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REPORTERS' MEMO

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How the Korea FTA Could Provide New Revenue for the North Korean Dictatorship via Increased Access to the U.S. Market: Responding to Inaccuracies in Recent Commentary

The prospect of the Korea Free Trade Agreement (FTA) providing a means for the North Korea Kim Jong Il dictatorship to generate new funding for its weapons programs is emerging as a hot issue in the escalating Korea FTA debate. The current South Korean Ambassador, Han Duk-Soo, now tasked with selling the FTA here, was prime minister when the FTA was signed in 2007. At the time, he said: **"The planned ratification of the South Korea-U.S. free trade agreement will pave the way for the export of products built in Kaesong [a North Korean export processing zone with 120 South Korean firms] to the U.S. market."**[1]

As congressional consternation about the FTA's conflict with U.S. policy on North Korea trade grows, the Obama administration and others are trying to quell concerns. There are two distinct aspects to this conflict that policymakers must consider.

First is **the FTA's rules of origin, which could immediately allow large increases in duty-free U.S. access for goods *assembled* in South Korea from parts sourced from North Korea.** The FTA's low rules of origin provide FTA benefits for goods assembled in South Korea that contain up to 65 percent by value of non-South Korean inputs, but despite congressional demands do not exclude North Korean inputs. The second issue is the procedures under which products *assembled* in North Korea could obtain FTA benefits in the future. (This possibility is raised in Annex 22-B of the agreement.)

Unfortunately, the Obama administration's 2010 supplemental Korea FTA talks did not remedy either of these problems, which were initially raised four years ago. This memo reviews statements by congressional and administration sources and unpacks the relevant FTA text, which shows that the concerns are very real. Public Citizen is preparing a detailed report on the issue.

In response to a March 16 congressional news conference raising these issues, an anonymous administration official was cited in press reports saying incorrectly that the FTA did not allow 65 percent non-South Korean content. The FTA text clearly provides for such, as can be seen in Chapter 6 and Annex 6-A[2] (http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file680_12704.pdf). In a longer March 17 response document, the administration simply did not address the problem of North Korean content in South Korea-assembled goods, but instead focused only on the second problem identified above: the Annex 22-B issue, which relates to how, whether and when goods assembled in North Korea might receive FTA benefits**. Careful review of the FTA text shows that there are no provisions that address the North Korean inputs problem. Among the facts to consider are:**

- It is critical to understand that the United States does not now have an *embargo* against North Korean goods. Rather, the sanctions program requires that before importing "products into the United States from North Korea," a license must be obtained from the Office of Foreign Assets Control (OFAC).[3] In practice, this discretionary licensing system results in most goods with North Korean value not entering the U.S. According to official statistics, the United States has directly imported $330,000 from North Korea in the past 10 years.[4]

- The FTA's rules of origin (in Chapter 6 generally and Chapter 4 for textiles) set specific terms for how much non-U.S. or non-South Korean value a good may have and still obtain FTA benefits. **The FTA's rules-of-origin provisions do not prohibit North Korean inputs or provide that use of such inputs could result in denial of FTA benefits or subject such a good to special treatment (i.e. admissible only upon obtaining the required OFAC license.)** Adding this simple clarification has been a key congressional demand. As a result, if the FTA goes into effect as written, the U.S. would be violating the FTA and subject to challenge and sanctions if the U.S. denied FTA benefits to a South Korean-assembled good containing North Korean inputs that met the FTA rules of origin – much less continued to deny entry to such goods altogether, as is current practice.

- The U.S. also failed to list the OFAC license as an exception to the FTA's ban on import licenses. The Korea FTA reads-in GATT Article XI, which requires that countries cannot institute "prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or other measures." FTA Article 2.8.3 provided an opportunity to list exceptions. OFAC licensing is not listed although U.S. controls relating to raw log exports are, among other licensing programs.[5]

Recently, Korea FTA supporters have started to claim that the FTA would not in any way affect the current OFAC licensing requirements. That the administration acted to preserve other existing U.S. import and export restriction policies by listing them as exceptions to the FTA rules only highlights the clear meaning of the FTA text: ***"The Parties shall ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by regional levels of government."***[6] Thus, if a U.S. policy (the current North Korean sanctions programs) conflicts with FTA obligations, the U.S. is obliged to change its domestic law to conform to the FTA, with indefinite trade sanctions permitted for failure to do so – *unless* an explicit exception has been agreed as part of the FTA text. No such exception exists with respect to North Korean inputs in South Korean goods that otherwise meet the FTA rules of origin.

