measures that it *considers* necessary for...*the protection of its own essential security.*”

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**Deliberative/Legislative Process for Expanding KORUS FTA.** The only way in which Kaesong could later be included in the KORUS FTA is through a deliberative, bilateral process. Annex 22B of the KORUS clearly describes how a joint South Korea–U.S. committee would first need to certify any “outward processing zone” based on specified prohibitive criteria that include (among others) “[North Korean] progress toward denuclearization of the Korean Peninsula.” Deputy U.S. Trade Representative Demetrios Marantis testified in April 2011 that “[a]ny change to how Kaesong is treated under the agreement would require Congress to pass and the president to sign legislation. . . . [T]here is nothing in this agreement that provides any benefits to Kaesong [and] *Congress has the final word.*”

**Seoul Cannot Declare Kaesong To Be Part of South Korea.** The KORUS FTA specifically defines the territory of South Korea as “the land, maritime, and air space over which Korea *exercises sovereignty*, and those maritime areas, including the seabed and subsoil adjacent to and beyond the outer limit of the territorial seas over which it may exercise sovereign rights or jurisdiction in accordance with international law and its domestic law.” Title 31 Part 500.328 of the U.S. Code of Federal Regulations similarly defines South Korea as “those portions of Korea which are *under the control of the government of the Republic of Korea.*”

**Kaesong on Life Support.** Contrary to original grandiose predictions, the KIC has failed to meet even modest expectations, and the future of the business venture appears bleak. Currently, there is little South Korean corporate advocacy for, economic incentive for, or political interest in expanding the KIC. Since May 2010, Seoul has prohibited

new investment in the KIC in retaliation for North Korea’s sinking of a South Korean naval vessel.

The predicted benefits of cheap labor were unable to compensate for North Korean resistance to capitalism and economic reform, frequent production stoppages, security risks, declining business interest, and Pyongyang’s belligerent actions. North Korea’s annual income from Kaesong is only \$30 million–\$60 million.

**What Should Be Done.** Congress should reject the protectionists’ arguments. The current KORUS FTA text and existing U.S. laws are sufficient to prevent the import of North Korean goods into the United States.

Rather than dwelling on politicized fiction, Congress should focus on how the KORUS FTA would increase U.S. exports by \$10 billion–\$11 billion annually, improve the U.S. trade balance with Korea by \$3 billion–\$4 billion, and generate an estimated 70,000 jobs without any cost to U.S. federal or state governments. The KORUS FTA would also serve as a powerful statement of U.S. commitment to East Asia and reduce a key ally’s vulnerability to Chinese pressure by decreasing South Korea’s economic reliance on Beijing.

Rejecting the KORUS FTA would needlessly disadvantage U.S. companies by locking in outdated and unbalanced rules. Congress’s failure to approve this agreement has cost our nation \$40 billion in potential exports over the past four years. If it rejects the agreement now, only foreign competitors will benefit.

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# Background

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## Complaints About North Korean Imports a Smoke Screen for Trade Protectionism

*Bruce Klingner*

After years of languishing before Congress, three U.S. free trade agreements—with South Korea, Colombia, and Panama—are finally gathering momentum for congressional approval. Additional measures to ameliorate criticisms (both valid and invalid) have been implemented, and several key Members of Congress who previously opposed the FTAs are now advocating their implementation.

The accords will not, of course, achieve unanimous support, either because of ideological resistance to free trade agreements or because of lingering criticism that specific clauses were not sufficiently generous to particular industries or congressional districts. Such is the nature of the legislative process.

However, some die-hard opponents of free trade continue to use red herrings to stoke resistance to the agreements. For the South Korea–U.S. (KORUS) FTA, the most egregious such claim is the allegation that North Korean goods will freely enter the U.S. market via the North Korean Kaesong industrial zone, resulting in America's *de facto* subsidization of Kim Jong-il's regime. Despite the fact that such assertions are contrary to existing U.S. law and have been rebutted repeatedly by U.S. officials, the purveyors of this myth continue to spread it.

