



Imports from North Korea: Existing Rules, Implications of the KORUS FTA, and the Kaesong Industrial Complex

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Summary

In early 2011, many Members of Congress focused their attention on U.S. rules and practices governing the importation of products and components from North Korea. Their interest was stimulated by debate over the proposed South Korea-U.S. Free Trade Agreement (KORUS FTA) and the question of whether the agreement could lead to increased imports from North Korea. Some observers, particularly many opposed to the agreement, have argued that the KORUS FTA could increase imports from North Korea if South Korean firms re-export items made in the Kaesong Industrial Complex (KIC), a seven-year-old industrial park located in North Korea, where more than 100 South Korean manufacturers employ over 45,000 North Korean workers. Two concerns expressed by critics are (1) that South Korean firms could obtain low-cost KIC-made goods or components, incorporate them into finished products and then reship the goods to the United States with “Made in [South] Korea” labels so that they would receive preferential treatment under the KORUS FTA; and (2) that such exports would benefit the North Korean government.

At present, North Korea’s relative economic isolation and an array of U.S. restrictions have resulted in less than \$350,000 in U.S. cumulative imports from North Korea since 2000. Thus, the issue of U.S. imports from North Korea is essentially about what might happen in the future.

This report examines the issue of U.S. imports from North Korea in three parts:

- **U.S. rules and practices governing imports from North Korea.** The United States does not maintain a comprehensive embargo against North Korea. However, imports from North Korea require approval from the Treasury Department’s Office of Foreign Assets Control (OFAC). This restriction includes finished goods originating in North Korea as well as goods that contain North Korea-made components. The U.S. Customs and Border Protection (CBP), of the Department of Homeland Security, is responsible for reviewing an importer’s OFAC license as the goods enter the United States.
- **North Korea’s exports to South Korea (via the KIC) and China, its dominant export markets.** In 2010, over three-quarters of North Korea’s export shipments went to China and South Korea. Most of North Korea’s \$1.2 billion in exports to China in 2010 were mineral resources or primary products (such as fish, shellfish, and agro-forest products). An increasing proportion of North Korea’s exports to South Korea have become attributable to activities in the KIC, where factories manufactured more than \$320 million in goods in 2010, a 25% increase over 2009. The present South Korean government has halted plans for a major expansion of the complex. If a future South Korean government resumes these plans, or if China and North Korea significantly boost bilateral economic integration, more North Korean goods and components could enter global supply chains and test U.S. restrictions against North Korean imports.
- **The KORUS FTA’s potential effect on U.S. imports of North Korean content.** The KORUS FTA appears likely to have only a minimal impact on whether U.S. sanctions on North Korean imports are put to the test. At present, the agreement would not give preferential treatment to finished products made in the KIC. The agreement would establish a binational committee to discuss whether zones such as the KIC should be given preferential treatment in the

future. The committee would operate by consensus, and Congress would need to pass a law to extend any KORUS FTA tariff benefits to products made in the KIC. Moreover, the KORUS FTA contains provisions that make it highly unlikely the agreement would constrain the United States' ability to maintain its restrictions on North Korean products. Many critics of the KORUS FTA argue that the agreement's rules of origin would make it possible for South Korean exports with North Korean components to receive preferential treatment. However, the KORUS FTA's rules of origin do not appear to limit the United States' ability to enforce its restrictions on imported products that contain North Korean inputs.

The issue of how best to handle imports from North Korea appears to center on customs controls, cooperation, and enforcement. The complex nature of many types of goods, such as automobiles and electronics, poses a particular challenge for Customs and Border Protection officials to determine the origin of these products. There is no means to determine with one hundred percent certainty that there are no goods or components originating in North Korea entering U.S. commerce without proper authorization. This will be true regardless of whether the KORUS FTA is in effect. Thus, perhaps the most important factor that will determine whether U.S. restrictions on North Korean imports are tested appears to be the degree to which North Korean goods enter global supply chains.

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Introduction

A number of groups and individuals have recently focused attention on U.S. rules governing imports from North Korea. Their interest has been sparked by the debate over the South Korea-U.S. Free Trade Agreement (KORUS FTA), which would lower or eliminate U.S. tariffs and non-tariff barriers on most imports from South Korea.¹ Some, particularly the agreement's opponents, argue that the agreement could lead to increased U.S. imports of goods or components made in North Korea. The KORUS FTA will not enter into force unless Congress approves implementation legislation, which Obama Administration officials have said they expect to send to the 112th Congress.