Of special concern is the prospect that significant non-Korean content could come from the large Kaesong Industrial Complex located in North Korea 43 miles from Seoul where 44,000 North Korean workers are employed at 25-38 cents per hour by 120 South Korea firms in auto parts, bolts, garments, textiles, electronics, chemical materials, shoes, toys and other products.[7] **North Korean workers in the Kaesong sweatshop complex have their wages paid directly to the government, which then skims off up to 45 percent.[8]**

The U.S. government estimates that the North Korean government currently collects $3 million to $4 million a month from the Kaesong operations now, prior to a massive planned expansion of the border sweatshop zone. South Korea cut off most trade with North Korea after attacks last year, but left Kaesong trade open.[9] There was $1.9 billion in total trade between the two Koreas in 2009, about half of which was through production by South Korean firms in Kaesong.[10] While $1.9 billion is not a lot of

money relative to the U.S. or South Korean economy, it constitutes more than a third of North Korea's total external trade.[11] Given the Department of Defense estimates that North Korea's nuclear program cost the regime as little as $200 million to develop, the hard currency generated by North Korean trade flows is sufficient to finance the North's nuclear proliferation regime several times over.[12]

The North Korean government is projected to receive $9.55 billion in economic gains from Kaesong over nine years under a planned major expansion.[13] This is equivalent to 36 percent of North Korea's estimated national income. Hyundai and the Korea Land Corporation, the principal developers of Kaesong, plan to enlarge the complex from its current 800 acres to a more than 6,000-acre complex (or nine square miles), where 1,500 South Korean and other foreign firms will employ 350,000 North Korean workers.[14] This would make the complex more than half the size of Alexandria, Virginia.[15]

The South Korean government has extensively subsidized the Kaesong complex in the hopes that its firms will utilize the low-wage labor force there as an alternative to establishing Chinese subsidiaries. The government has offered companies establishing operations in Kaesong the same low-interest loans it offers to public works projects, and offers extensive political risk insurance of up to 90 percent of the value of Kaesong investments.[16]

Both the question of FTA treatment for South Korean goods containing North Korean inputs from Kaesong, and an annex in the FTA concerning the prospect of future duty-free access for goods actually *assembled* in outward processing zones, were initially raised as problems by Rep. Brad Sherman (D-Calif.) four years ago. Then, Sherman led a hearing on the FTA as chairman of the House International Relations subcommittee on Proliferation, Terrorism and Trade. [17] (See http://www.internationalrelations.house.gov/110/sherman061307.htm .)

On December 3, 2010, the Obama administration announced a supplemental agreement to the Bush administration's 2007 FTA text. But neither the problem of South Korea-assembled goods containing North Korean inputs obtaining immediate FTA benefits nor what would be required to allow North Korea-assembled goods FTA treatment was addressed. A letter to the administration from Rep. Sherman sums up what was needed to address each problem.(See: http://bradsherman.house.gov/KORUSFTAPRESFinal%20%282%29.pdf.)

Sherman has not been alone in raising concerns about "leakage" in the current U.S. sanctions program against North Korea. A recent Congressional Research Service (CRS) report noted: "Another current issue dealing with enforcement of U.S. policy objectives is the treatment of goods and products manufactured in the Kaesong Industrial Complex (KIC) located in North Korea. While the KIC is physically located in North Korea, many of its manufacturing operations are owned and run by South Korean companies. The South Korean government has asked the United States to treat the products made in the KIC by South Korean companies as South Korean products, even though current U.S. rules of origin laws and regulations would designate them as being products of North Korea. The United States currently has a trade embargo on products from North Korea, and the United States has never granted North Korea "normal trade relations" (NTR) status. ***Whether or not the United States agrees to this proposal, there is nothing to prevent South Korean firms from performing intermediate manufacturing operations in North Korea, and then performing final manufacturing processes (sufficient to confer origin) in South Korea***." [emphasis added] [18] CRS reiterated this comment in a March 17, 2011, document, stating that "the possibility of goods of South Korean origin with North Korean content exists now."[19]

Given recent Pentagon defense assessments that suggest North Korea is within five years of strike capacity against the U.S. West Coast,[20] Congress and the public are rightly concerned with any policy that could provide further financial resources to the Kim Jong Il regime.