The tragedy is that the KORUS FTA, which experts estimate could increase U.S. exports by \$10 billion–\$11 billion annually and generate at least 70,000 new U.S. jobs, is being targeted because of a struggling South–North Korea joint industrial zone that nets Pyongyang a mere \$50 million annually. Allow-

### Talking Points

- Contrary to claims by trade protectionists, the KORUS FTA does not allow North Korean goods into the U.S. Goods produced in the Kaesong Industrial Complex are not eligible to be imported into the United States even as components in South Korea products.
- U.S. sanctions against North Korea always trump the KORUS FTA. As long as U.S. sanctions against North Korea remain in place, the allowable percentage of Kaesong content in South Korean goods is zero. The agreement specifically allows the U.S. to maintain existing measures against North Korean imports.
- Congress must reject protectionist efforts to undercut a free trade agreement that would significantly benefit the United States.
- The KORUS FTA would increase U.S. exports by \$10 billion–\$11 billion annually and add an estimated 70,000 jobs without any cost to U.S. federal or state governments.

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ing this industrial zone to scuttle the deal would be a case of throwing the whole family, not just the baby, out with the bathwater. The four-year delay since the agreement was signed has already cost the United States \$40 billion in lost exports.

### Kaesong Industrial Complex

The Kaesong Industrial Complex (KIC) is a joint economic venture in which South Korean companies have established factories in a North Korean enclave 10 miles north of the demilitarized zone. Although touted as a way for South Korean firms to use inexpensive North Korean labor for low-end products, the economic initiative's goals were primarily political. The liberal Roh Moo-hyun administration, which has since been replaced by a conservative government, pursued a vigorous and mostly unconditional engagement policy toward North Korea in hopes that Pyongyang would moderate its belligerent behavior and implement economic reforms.

President Roh sought to make Kaesong economically viable by securing foreign markets for goods produced at the industrial complex. Toward that end, his administration attempted to place language in the KORUS FTA that would consider Kaesong products as having originated in South Korea and thus gain duty-free status. The United States steadfastly refused to include such language in the agreement since it did not want to provide economic benefits to the North Korean regime, particularly after Pyongyang violated the Agreed Framework and conducted nuclear and long-range missile tests.

The 2007 KORUS agreement made no mention of Kaesong but did provide a face-saving gesture for South Korea that allowed for the theoretical possibility of eventual inclusion of products from an outward processing zone—if an arduous and

lengthy series of preconditions were met. While South Korean politicians claimed victory, the reality was that, for Kaesong to be included in the KORUS FTA, North Korea would have to implement significant changes in its nuclear weapons programs and improve its human rights record—steps that, for decades, it has refused to take.

### KORUS FTA Does Not Allow North Korean Goods into the U.S.

The KORUS FTA is an accord between the sovereign nations of South Korea and the United States. Therefore, goods produced in the KIC are not eligible to be imported into the United States under its provisions.

- In April 2007, then-Deputy U.S. Trade Representative Karan Bhatia publicly commented, “This agreement is with South Korea, not North Korea. No goods from North Korea can flow into the U.S. under this agreement.”<sup>1</sup> Bhatia affirmed this position during testimony before the House Foreign Affairs Committee in June 2007. “The issue is very simple,” Bhatia explained. “There is no coverage of North Korean goods in this agreement.”<sup>2</sup>
- In response to a 2007 congressional inquiry, then-U.S. Trade Representative Susan Schwab affirmed that the KORUS FTA “would be between the United States and the Republic of Korea and would only cover goods from those countries. As a result, the KIC is not explicitly mentioned or covered anywhere in the FTA, and *goods made in the KIC are not eligible for FTA tariff preferences.*”<sup>3</sup>
- In March 2011, Assistant Secretary of State Kurt Campbell testified before the House Foreign Affairs Committee that the U.S. had made it clear to South Korea that “we will not import goods produced in North Korea.”<sup>4</sup>

1. Annie I. Bang, “Korea, U.S. at Odds over Products Made in Gaeseong,” *Korea Herald*, April 10, 2007, at <http://www.koreaherald.com/specialreport/Detail.jsp?newsMLId=20070410000050> (May 6, 2011).
2. Hearing, *The United States–South Korea FTA: The Foreign Policy Implications*, Subcommittee on Terrorism, Nonproliferation, and Trade, Committee on Foreign Affairs, U.S. House of Representatives, June 13, 2007, at <http://foreignaffairs.house.gov/110/36060.pdf> (May 6, 2011).
3. Susan Schwab, U.S. Trade Representative, letter to Representative Edward Royce (R–CA), May 9, 2007, reprinted in *ibid.* Emphasis added.
4. “US: SKorea Trade Pact Will Bar Imports from NKorea,” *Business Week*, March 31, 2011, at <http://www.businessweek.com/ap/financialnews/D9MAFHPO1.htm> (May 7, 2011).

