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EXPECT THE BEST

Canada and South Korea Sign Free Trade Agreement

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On September 22, 2014, Prime Minister Stephen Harper and South Korean President Park Geun-hye officially signed the Canada-Korea Free Trade Agreement (the "CKFTA"), which was announced on March 11, 2014. The ceremony took place during Park Geun-hye's official visit to Canada.

As we previously reported in the March 2014 issue of *International Business Bulletin*, the CKFTA will cover virtually all aspects of Canada-South Korean trade, including trade in goods and services, investment, government procurement, non-tariff barriers, environment and labour cooperation, and other areas of economic activity. Some tariffs will be eliminated immediately while others will be phased out over several years.

One of the most controversial issues arising from the CKFTA was the elimination of Canadian duties applied to South Korean automobiles. This prompted strong objections from Ontario's automobile industry, which claimed that the elimination of this duty would cause an even greater trade imbalance with South Korea. Although these objections are certainly understandable, many of the South Korean cars sold in Canada are already expected to enter the country duty free from the United States pursuant to the North American Free Trade Agreement.

Some critics of the CKFTA have pointed to the increased trade deficit that the United States has experienced since the U.S.-South Korea Free Trade Agreement ("KORUS FTA") came into force on March 15, 2012. The Congressional Research Service considered this change in its recent report on the KORUS FTA (the "CRA Report"), which was prepared for members and committees of the United States Congress.

The CRA Report, which was published on September 16, 2014, found that from 2011 (the last full year before the KORUS FTA was implemented) to 2013, U.S. goods exports to South Korea decreased from $41.3 billion to $39.2 billion (a 5% decrease) and imports increased from $56.0 billion to $62.1 billion (an 11% increase). This caused the U.S. goods trade balance with South Korea to decrease (become more negative) from $-14.7 billion to -$23.0 billion (a 56% decrease). However, during the same period, U.S. services exports increased from $16.7 billion to $20.9 billion (a 25% increase), while imports increased from $9.7 billion to $10.8 billion (a 10% increase). This caused the U.S. services trade balance with South Korea to increase from $6.9 billion to $10.1 billion (a 46% increase).

Although the CRA Report acknowledged that the increased U.S. goods trade deficit has been a cause of concern for some U.S. policymakers, it also explained that some of the decrease in goods exports to South Korea was likely due to fluctuations in the business cycle in South Korea and that this was not unique to the United States. For example, from 2011 to 2013, South Korea's goods imports from the world overall fell 1.7%, as did South Korea's imports from its top three import suppliers.

In terms of the automobile industry, the CRA Report found that the total value of South Korean automotive exports to the United States, including parts, was $19.7 billion in 2013, compared with U.S. exports of similar products to South Korea of $1.5 billion. In other words, the United States ran a bilateral trade deficit in autos of $18.2 billion in 2013; an increase from $10.6 billion five years ago. However, one analyst who examined the effects of the KORUS FTA found in simulation models of projected market changes that South Korea would always gain relative to the United States from bilateral liberalization, because it has been much more successful in accessing the U.S. market than the United States has been in accessing the Korean market.

The CRA Report explained that assessing the impact of the KORUS FTA on U.S.-South Korea trade flows and the U.S. economy was a difficult question to answer definitively for several reasons:

a) Assessing the impact of a policy change (the KORUS FTA) on an economic variable (trade flows) requires a careful analysis that takes into account other variables, which may also affect the outcome. Otherwise, one may mistakenly attribute a change in the trade balance to the KORUS FTA when changes in exchange rates or aggregate demand are instead responsible.

b) The KORUS FTA has only been in effect for about two years, making it difficult to determine its long-term direct economic and trade effects on the United States. Tariffs on the most sensitive products will be phased out over several more years, and production and consumption patterns take time to adjust.

c) Aggregate data on trade flows may not capture the full impact of the agreement. Any significant effects of the KORUS FTA are more likely to be evident on individual firms and industries rather than trade flows as a whole.

d) Some of the potential benefits of free trade, which include lower-priced and more diverse goods and services, as well as improved productivity among firms, cannot be easily measured by trade balances.

It would appear as though we should not rely too much on U.S. trade numbers during the early years of the KORUS FTA, as an indicator of how the CKFTA will affect Canada's trade with South Korea. Although it is inevitable that some Canadian industries will benefit more than others, it is too early to determine whether the overall effect of the CKFTA on Canada's trade balance will be positive or negative. ■