Yet administration and corporate sources have made misleading comments in recent days about the potential benefits to the Kim dictatorship from the U.S.-Korea FTA, which we address below. For a full analysis of the issues, please see our detailed memo at http://www.citizen.org/documents/kaesong-factsheet.pdf.

Recent interventions by administration and corporate sources also not convincing

USTR and the Korea-U.S. Partnership, an effort backed by the Korean Embassy, has released several documents addressing the Kaesong debate. But these interventions have been misleading or have failed to address the key issues.

CLAIM: The Korea-U.S. Partnership has written: "Concerns have been expressed that products made in the KIC might be marked as made in South Korea, then shipped to the U.S. or that they might be combined with other products in South Korea, then sent to the U.S. … The KORUS FTA will introduce one of the most effective customs enforcement measures the U.S. has ever agreed to in an FTA, including unannounced visits to Korean textile and apparel producers and denying entry for effective goods. This will effectively help prevent any fraudulent declaration of origin."[21]

FACT: Fraud is not the issue. This comment misses the point. Fair traders are certainly concerned about customs fraud. But the issues raised around Kaesong are not primarily that North Korean inputs would be fraudulently incorporated into South Korean-assembled products, but that under the FTA's rules of origin, North Korean inputs can non-fraudulently be incorporated into South Korea-assembled products in a way that is perfectly compatible with the actual legal text of the agreement.

Customs officials confirmed as much in a recent interview with *Inside U.S. Trade,* stating that a "claim for preferential treatment has to include the information relied upon in claiming the origin … [for verification] the importers have to provide to CBP all information relied upon in claiming the origin."[22] The news story goes on to quote an "informed source" as stating that the importer only has to add up the value of the originating material until the threshold is reached (under, say, the build up method) to confer a South Korean origin. Customs officials would only investigate further if they thought there was fraud, which a South Korean car would not be indicative of if it contained less than 65 percent North Korean content.

CLAIM: The Korea-U.S. Partnership has written: "Most products made in the KIC are destined for markets in Asia and Eastern Europe. Korean companies that do business in the KIC purposefully isolate all products with any relation to the area and do not allow them to be shipped to the U.S. One reason is that no Korean company wants to run the risk of losing access to the American market because they violated the U.S. embargo on North Korea. The approval of the FTA won't change that."[23]

FACT: **Alleged discretionary initiatives are not enough.** The Embassy's point about existing markets for Kaesong products and Korean companies may or may not be true (they provide no support). But it is also beside the point; Congress is concerned about the legal requirements, not discretionary initiatives. U.S. and South Korean laws (and likely also the laws of the unnamed Asian and European markets) allow a product to be deemed South Korean even if it contains substantial North Korean content. The Embassy

provides no information that would reassure Congress that Kaesong inputs would not benefit from "leakage" of the FTA's tariff treatment.

CLAIM: A more recent March 24, 2011, document from the Embassy makes an even more misleading claim: "U.S. law strictly prohibits imports of goods or parts of goods from North Korea, including the Kaesong Industrial Complex, without a license. The KORUS FTA does nothing to alter that. Even after the FTA is approved, North Korean products will be restricted from the U.S. in accordance with the embargo." Also, according to *Inside U.S. Trade*: "A U.S. Treasury Department official, however, said that no goods containing North Korean inputs may be brought into the U.S. without a license from the Office of Foreign Assets Control (OFAC). 'Under the most recent import restrictions, North Korean products could not be imported to the United States if used as components of South Korean finished goods without prior review by OFAC, based on guidance from the State Department,' the official said. John Brinkley, spokesman for the South Korean embassy to the U.S., echoed this point. 'The [U.S] trade embargo forbids the export of anything from Kaesong to the United States, either through South Korea or directly,' he said. '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,' Brinkley added."[24]

FACT: U.S. licensing procedures are not at all clear that goods containing North Korean content but assembled elsewhere require an OFAC license. The relevant regulations – originally promulgated in 2000 by the Clinton administration – simply state: "(2)(i) The importation of products into the United States from North Korea requires approval from the Office of Foreign Assets Control." (31 CFR § 500.586) The default mode of defining where products originate in U.S. law is through a rule of origin, such as the one under the FTA for autos that allows 65 percent non-U.S., non-South Korean value. These regulations provide no alternative methodology.