North Korea cannot receive the benefits of the KORUS FTA. Footnote 2 of Chapter 1 (Initial Provisions and Definitions) states, “A natural person who is domiciled in the area north of the Military Demarcation Line on the Korean Peninsula shall not be entitled to benefits under this Agreement.”<sup>5</sup>

### Rules of Origin Are Not a Loophole

Opponents have claimed that KORUS FTA rules of origin would surreptitiously allow North Korean goods from Kaesong to be imported into the United States. In this manner, it is claimed, the agreement would lead to an indirect U.S. subsidy of the nefarious Kim Jong-il regime since it appears—from an uninformed reading of the agreement—that up to 65 percent of all South Korean exports could be of foreign, including North Korean, origin.

Rules of origin are far more technical and complicated than a simplistic “100 percent minus 35 percent equals 65 percent.” For example, under the agreement, 35 percent of the net cost of South Korean automobiles must be South Korean in origin. However, the “total cost of the product” refers to more than just the component cost; labor, advertising, transportation, and research and development must also be considered. The result is that virtually any product, particularly autos, exported under the KORUS FTA would be far more than 35 percent South Korean in origin.

More important, however, is the reality that U.S. sanctions against North Korea always trump the KORUS agreement. Regardless of the technical characteristics of any KORUS rules of origin, as long as U.S. sanctions against North Korea remain

in place, the allowable percentage of Kaesong content in South Korean goods is zero. The only way for KORUS rules of origin to allow Kaesong products, including components, to be imported into the United States would be if Washington first removed its sanctions against North Korea.

The KORUS agreement includes provisions that separate eligibility for tariff preferences from admissibility into the United States. According to Chapter 6, footnote 1, “For greater certainty, whether a good is originating is not determinative of whether the good is also admissible.”<sup>6</sup> This means that just because a product may be eligible to receive tariff benefits does not guarantee that it can be imported into the United States.

In March 2011, a U.S. Treasury official emphasized that “North Korean products could not be imported to the United States if used as components of South Korean finished goods without prior review by Office of Foreign Assets Control, based on guidance from the State Department.”<sup>7</sup> In 2010, total North Korean imports into the United States were worth approximately \$9,000.<sup>8</sup>

In April 2011, President Obama approved Executive Order 13570 (Prohibiting Certain Transactions with Respect to North Korea), which declares that “the importation into the United States, directly or indirectly, of any goods, services, or technology from North Korea is prohibited.”<sup>9</sup> The executive order precludes the importation of any goods from North Korea except those that are specifically licensed after the U.S. government has reviewed a detailed application and determined that it is consistent with U.S. national security interests.

5. Free Trade Agreement Between the United States of America and the Republic of Korea (hereafter KORUS FTA), Chapter 1 (Initial Provisions and Definitions), footnote 1, June 30, 2007, at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file816\\_12698.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file816_12698.pdf) (May 4, 2011).
6. Korus FTA, Chapter 6 (Rules of Origin and Origin Procedures), Section A (Rules of Origin), Article 6.1 (Originating Goods), footnote 1, June 30, 2007, at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file680\\_12704.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file680_12704.pdf) (May 19, 2011).
7. Ben Hancock, “USTR, Korea Push Back on Kaesong Allegations from House Members,” *Inside US Trade*, March 25, 2011, at <http://www.bghancock.com/records/trade-kaesong1> (May 3, 2011).
8. Mark Toner, Acting Deputy Spokesman, State Department Daily Press Briefing, April 19, 2011, at <http://iipdigital.usembassy.gov/st/english/texttrans/2011/04/20110419195531su0.3139109.html#axzz1LybasSkM> (May 9, 2011).
9. The White House, “Prohibiting Certain Transactions With Respect to North Korea,” Executive Order 13570, Section 1, April 18, 2011, at <http://www.whitehouse.gov/the-press-office/2011/04/18/executive-order-prohibiting-certain-transactions-respect-north-korea> (May 5, 2011).

The “indirectly” clause applies to North Korean parts, components, or labor that are incorporated into products made in other countries. It would therefore prevent Kaesong parts incorporated into South Korean goods from being imported into the United States.

### **KORUS FTA Does Not Supersede U.S. Sanctions**

The KORUS FTA does not override—and could never be in conflict with—current U.S. laws prohibiting the import of North Korean products. The agreement even contains text that specifically allows the U.S. to maintain any existing measures against North Korean imports into the United States.