As a result of North Korea's relative economic isolation, the undeveloped state of its export sector, and U.S. trade restrictions, the United States imports virtually no finished goods from North Korea.² Between 2000 and 2010, cumulative U.S. bilateral imports of finished North Korean goods totaled \$335,700, which is equivalent to a rounding error in annual U.S. trade flows with most countries.³ Nearly half of this amount consisted of stamps, with another 40% or so consisting of women's clothing. Since 2005, according to U.S. trade data, the only finished imports that have entered the United States from North Korea have been \$8,363 worth of stamps, which were imported in June 2010. Imports of finished North Korean goods have literally been zero in four of the past five years.

Those concerned that the KORUS FTA would change this situation focus considerable attention on the Kaesong Industrial Complex (KIC), a seven-year-old industrial park located in North Korea just across the demilitarized zone, where more than 100 South Korean manufacturers employ over 45,000 North Korean workers at relatively low wages. Critics argue that South Korean firms could obtain low-cost Kaesong-made goods or components, incorporate the latter into finished products such as electronics or automobiles, and then reship the final goods to the United States with "Made in [South] Korea" labels. If the KORUS FTA were in effect, the argument runs, these goods might receive preferential treatment, to the benefit of the North Korean government, which receives revenue from the KIC.

The first section of this report examines existing U.S. rules and practices governing imports from North Korea. The second section analyzes the two main portals through which North Korea conducts its minimal economic interaction with the outside world: the KIC and China. The third section addresses the issue of how, if at all, the KORUS FTA would affect potential U.S. imports of North Korean content, including whether the agreement could result in legal action against the U.S. government if it kept out imports of North Korean content.

¹ For more on the KORUS FTA, see CRS Report RL34330, *The Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA): Provisions and Implications*, coordinated by William H. Cooper.

² North Korea's official name is the Democratic People's Republic of Korea (DPRK). South Korea's official name is the Republic of Korea (ROK).

³ By way of comparison, from 2000 to 2010, the United States imported over 4,000 times more in goods from Nepal, a country with a comparable population and gross domestic product (GDP) to North Korea. U.S. imports from Nepal were worth over \$1.4 billion during that time period. Sources: *The World Factbook 2009*, Washington, DC: Central Intelligence Agency, 2009. Trade data compiled from the U.S. Department of Commerce and the U.S. International Trade Commission and accessed via the U.S. International Trade Commission's Interactive Tariff and Trade DataWeb.

Existing U.S. Laws and Regulations Governing Imports of North Korean Goods and Components

Overview

Though the United States requires licenses for all imports from North Korea and severely restricts exports to that country, it no longer maintains the comprehensive embargo that was in place for years after the Korean War (1950-1953).⁴ In 1999, President Clinton significantly loosened restrictions on U.S. exports to and imports from North Korea except those involving national security concerns. The Departments of Commerce, Treasury, and Transportation issued new regulations a year later that implemented the new policy.⁵ In 2008, President Bush terminated the exercise of Trading With the Enemy Act (TWEA) authorities with regard to North Korea and removed the North Korean government from the list of state sponsors of acts of international terrorism. At the same time, the President declared a new national emergency to continue to block assets that had been frozen as of June 2000 and to continue restrictions related to DPRK-flagged vessels.⁶

Throughout this period, from the 1950 outbreak of the Korean War through the 2008 removal of the DPRK-related Trading With the Enemy Act authorities and state sponsor of terrorism designation, importing from North Korea was either highly circumscribed or banned altogether. Though President Bush removed these two obstacles to trade relations, North Korea remained subject to import restrictions based on requirements in the Arms Export Control Act and related determinations that North Korean entities were engaged in missile proliferation activities.⁷

⁴ For more on the history and full range of U.S. economic sanctions on North Korea, see CRS Report RL31696, *North Korea: Economic Sanctions Prior to Removal from Terrorism Designation*, by Dianne E. Rennack, and CRS Report R41438, *North Korea: Legislative Basis for U.S. Economic Sanctions*, by Dianne E. Rennack.