Even if the regulations functioned in the way that Brinkley claims, there is no guarantee that the requirement could be adequately enforced, given conflicting rules of origin methodologies and difficulties of information gathering. It is not credible that one branch of the U.S. government (Treasury) would be able to track commodities that are not required to be labeled as North Korea-originating by either U.S. or South Korean customs official – or the FTA. There is moreover no guarantee that an existing domestic policy, even if it operated as suggested by Brinkley and was adequately enforced, would not be changed by current or future U.S. administrations at their own discretion.

CLAIM: According to *Inside U.S. Trade*: "One informed source acknowledged that nothing in the agreement precludes inputs from North Korea. But he claimed that the footnote was more than sufficient - and actually extraneous - because the deal is between two sovereign nations and does not override either country's existing laws. The source also said that a carve-out for Kaesong is not necessary in the FTA. No U.S. trade agreement has ever spelled out that non-originating input cannot come from countries against which the U.S. has sanctions, such as Iran or Syria, the source explained. He argued that it is not the function of a bilateral economic deal to enforce embargoes against third parties."[25]

FACT: The issue is not that the FTA would somehow "override" a U.S. law. The issue is that, were the U.S. to enforce a prohibition of South Korean products with North Korean inputs that did not have an OFAC license, it could be challenged by South Korea as violating the terms of the FTA and the United States could face trade sanctions if it did not allow such imports. This is not a speculative concern. Indeed, in 1996, the European Union (EU) brought a World Trade Organization (WTO) case against the U.S. Cuban Liberty and Solidarity Act (Helms-Burton), challenging the U.S. effort to expand the embargo on Cuba by applying penalties to EU firms that were involved in trade and investment in Cuba.[26] If Congress wants to avoid this scenario, it must amend the actual text of the agreement. Congress

has never before considered an FTA with a country like South Korea, which has a major industrial and foreign policy interest in a co-production sweatshop facility in a neighboring country so antagonistic toward the U.S. While similar revisions to safeguard U.S. embargo policies can and should be incorporated into other FTAs, that does not provide an excuse for inaction on reform under this FTA, especially given the entwinement of the South Korean economy and Kaesong.

CLAIM: Some have claimed that Footnote 1 of Chapter 6 on the Rules of Origin and Origin Procedures provides room for the U.S. to block products from Kaesong: "For greater certainty, whether a good is originating is not determinative of whether the good is also admissible."

FACT: As noted above, the U.S. would have had to create a distinct rule of origin for this situation, or otherwise clearly carve out policies related to North Korean inputs, if it wanted to be able to block "South Korean" goods with North Korean inputs without running afoul of the FTA. The U.S. did not do so.

ENDNOTES

[1] Yoo Cheong-mo, "Prime Minister Han visits N. Korean industrial park," Yonhap News Agency, December 12, 2007, Available at: http://english.yonhapnews.co.kr/national/2007/12/12/18/0301000000AEN20071212008600315F.HTML

[2] http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file680_12704.pdf

[3] 31 CFR § 500.586.

[4] According to the U.S. International Trade Commission's Dataweb, U.S. customs officials recorded no imports from North Korea prior to 2000. In 2000, postage stamps were imported. In 2001, some stainless steel was imported. In 2002, books and circuitry were imported. In 2003 and 2004, fiber for women's clothing was imported. In 2005, some tool parts were imported. In 2010, postage stamps were imported. See USITC Dataweb, All Import Commodities: Customs Value by Customs Value for North Korea, U.S. Imports for Consumption, Annual + Year-To-Date Data from Jan – Oct, accessed Dec. 15, 2010.

[5] See Annex 2-A, page 2-12 for the U.S. list of exceptions. It is also worth noting that FTA Article 2.8.4 allows a signatory to prohibit the export and import of goods from certain countries, but this applies to finished goods (ie. this allows the U.S. to continue to prohibit sales of North Korean assembled products even if they were to be sold from South Korea, subject paying the non-FTA tariff rates and despite FTA rules banning quantitative restrictions.) But, this provision, which also covers the U.S. ban on re-exporting goods exported with a dual use license, does not cover the situation described in this memo: of imports of a finished good deemed South Korea-originating but that contains inputs from North Korea. This is the relevant provision: "4. In 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; or (b) requiring as a condition for exporting the good of the Party to the territory of the other Party, that the good not be re-exported to the non-Party, directly or indirectly, without being consumed in the territory of the other Party."