Title 31 Part 500 of the U.S. Code of Federal Regulations states that “Goods of North Korean origin may not be imported into the United States either directly or through third countries, without prior notification to and approval of the Office of Foreign Assets Control.” Potential importers must provide information to OFAC that includes “a description of the product to be imported, including quantity and cost; the name and address of the producer of the product; the name of the location where the product was produced; and the name and address of the North Korean exporter.”<sup>10</sup>

In March 2011, an official from the South Korean embassy in Washington commented that:

The U.S. trade embargo forbids the export of anything from Kaesong to the United States, either through South Korea or directly. So no South Korean company can bring parts down from Kaesong for products that they’re going to sell to the United States. If any company is caught doing that, they’re going to lose their export license.<sup>11</sup>

Even if Seoul were to challenge the U.S. laws that prohibit North Korean imports, Washington could invoke KORUS Article 23.2(b) Essential Security Exception:

Nothing in this Agreement shall be construed...to preclude a Party from applying measures that it *considers* necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security or *the protection of its own essential security*.<sup>12</sup>

The “considers” clause is particularly important since it provides stronger protection than exists in other FTAs. The United States can impose or maintain sanctions against North Korea and prevent any imports based simply on anything that Washington *considers* to be against U.S. interests.

In addition, KORUS Article 2.8.4 (National Treatment and Market Access for Goods Import and Export Restrictions) stipulates that:

[I]n the event that a Party adopts or maintains a prohibition or restriction on the importation from or exportation to a non-Party of a good, no provision of this Agreement shall be construed to prevent the Party from (a) limiting or prohibiting the importation of the good of the non-Party from the territory of the other Party.<sup>13</sup>

### **Deliberative/Legislative Process for Expanding KORUS FTA**

Annex 22B of the KORUS FTA describes the process through which Kaesong or any other “outward processing zones” must gain approval before their goods can be imported into the United States. First, a bilateral South Korean–U.S. committee of government officials would need to be formed no earlier than one year after entry into force of the FTA to

10. 31 Code of Federal Regulations § 500.586 (2006); U.S. Department of the Treasury, Office of Foreign Assets Control, “North Korea: An Overview of Sanctions With Respect to North Korea,” updated May 6, 2011, at <http://www.treasury.gov/resource-center/sanctions/Programs/Documents/nkorea.pdf> (May 19, 2011).

11. Ben Hancock, “USTR, Korea Push Back on Kaesong Allegations from House Members.”

12. KORUS FTA, Article 23.2 (b) Essential Security Exception, at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file476\\_12722.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file476_12722.pdf) (May 3, 2011). Emphasis added.

13. KORUS FTA, Article 2.8.4 (National Treatment and Market Access for Goods Import and Export Restrictions), at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file904\\_12701.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file904_12701.pdf) (May 3, 2011).

determine whether any economic zones should be considered for inclusion in the agreement. Then the committee would:

Establish criteria that must be met before goods from any outward processing zone may be considered originating goods...including but not limited to: [North Korean] progress toward denuclearization of the Korean Peninsula; the impact of the outward processing zones on intra-Korean relations; and the environmental standards, labor standards and practices, wage practices and business and management practices prevailing in the outward processing zone with due reference to the situation prevailing elsewhere in the local economy and the relevant international norms.<sup>14</sup>

With regard to this second step, then-Deputy Trade Representative Bhatia commented:

[T]here's no contemplation on the U.S.' part to allow goods from North Korea into the U.S. somehow through the FTA. That won't happen. What we have agreed to do is create a committee...and within that committee we are willing to discuss economic development issues.<sup>15</sup>

Third, even if U.S. negotiators were to agree that Kaesong met the criteria to be included, that recommendation would still require legislative approval by Congress since "decisions reached by the unified consent of the Committee shall be recommended to the Parties, which shall be responsible for seeking legislative approval."<sup>16</sup>

Schwab affirmed that before any recommendation to add an outward processing zone to the

KORUS FTA could be implemented, it "would need to obtain legislative approval.... Consequently, goods from the KIC could not obtain preferences under the Agreement without additional legislative action by both the United States and Korea."<sup>17</sup>

In April 2011, Deputy U.S. Trade Representative Demetrios Marantis testified similarly that:

Goods produced in Kaesong do not receive any benefits under the U.S.–Korea trade agreement. Any change to how Kaesong is treated under the agreement would require Congress to pass and the president to sign legislation. So there is nothing in this agreement that provides any benefits to Kaesong.<sup>18</sup>