⁵ 65 *Federal Register* 38148-38166, June 19, 2000, in which the Departments of Commerce, Transportation, and the Treasury each issued changes to regulations (15 CFR § 730 et seq., 44 CFR § 403, and 31 CFR Part 500, respectively) to implement the President's June 1999 announcement.

⁶ Executive Order 13466, "Continuing Certain Restrictions With Respect to North Korea and North Korean Nationals," 73 *Federal Register* 36787, June 26, 2008; 31 C.F.R. Part 510, North Korea Sanctions Regulations, 75 *Federal Register* 67912, November 4, 2010. The President also issued a proclamation to terminate the exercise of Trading With the Enemy Act authorities with regard to North Korea, as they were implemented in the Foreign Assets Control Regulations, 31 C.F.R. Part 500, and the Transaction Control Regulations, 31 C.F.R. Part 505. Presidential Proclamation 8271 of June 26, 2008, 73 *Federal Register* 36785, June 27, 2008. OFAC subsequently removed the Foreign Assets Control Regulations and Transaction Control Regulations in their entirety, effective June 20, 2011 (76 *Federal Register* 35739).

⁷ Section 73 of the Arms Export Control Act (AECA; P.L. 90-629; 22 U.S.C. 2797b) requires the President to deny U.S. government contracts and export licenses relating to missile equipment or technology to any foreign person he determines has knowingly exported, transferred, or otherwise engaged in equipment or technology controlled under the Missile Technology Control Regime (MTCR). Sanctions vary depending on the nature of the engagement: trade in MTCR Annex category II materials and technology requires a two-year imposition; trade in category I materials and technology triggers more restrictions of a possibly longer duration.

Section 73 of the AECA further requires the President to "prohibit, for a period of not less than 2 years, the *importation* into the United States of products produced by that foreign person" if he determines that "the export, transfer, or trade has substantially contributed to the design, development, or production of missiles in a country that is not an MTCR adherent" [emphasis added]. Section 73, in turn, cites Section 11B of the Export Administration Act of 1979 (P.L. 96-72; 50 U.S.C. app. 2410b), which similarly requires the President to impose a range of sanctions on any foreign person (continued...)

In August 2010, President Obama invoked national emergency authorities granted his office in the International Emergency Economic Powers Act and the National Emergencies Act to block assets of any individual and entity found to be importing luxury items into North Korea, and to block assets of targeted individuals and entities engaged in proliferation, money laundering, counterfeiting of goods or currency, bulk cash smuggling, narcotics trafficking, or other illicit economic activity.⁸ On April 18, 2011, the President expanded on his 2010 actions to prohibit imports from North Korea. Direct and indirect importation of goods, services, and technology from North Korea is prohibited, and “unless exempt, all imports into the United States from North Korea must be authorized.”⁹

From late 2008 to 2010, the North Korean government made a series of provocative decisions, including walking away from the Six-Party denuclearization negotiations, testing short-range and long-range ballistic missiles, claiming to have successfully detonated a nuclear explosive device, violating U.N. Security Council resolutions, presumably sinking a South Korean naval vessel (the *Cheonan*), and launching artillery shells at the South Korean island of Yeongpyeong. In May 2010, a six-nation, civilian-military ad hoc group determined that North Korea was complicit in the *Cheonan*'s sinking.

Importing from North Korea into the United States

In considering how imports from North Korea are treated under U.S. laws and regulations, it is necessary to distinguish between two concepts: (1) whether North Korean finished goods or

(...continued)

he finds in violation of MTCR-related controls under that act.

Assessing missile proliferation activities of a North Korean person or entity in the context of Sec. 73 is impacted by North Korea's non-market economy. Section 74 AECA (22 U.S.C. 2797c) requires that, “in the case of countries with non-market economies ..., the term ‘person’ means ... all activities of that government relating to the development or production of any missile equipment or technology; and ... all activities of that government affecting the development or production of electronics, space systems or equipment, and military aircraft.” As a result, if a North Korean “person” is identified as engaged in missile proliferation pursuant to Sec. 73, activities of the government are also subject to economic sanctions.