[6] Korea FTA, Art. 1.3: EXTENT OF OBLIGATIONS

[7] Dick Nanto and Mark Manyin, "The Kaesong North-South Korean Industrial Complex" Congressional Research Service, Report No. RL34093, June 1, 2010, at 6.

[8] Dick Nanto and Mark Manyin, "The Kaesong North-South Korean Industrial Complex" Congressional Research Service, Report No. RL34093, June 1, 2010, at 9
and U.S. State Department, "2009 Human Rights Report," March 11, 2010

[9] One Korea policy expert noted that, "Some economists in South Korea have estimated that the actual cost to the North Korean economy in terms of hard currency, would be about $200 million. Again, in Washington, that's not a big amount of money. But if you're a hard currency-starved isolated country like North Korea, that's a big chunk of money." However, this expert went onto note that Kaesong trade is "not something that's proposed to be on the chopping block right now with this current round of sanctions between North and South." "The Economic Ties Between South, North Korea," NPR, May 24, 2010. Available at: http://www.npr.org/templates/story/story.php?storyId=127095906

[10] Dick Nanto and Mark Manyin, "The Kaesong North-South Korean Industrial Complex" Congressional Research Service, Report No. RL34093, June 1, 2010, at 1.

[11] "The Economic Ties Between South, North Korea," NPR, May 24, 2010. Available at: http://www.npr.org/templates/story/story.php?storyId=127095906

[12] According to Department of Defense estimates, North Korea's nuclear program cost the regime as little as $200 million to develop. See Andrew Coe, "North Korea's New Cash Crop," *Washington Quarterly,* Summer 2005, at 79. Available at: http://www.acq.osd.mil/ncbdp/nm/docs/Featured%20Articles/North%20Korea's%20New%20Cash%20Crop.pdf
[13] Dick Nanto and Mark Manyin, "The Kaesong North-South Korean Industrial Complex" Congressional Research Service, Report No. RL34093, June 1, 2010, at 12.
[14] Dick Nanto and Mark Manyin, "The Kaesong North-South Korean Industrial Complex" Congressional Research Service, Report No. RL34093, June 1, 2010, at 6.
[15] Alexandria is just over 15.4 square miles in size.
[16] Dick Nanto and Mark Manyin, "The Kaesong North-South Korean Industrial Complex" Congressional Research Service, Report No. RL34093, June 1, 2010, at 5.
[17] Opening Statement of Congressman Brad Sherman, Chairman, Subcommittee on Terrorism, Nonproliferation and Trade, June 13, 2007. Available at: http://www.internationalrelations.house.gov/110/sherman061307.htm
[18] See Vivian C. Jones and Michael F. Martin, "International Trade: Rules of Origin," Congressional Research Service Report, RL34524, March 6, 2009, at 14-15. Available at: http://assets.opencrs.com/rpts/RL34524_20090306.pdf
[19] Quoted in "USTR, Korea Push Back on Kaesong Allegations from House Members," *Inside U.S. Trade,* March 25, 2011.
[20] Elizabeth Bumiller and David Sanger, "Gates Warns of North Korea Missile Threat to U.S.," *New York Times,* Jan. 11, 2011. Available at: http://www.nytimes.com/2011/01/12/world/asia/12military.html
[21] See http://www.koreauspartnership.org/pdf/kaesong-industrial-complex.pdf
[22] "USTR, Korea Push Back on Kaesong Allegations from House Members," *Inside U.S. Trade,* March 25, 2011.
[23] See http://www.koreauspartnership.org/pdf/kaesong-industrial-complex.pdf
[24] "USTR, Korea Push Back on Kaesong Allegations from House Members," *Inside U.S. Trade,* March 25, 2011.
[25] "USTR, Korea Push Back on Kaesong Allegations from House Members," *Inside U.S. Trade,* March 25, 2011.
[26] Case history here:
http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds38_e.htm