In response to an inquiry by Representative Kevin Brady (R–TX) on whether adding Kaesong would require a specific act of Congress, Marantis replied, "If we choose to act on those recommendations, the only way to do so is to come here and seek legislative authority from Congress. So *Congress has the final word. It would have to pass a law, and the president would have to sign that law into force.*"<sup>19</sup>

All of the criticisms that opponents of the KORUS FTA level against abysmal North Korean business practices in Kaesong would be a basis for legislative rejection of any future recommendation to reclassify the complex as an outward processing zone. Nor has North Korea made any progress on denuclearization since the Six-Party Talks collapsed in late 2008. Furthermore, Pyongyang's provocative behavior, including two deadly attacks on South Korea in 2010, has reduced the potential for progress in any bilateral or multilateral talks.

14. KORUS FTA, Annex 22-B, at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file973\\_12721.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file973_12721.pdf) (May 4, 2011).

15. "Korea, U.S. Still at Odds Over Kaesong Goods," *Chosun Ilbo*, April 4, 2007, at <http://english.chosun.com/w21data/html/news/200704/200704040011.html> (May 4, 2011). Emphasis added.

16. KORUS FTA, Annex 22-B, at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file973\\_12721.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file973_12721.pdf) (May 5, 2011).

17. Letter from U.S. Trade Representative Susan Schwab to Representative Edward Royce (R–CA), May 9, 2007, in hearing, *The United States–South Korea FTA: The Foreign Policy Implications*.

18. Ambassador Demetrios Marantis, Deputy U.S. Trade Representative, testimony before the Subcommittee on Trade, Committee on Ways and Means, U.S. House of Representatives, April 7, 2011, at [http://www.yellowbrix.com/index.nsp?sid=bp&pid=16&demo=1&show=&ticker=MMM&story\\_id=157857100&&ID=infobrix&scategory=Computers](http://www.yellowbrix.com/index.nsp?sid=bp&pid=16&demo=1&show=&ticker=MMM&story_id=157857100&&ID=infobrix&scategory=Computers) (May 9, 2011).

19. *Ibid.* Emphasis added.

## Seoul Cannot Declare Kaesong To Be Part of South Korea

Some opponents of the KORUS agreement claim that since the South Korean constitution stipulates that the “territory of the Republic of Korea shall consist of the Korean peninsula and its adjacent islands,”<sup>20</sup> Seoul could unilaterally declare Kaesong part of South Korean territory.

The KORUS FTA text specifically defines the territory of South Korea as “the land, maritime, and air space over which Korea *exercises sovereignty*” as well as “those maritime areas, including the seabed and subsoil adjacent to and beyond the outer limit of the territorial seas over which it may *exercise sovereign rights or jurisdiction* in accordance with international law and its domestic law.”<sup>21</sup> Title 31 Part 500.328 (Foreign Assets Control Regulations) of the U.S. Code of Federal Regulations similarly defines South Korea as “those portions of Korea which are *under the control of the government of the Republic of Korea.*”<sup>22</sup>

South Korea does not exercise sovereignty or control over the KIC, nor would the United States formally recognize such a claim. Section 4(d) of Executive Order 13570 stipulates that North Korea “includes the territory of the Democratic People’s Republic of Korea.” That would, of course, include the Kaesong Industrial Complex.<sup>23</sup>

## Kaesong on Life Support

The future of the KIC appears to be bleak. Currently, there is little South Korean corporate advo-

cacy for, economic incentive for, or political interest in expanding the KIC.

The KIC opened amid grandiose predictions of a meteoric expansion fueled by an ever-increasing number of South Korean and foreign firms. Initial estimates were that by 2010, Kaesong would have 2,000 companies employing 250,000 workers producing \$150 billion annually. When completed in 2012, the complex was expected to have 700,000 workers.

In reality, however, the KIC has failed to meet even modest expectations. The predicted benefits of cheap labor were unable to compensate for North Korean resistance to capitalism and economic reform, frequent production stoppages, security risks, declining business interest, and Pyongyang’s belligerent actions.

As of June 2010, Kaesong comprised 121 factories employing only 43,000 North Korean workers and 800 South Korean staff. Exports totaled \$140 million from April 2005 to May 2010,<sup>24</sup> and North Korea’s annual income from Kaesong is only \$30 million—\$60 million.<sup>25</sup>

Kaesong factories are producing low-end goods such as clothing and textiles (71 firms), kitchen utensils (four firms), auto parts (four firms), semiconductor parts (two firms), and toner cartridges (one firm).<sup>26</sup> Since May 2010, Seoul has prohibited new investment in the KIC in retaliation for North Korea’s sinking of a South Korean naval vessel.