Various North Korean entities have been identified under terms of Sec. 73 over the years (see CRS Report R41438, *North Korea: Legislative Basis for U.S. Economic Sanctions*, Appendix C, for a complete list); most recently on February 2, 2009, the State Department determined that the Korean Mining and Development Corporation, Moksong Trading Corporation, and Sino-Ki had engaged in MTCR Annex category II missile proliferation, resulting in two-year trade restrictions.

In short, in any period in which a North Korean entity is under Section 73 AECA sanctions, U.S. persons would also be prohibited from importing into the United States goods produced by that foreign person, unless licensed to do so by OFAC.

⁸ Executive Order 13551, “Blocking Property of Certain Persons With Respect to North Korea,” 75 *Federal Register* 53837, August 30, 2010. President Obama issued this executive order as an expansion of the national emergency declared by President Bush in 2008; in addition, he cited authorities granted his office in the United Nations Participation Act of 1945 (P.L. 79-264; 22 U.S.C. 287c). The United Nations Security Council had called on its member states to impose certain import restrictions in UNSC Resolutions 1718 (October 14, 2006) and 1874 (June 12, 2009).

⁹ Executive Order 13570, “Prohibiting Certain Transactions With Respect to North Korea,” 76 *Federal Register* 22291, April 18, 2011. The initial declaration that a national emergency exists because of activities of North Korea is contained in Executive Order 13466 of June 26, 2008; the two subsequent executive orders (13551 and 13570) expand on that original declaration. The President also cites Section 5 of the United Nations Participation Act of 1945 (P.L. 79-264; 22 U.S.C. 287c) in the second and third executive orders. 31 C.F.R. Part 510, North Korea Sanctions Regulations, 75 *Federal Register* 67912, November 4, 2010, and 76 *Federal Register* 35740, June 20, 2011.

components are *admissible* (i.e., allowed) into the United States; and (2) the *tariff treatment* of goods that are deemed to be admissible.

Admissibility: Department of Treasury Approval Required

Importing Directly from North Korea

One may not import directly from North Korea without approval from OFAC; this applies to all imports from North Korea. The President's executive order of April 2011 states

Except to the extent provided in statutes or in licenses, regulations, orders, or directives that may be issued pursuant to this order, and notwithstanding any contract entered into or any license or permit granted prior to the date of this order, the importation into the United States, directly or indirectly, of any goods, services, or technology from North Korea is prohibited.¹⁰

The Office of Foreign Assets Control prohibits all transactions that are first prohibited by Executive Orders 13466 (continuing some prohibitions imposed under Trading With the Enemy Act authorities), 13551 (prohibiting transactions with designated persons and entities), and 13570 (prohibiting unlicensed direct or indirect importation into the United States from North Korea).¹¹

The Secretary of the Treasury (or OFAC, as delegated), in consultation with the State Department, is authorized by the President to promulgate the regulations and rules required to implement the purposes of the executive order. OFAC is authorized to issue licenses for engaging in transactions, including those required to import from North Korea.¹² The President retains authority to revise or revoke the executive order at any time if he finds national emergency conditions no longer exist. Executive orders invoking a national emergency require annual renewal, however, to remain in force.

Importing Indirectly from North Korea

Importers seeking to bring North Korean goods into the United States through a third country must have OFAC approval to do so. The President reiterated this in the executive order of April 18, 2011, stating, "except to the extent provided ... the importation into the United States, directly or indirectly, of any goods, services, or technology from North Korea is prohibited." The importation of finished goods made with North Korean components is also prohibited, as stated in OFAC guidance issued following the President's 2011 executive order, which provides that

goods, services, and technology from North Korea may not be imported into the United States, directly or indirectly, without a license from OFAC. This broad prohibition applies to goods, services, and technology from North Korea that are used as components of finished products of, or substantially transformed in, a third country.¹³

¹⁰ Section 1, Executive Order 13570, 76 *Federal Register* 22291, April 20, 2011.

¹¹ 31 CFR § 510.201.

¹² See 31 CFR Part 510, Subpart E, and 31 CFR Part 501, the latter of which states definitions and guidance for general licenses, specific licenses, and procedure for application, issuance, and denial.

