Testimony of
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Before the
Interstate Commerce, Trade, and Tourism Subcommittee
Senate Committee on Commerce, Science and Transportation
September 24, 2008
(Written Submission)

Thank you for the opportunity to testify before this subcommittee on the U.S.-Korea Free Trade Agreement (FTA). In examining the issues relating to the imbalance in U.S.-Korea Automobile trade, I would like to approach that assessment from a different perspective, first, by examining why the trade agreements that we have negotiated have often failed to live up to the expectations of those of us who negotiated those agreements; second, how those negotiating failures relate to the U.S.-South Korea FTA and its impact on the imbalance in U.S.-Korea Automobile trade. Let me emphasize at the beginning that these comments are my own and do not necessarily reflect the views of Kelley Drye Warren LLP or its clients.

By way of background, most of my 30-year career of service for the U.S. government has been directly involved with U.S. international trade and finance. My most recent experience involved 15 years with the Office of the U.S. Trade Representative (USTR), under both Republican and Democratic administrations, negotiating sectoral agreements on steel, shipbuilding, transportation vehicles, and intellectual property rights, as well as bilateral agreements with the EU, South Korea, Taiwan, Thailand, and the Philippines, and also plurilateral agreements mostly among Asian countries. My most recent experience was as chief negotiator for the U.S.-China Market Access Agreement of 1999 which was the basis for China's later accession to the World Trade Organization (WTO). I mention this experience only because my views derive not from exhaustive academic research, which of course is valuable, but from years of negotiating – in the trenches, so to speak -- on behalf of perceived U.S. economic interests.

Since retiring from government service, I have had some time to reflect on the negotiating accomplishments of the past and have concluded that the agreements that we negotiated did not live up to our expectations. We failed to address the underlying fundamental market distortions that skew the benefits toward the few while leaving behind the rest of the U.S. economy. As George Soros, in a Bloomberg News interview on the financial crisis, recently said, "…the system, as it currently operates, is built on false premises." The premise on which our trade agreements are negotiated is at best flawed, if not broken.

Failed Expectations

China's agreement to enter the WTO is a perfect example of failed expectations. In order to join the WTO, China made unilateral concessions to reduce and, in some cases, eliminate barriers to entry for U.S. goods and services. While no one claimed that the bilateral deficit would be reduced, claims were made that U.S. exports of goods to China would increase, thus creating jobs in the higher-paying export sector.

U.S. exports to China have increased and, as USTR often emphasizes, at a higher rate than to any other country. But such claims distort the real truth that exports grew faster because they grew from a very low level. In absolute terms, the increase in U.S. exports of goods to the EU was almost 70% greater than the increase in exports of goods to China, and the increase in U.S. exports to Canada was 40% more than to China. Neither of those trading partners made any trade concessions to the United States during this period.

Conversely, on the U.S. import side, the United States made no concessions to China, yet U.S. imports from China in 2007 were more than triple the pre-accession levels, to $321 billion in 2007, almost matching imports from the entire European Union. In contrast, increases in imports from Canada, our largest trading partner, rose by $82 billion, and imports from the EU increased by $134 billion.

Who Benefits?

The beneficiaries of the agreement with China fall into two groups: multinational companies that moved to China, and the financial institutions that financed those investments, trade flows, and deficits. Foreign direct investment (FDI) in China accelerated at a time when such investment to other parts of Asia was declining and, in 2001, even matched FDI to the United States. Sourcing by U.S. companies from China, whether from direct investment or through licensing arrangements, has allowed companies to cut costs and increase profits, as reflected, until recently, in increased corporate profits and the surge in the U.S. stock market.

Conversely, it is doubtful that the U.S. economy or its workers are better off. U.S. manufacturing jobs declined by more than 2.5 million after China joined the WTO in December 2001. While services jobs increased during this period, with the exception of telecommunications, non-tradable jobs accounted for the most significant portion of that increase. Wages have been stagnant, and real disposable income for three-quarters of U.S. households has been stable or declining. Only the top quartile of families has seen significant increases in real disposable income.

The beneficiaries of these trade agreements try to divert attention from these facts by arguing that our trade in services has increased or that our competitiveness has declined. Those arguments, however, don't explain why our exports of goods to countries that made no concessions increased more than our exports to China, which made significant tariff and non-tariff concessions. Such arguments also fail to explain why our imports of goods from China increased more than our imports from other major trading partners. Is there any wonder that the people on Main Street think that trade agreements do not work?

Broken Premises

Were this simply a problem with our bilateral trade relationship with China, policy makers could focus on resolving that dysfunctional relationship. However, the problem extends to nearly all trade agreements since they are based on the flawed premise that free trade benefits the economy. Let me be clear, the "free trade" model has a valid theoretical basis. But the premise is flawed and broken since free trade does not exist in a "free market" Petri dish where there are no barriers to competition.

Using China as an example once again, proponents of the free trade model argue that China has a competitive advantage in wage rates that makes it ideal as the global manufacturing center that it has become. A closer examination, however, reveals that China has adopted an export-led development strategy, the centerpiece of which is a currency that is undervalued by 20-80%, with the consensus leaning toward 30-40% at the present time. Using this consensus estimate, China's wages, in U.S. dollar terms, are 30-40% cheaper than they would have been if the currency were allowed to freely float. Chinese exports receive a 30-40% subsidy. Similarly, foreign investors receive a 30-40% subsidy to develop operations in China. To add insult to injury, our exports are taxed at an additional effective 30-40% rate.