All of the “North Korean” products produced in the KIC consist of South Korean raw materials

20. Constitution of the Republic of Korea, Chapter I, Article 3, at <http://www.international.ucla.edu/eas/documents/korea-constit.htm> (May 5, 2011).

21. KORUS FTA, Chapter 1 (Initial Provisions and Definitions), Section B (General Definitions), Article 1.4 (Definitions), at [http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file816\\_12698.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file816_12698.pdf) (May 6, 2011). Emphasis added.

22. 31 Code of Federal Regulations § 500.328 (2006). Emphasis added.

23. The White House, “Prohibiting Certain Transactions With Respect to North Korea.”

24. “Gaeseong Industrial Complex,” Republic of Korea Ministry of Unification, at [http://eng.unikorea.go.kr/eng/default.jsp?pgname=AFFexchanges\\_gaeseong](http://eng.unikorea.go.kr/eng/default.jsp?pgname=AFFexchanges_gaeseong) (May 4, 2011).

25. “Tension on Borders,” *Korea Times*, March 16, 2009, at [http://www.koreatimes.co.kr/www/news/opinion/2009/03/137\\_41390.html](http://www.koreatimes.co.kr/www/news/opinion/2009/03/137_41390.html) (May 5, 2011); “Our Kaesong Dilemma,” *JoongAng Ilbo*, March 17, 2009, at <http://joongangdaily.joins.com/article/view.asp?aid=2902299> (May 5, 2011); “Failed Venture?” *Korea Herald*, June 19, 2009, at [http://cafe325.daum.net/\\_c21/\\_bbs\\_search\\_read?gpid=Qy6E&fclid=G40Z&contentval=000rYzzzzzzzzzzzzzzzzzzzzzzzzzzzzzz&nenc=&fenc=&q=incredibly&nil\\_profile=cafetop&nil\\_menu=sch\\_updw](http://cafe325.daum.net/_c21/_bbs_search_read?gpid=Qy6E&fclid=G40Z&contentval=000rYzzzzzzzzzzzzzzzzzzzzzzzzzzzzzz&nenc=&fenc=&q=incredibly&nil_profile=cafetop&nil_menu=sch_updw) (May 5, 2011); “Is the N. Korean Regime Unraveling?” *Chosun Ilbo*, January 20, 2011, at [http://english.chosun.com/site/data/html\\_dir/2011/01/20/2011012000429.html](http://english.chosun.com/site/data/html_dir/2011/01/20/2011012000429.html) (May 4, 2011).



and components driven north to Kaesong for final assembly and then returned to South Korea. The only North Korean aspect of the production process is the physical assembly by local workers.

No South Korean conglomerates or large companies are involved in Kaesong. Hyundai Asan is separate from the larger Hyundai conglomerate, including Hyundai Motor Company, with no legal or financial connections between them. Asan is simply the developer for KIC; it does not have any factories there.

South Korean companies at Kaesong are small or medium-size businesses. These firms tend to be reliant on cheap labor supplied by North Korea, as well as subsidies from Seoul, since they would otherwise not be competitive in South Korea.<sup>27</sup>

The early years of Kaesong were extremely difficult for South Korean firms. A 2007 South Korean parliamentary audit revealed that most South Korean companies in Kaesong performed much less well than their local rivals. Thirteen of 16 South Korean companies using Export-Import Bank loans “suffered losses for two straight years.”<sup>28</sup> Surveys by the Korea Federation of Small and Medium Business in 2007 showed that only five of 24 South Korean companies in Kaesong recorded a profit in three years.<sup>29</sup> By 2010, many companies responded that they had “yet to turn a profit, partly because North Korean workers are not as productive as their Chinese rivals.”<sup>30</sup>

These disappointing results are consistent with other South Korean joint ventures with North Korea outside of the KIC. In 2005, the Forum for Inter-Korea Relations, a coalition of civic groups focus-

ing on inter-Korean economic exchanges, stated that the majority of 1,000 South Korean companies involved in business deals with North Korea had either declared bankruptcy or abandoned the projects. A 2004 Korea Institute of National Unification survey showed that 45 of 150 South Korean companies had stopped their North Korean business ventures within six years. Another survey revealed that 30 percent of 241 South Korean factories in North Korea closed in the first year of business.<sup>31</sup>

South Korean conglomerates did not fare any better. Daewoo built a clothing manufacturing facility in the North in 1996 only to close it three years later after losing more than \$10 million annually. Hyundai Asan, in its seven years of operating tours to Mount Kumgang, recorded only minimal profits.<sup>32</sup>

### Kaesong’s Vanished Allure

Since the KORUS FTA was signed, South Korea’s political climate has changed significantly. As a result of these changes, it is unlikely that Seoul would seek to remove the bar to North Korean imports written into the KORUS agreement, pre-existing U.S. law, and U.S. regulations.

First, there was the transition from the far-left government of Roh Moo-hyun to conservative President Lee Myung-bak. President Lee abandoned the unconditional diplomacy of his liberal predecessors by imposing requirements for conditionality, transparency, and reciprocity when engaging North Korea.

The Lee administration announced that Seoul would not proceed with any of the exorbitant

26. Dick K. Nanto and Mark E. Manyin, “The Kaesong North-South Korean Industrial Complex,” Congressional Research Service Report for Congress, March 17, 2011, at <http://www.fas.org/sgp/crs/row/RL34093.pdf> (May 3, 2011).

27. Author interview with South Korean foreign affairs official (on condition of anonymity), September 2010.

28. “Businesses Still Struggling at Kaesong Complex—Lawmaker,” *Chosun Ilbo*, October 30, 2007, at [http://english.chosun.com/site/data/html\\_dir/2007/10/30/2007103061013.html](http://english.chosun.com/site/data/html_dir/2007/10/30/2007103061013.html) (May 5, 2011).

29. Kim Yong Hun, “First Profit for Top 5 Companies in the Kaesung Industrial Complex,” *Daily NK*, August 9, 2007, at <http://www.dailynk.com/english/read.php?cataId=nk00400&num=2492> (May 6, 2011).

30. Martin Fackler, “A Capitalist Enclave in North Korea Survives,” *The New York Times*, July 7, 2010, at <http://www.nytimes.com/2010/07/07/world/asia/07kaesong.html> (May 7, 2011).

31. Ser Myo-ja, “Group: Most Inter-Korean Businesses End Badly,” *JoongAng Ilbo*, October 21, 2005, at <http://joongAngdaily.joins.com/article/view.asp?aid=2632764> (May 8, 2011).

32. *Ibid.*

construction projects that Roh had promised during the 2007 inter-Korean summit. In response to Pyongyang's sinking of a South Korean naval ship in March 2010, Lee cut off all inter-Korean exchanges and trade—valued at \$300 million annually—but exempted Kaesong from the ban.<sup>33</sup>

Second, North Korea's belligerent actions in 2009 and 2010 generated a surge of hostility from the South Korean populace toward Pyongyang. Gone are the naïve hopes that engagement would alter Pyongyang's actions. Instead, a new consensus has taken hold: The North Korean regime should be punished for its transgressions.

Without dramatic changes by Pyongyang, the people of South Korea have little interest in engaging with North Korea—let alone in extending economic benefits to Pyongyang. Even the radically liberal *Hankroyeh* newspaper polls showed that 63 percent of the South Korean population was strongly against even providing food aid to North Korea. Leading liberal presidential candidate Sohn Hak-kyu expressed skepticism about the party's previous unconditional engagement policy, commenting that “it's time for the liberals to find a new path of change for inter-Korean relations.”<sup>34</sup>

Other polls show even stronger resistance to returning to the failed policy of providing large-scale benefits for nothing in return. South Korea no longer advocates on behalf of North Korea or wants to provide benefits to Pyongyang as opponents of the KORUS FTA assert.

### **KORUS FTA Achieves U.S. Economic and Geostrategic Objectives**

Representative Brad Sherman (D-CA) believes that the KORUS FTA would “accomplish the same result as what happened to the city of Detroit [when] burned to the ground” by British troops during the

War of 1812.<sup>35</sup> Actually, Detroit auto manufacturers and unions are now supporters of the agreement. In fact, the KORUS FTA would increase U.S. exports by \$10 billion–\$11 billion annually, improve the U.S. trade balance with Korea by \$3 billion–\$4 billion,<sup>36</sup> and generate an estimated 70,000 jobs without any cost to U.S. federal or state governments.

The KORUS FTA would further U.S. economic interests by eliminating 95 percent of South Korean tariffs on U.S. exports to Korea of industrial and consumer goods within five years, improving market access, and increasing transparency. South Korean manufacturing tariffs are currently double those of the United States, while South Korean agricultural tariffs are 54 percent compared to 9 percent in the U.S.