While China has allowed its currency to appreciate somewhat nominally against the U.S. dollar since July 2005, China has a long way to go to bring it to equilibrium levels. In addition, China's internal barriers to trade not only restrict U.S. exports, but also restrict China's market for Chinese domestic producers, thus reducing the size of the domestic economy. It is not surprising that, until the last few months, our imports from China continued to accelerate, jobs continued to move overseas, and our exports to China consisted primarily of raw materials. The weakened U.S. dollar has only recently had a positive impact on U.S exports. Europe, Canada, and other countries with freely floating exchange rates face comparable trends in their trade relationships with China.

Implications for the U.S.-Korea Free Trade Agreement

The implications for FTAs are obvious. While FTAs with small economies have relatively small impact on the U.S. economy, the same cannot be said for FTAs with the larger economies such as Canada, Mexico, and now Korea. Our FTAs are based on the premise that free trade benefits all economies, at all times, and in all circumstances. The argument is similar to Adam Smith's premise that perfect competition results in the most efficient allocation of resources. Unfortunately, free trade, like perfect competition, rarely if ever exists but that premise nevertheless remains the theoretical and philosophical underpinning of FTAs. Furthermore, anyone who argues against free trade and especially those who vote against Free Trade Agreements are castigated as know-nothings or, worse yet, as “protectionists.”

Advocates of FTAs argue that these model agreements level the playing field so that U.S. companies, and U.S. workers, can compete in markets free of distortions. The U.S.-Korea FTA is a perfect example of why such agreements fail to live up to their expectations. First, Korea, as does China, uses an undervalued exchange rate to maintain its competitive position in the U.S. market and in third country markets. Six months prior to the initiation of negotiations on an FTA, during the pre-negotiations stage, Korea began to appreciate the Korean won by almost 15% until it reached its peak just prior to the conclusion of the negotiations. Three months later, the currency depreciated until it was once again at the initial exchange rate. Even to the unpracticed eye, Korea’s exchange rate movements have been convenient in the extreme and indicate how Korea is likely to manage its exchange rate to achieve maximum commercial advantage. Whether intended as a means to gain an unfair competitive advantage or not, Korea’s undervalued exchange rate subsidizes its exports, subsidizes foreign direct investment, and taxes foreign imports into Korea.

Second, after years of observing and negotiating with Korea over a wide range of products and services, I have learned that Korea uses non-tariff barriers, particularly standards, as a means of providing an advantage to its domestic producers. Because the Korean market is relatively small, foreign suppliers are at a disadvantage. As a share of their sales, the Korean market is not large enough to justify meeting those extraordinary standards requirements and, when standards are met, the cost per unit is high. When taxes are added to the product, those taxes are applied to the full cost of the product, thus increasing the absolute price disparity between products. U.S. companies, and thus their workers, must absorb much of those increases through lower profit margins and stagnant wages.

Third, in the case of automobiles, Korean tax authorities have been known to harass purchasers in Korea of foreign automobiles, a practice which has been substantiated by European and North American producers. This harassment has discouraged Koreans from purchasing foreign-made automobiles in addition to other products. The impact on automotive trade is more extreme because of the visibility of those products.

Fourth, the Korean population has a bias against purchasing foreign-made products. While this is probably true in many countries, the impact on some products, particularly automobiles, is much larger than one would expect.

This list is incomplete and, to be fair, Korea could likely draw a list of obstacles to trade in the United States, such as inconsistent state regulations governing many services. But because the U.S. markets are so much larger, Korean suppliers can adjust to meet those increased costs and can do so profitably. With the exception of exchange-rate manipulation, it is difficult to assess the adverse economic impacts of many of these measures unless they are evaluated on a product-specific basis. Nevertheless, cumulatively these barriers, if allowed to exist in a bilateral FTA, can have significant effects on whether the benefits of an FTA are realized.

Whither the Future of the U.S.-Korea FTA

The dilemma facing Congress is whether the deficiencies of the agreement are serious enough to warrant disapproval and renegotiation. For the record, I support the negotiation of bilateral Free Trade Agreements, especially those that push the envelope for more open, transparent and global markets. But I am concerned that this agreement with such a large and important bilateral trading partner will set a dangerous precedent because it does not address in any meaningful ways the distortions to trade that result from currency depreciation and non-tariff barriers such as standards. Equally important, the agreement as negotiated incorporates seemingly product specific provisions for automobile trade that really do nothing to address the longstanding dispute the United States has had with South Korea in this sector.

The dispute settlement mechanism for automobile trade is deficient on a number of levels. First, the provision deals only with trade in automobiles (HS 8703). The bilateral exchange of benefits in the agreement for this sector relate to automotive trade for the United States while granting greater access for Korean trucks in the United States. By limiting the retaliation in that special provision to automobiles, it effectively eliminates any incentives for Korea to give real access to U.S. produced automobiles. A more effective mechanism would provide for a snap-back in truck tariffs if Korea nullifies or impairs U.S. access to Korea's automobile market because of exchange rate undervaluation, commercially restrictive standards or through other coercive measures such as tax harassment.

A second, though less serious problem, relates to the term of retaliation. The provision requires that retaliation cease when the other party eliminates the non-conforming measure. In my experience, Korea frequently reaches agreements but does not implement those measures at all or does not implement them as expected. Consequently, retaliation should only be reversed once the dispute settlement panel can be assured that the non-conforming measure has been eliminated.

Conclusion

The decision on whether to approve this agreement in its current form or whether to send it back for renegotiation now rests with the Congress. But until these FTAs and other trade agreements address the specific distortions to trade that occur through currency undervaluation and practices that impede competition, trade agreement rarely will deliver the results that Main Street expects and deserves