These immense economic benefits are sufficient reason to approve the FTA, but the agreement also provides several geopolitical strategic benefits for the United States by:

- Serving as a powerful statement of the U.S. commitment to East Asia at a time when many perceive a declining American interest, presence, and influence in the region;
- Marking a new era for U.S. economic engagement with East Asia as the first U.S. FTA in Northeast Asia;
- Strengthening U.S. commercial ties and expanding the bilateral relationship with South Korea beyond traditional military ties or the North Korean threat *de jure*; and
- Reducing a key U.S. ally's vulnerability to Chinese pressure by diversifying South Korea's trading base and decreasing its economic reliance on Beijing. Seoul has become increasingly concerned about China's belligerent and arrogant behavior and willingness to use its growing military and economic power to pressure smaller Asian nations.

33. “Is the N.Korean Regime Unraveling?”

34. Ser Myo-ja, “Sunshine Policy Scrap Between Two DP Bigwigs,” *Joongang Ilbo*, December 9, 2010, at <http://joongangdaily.joins.com/article/view.asp?aid=2929425> (May 9, 2011).

35. Hearing, *The United States–South Korea FTA: The Foreign Policy Implications*.

36. U.S. International Trade Commission, *U.S.–Korea Free Trade Agreement: Potential Economy-wide and Selected Sectoral Effects*, September 2007, at <http://www.usitc.gov/publications/332/pub3949.pdf> (May 11, 2011).

There also are tremendous costs to the United States if Congress continues to avoid ratifying the KORUS FTA:

- Damage to relations with a critical U.S. ally;
- Abandonment of significant economic benefits such as increases in U.S. exports, GDP, and jobs;
- Hindering of U.S. competitiveness by locking in discriminatory tariffs and non-tariff barriers that are detrimental to U.S. companies;
- Abdication of U.S. leadership and influence in Asia, as congressional delay in ratifying FTAs has led countries to look elsewhere for dependable economic partners;
- Undermining of U.S. credibility in any future trade negotiations; and
- Loss of additional market share to China, the European Union, and Japan, all of which now command a greater share of the South Korean market than the U.S., despite the fact that Washington was once Seoul's largest trading partner. A White House economic official has estimated that the U.S. could lose \$30 billion in exports if the European Union and Canada complete their trade pacts with Korea first.<sup>37</sup>

### What Should Be Done

Congress must reject attempts by protectionists to use erroneous arguments and scare tactics to undercut a free trade agreement that would significantly benefit the United States. It is incorrect to claim that the Kaesong Industrial Complex is a "Trojan horse" that threatens U.S. national security or props up Kim Jong-il's regime. Kaesong does not provide a conduit for North Korean goods into the United States. Most important, it does not undercut existing U.S. laws or punitive measures in place against Pyongyang.

Rather than dwelling on politicized fiction, Congress should focus on how the KORUS FTA furthers U.S. economic and geostrategic interests in Asia. The FTA would enable companies from both countries to engage in the intense competition of free and fair globalized trade on a more balanced playing field. But in order to realize these benefits, the agreement must first be implemented.

The current KORUS FTA text and existing U.S. laws are sufficient to prevent the import of North Korean goods into the United States. A careful reading of both proves that assertions by about Kaesong by opponents of the KORUS FTA have no basis in fact. Congress should reject demands for a renegotiation of the FTA with South Korea.

### Time for Action

Rejecting the KORUS agreement would needlessly disadvantage U.S. companies by locking in outdated and unbalanced rules. During the four years the agreement was held hostage by special-interest groups and congressional protectionists, the United States lost \$40 billion in potential exports.

As Congress dithered, the world moved forward, leaving the United States behind. Since signing the agreement, Seoul has engaged in negotiations on, and in some cases has completed, FTAs with India, the European Union, Australia, Canada, Japan, New Zealand, Colombia, Peru, China, and ASEAN.

South Korea will continue to open its market, with or without approval of the KORUS FTA, but if Congress rejects this agreement, only foreign competitors will benefit. It is time for Congress to remember that the American national bird is the eagle and not the ostrich.

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37. Elizabeth Williamson, "U.S. Vows New Push in Korean Trade Pact," *The Wall Street Journal*, June 25, 2010, at <http://online.wsj.com/article/SB10001424052748704846004575333303589295326.html> (May 18, 2011).