¹³ Office of Foreign Assets Control, "North Korea: An Overview of Sanctions With Respect to North Korea," May 6, 2011.

New regulations issued by OFAC in June 2011 implement the license requirements for both direct and indirect importing.¹⁴

Although the updated North Korea Sanctions regulations (31 C.F.R. Part 510) do not expressly address such issues as the treatment of North Korean component parts used in third-country manufacturing, OFAC has stated that it “intends to supplement” its June 2011 regulations “with a more comprehensive set of regulations, which may include additional interpretive and definitional guidance and additional general licenses and statements of licensing policy.”¹⁵ The relatively small amount of import trade with North Korea presumably accounts for the skeletal nature of the past regulatory regime. If North Korea’s export sector expands significantly, the scope and timing of any elaboration of U.S. regulatory requirements may be affected as well.

North Korea and the Global Economy¹⁶

The North Korean economy is one of the world’s most isolated. The DPRK’s stated policy of self-reliance (*juche*), its suspicion of foreign countries, and the collapse of its industrial base since the late 1980s have resulted in an extremely low level of commercial and financial relations with other nations in the world. Over the course of the 2000s, North Korea’s significant export markets shrunk to two countries, South Korea and China, which in 2010 appear to have accounted for over three-quarters of North Korea’s export shipments.¹⁷

North Korea’s Exports to South Korea: The Kaesong Industrial Complex (KIC)¹⁸

North Korea’s exports to South Korea have increased by nearly 25% since 2006, though at \$1 billion in 2010, they are still at a relatively low level.¹⁹ Over time, a greater proportion of these exports have been due to the activities at the Kaesong Industrial Complex. This phenomenon accelerated in 2010, when South Korea halted virtually all non-KIC trade with North Korea following the *Cheonan*’s sinking in March 2010. By the end of February 2011, almost all of North Korea’s exports to South Korea were attributable to activities in the KIC.²⁰

¹⁴ 31 CFR Part 510, 75 *Federal Register* 67912, November 4, 2010; 76 *Federal Register* 35740, June 20, 2011.

¹⁵ 76 Fed. Reg. at 35740.

¹⁶ For more information, see CRS Report RL32493, *North Korea: Economic Leverage and Policy Analysis*, by Dick K. Nanto and Emma Chanlett-Avery.

¹⁷ CRS estimates that in 2010, the DPRK exported \$2.8 billion in goods to the world, of which China accounted for \$1.2 billion and South Korea for \$1.0 billion. The estimate for total exports to the world was derived by summing imports from North Korea by countries that report to the United Nations using the UN Commodity Trade database and augmenting that with data from Global Trade Atlas for countries that had not yet reported to the United Nations. Data for South Korean trade with the DPRK are from the South Korean Ministry of Unification and are included in the total even though South Korea considers such trade as inter-Korean and not foreign trade.

¹⁸ For more information, see CRS Report RL34093, *The Kaesong North-South Korean Industrial Complex*, by Mark E. Manyin and Dick K. Nanto.

¹⁹ According to the Bank of Korea, South Korea’s total imports in 2010 were over \$425 billion.

²⁰ South Korean Ministry of Unification, as reported by U.S. Embassy Seoul Economic Section, *North Korea Economic Briefing*, January 21, 2011, and April 1, 2011.

By the end of 2010, over 120 small and medium-sized South Korean manufacturing companies were operating in Kaesong. The facility in 2010 produced \$323 million in output. Most of the manufacturers (71 firms) produce clothing and textiles. Other companies produce kitchen utensils (four firms), auto parts (four firms), semiconductor parts (two firms), and toner cartridges (one firm). Light industry and other manufacturers that depend on low labor costs and low-level technology products (e.g., textiles and apparel, general machinery, some electronics, and furniture) are among those most likely to move facilities into the complex, particularly given concerns about the level of intellectual property rights protection in North Korea. About 10% of the production at Kaesong is exported to third countries after clearing customs in South Korea. In 2010, the primary export destinations were Australia, the European Union, Russia, and China.²¹

The Kaesong complex's future hinges on the course of inter-Korean relations and the policies of future South Korean leaders. Since President Lee Myung-bak came into office in 2008, his government has been ambivalent about the KIC. On the one hand, it has halted plans for a major expansion of the complex, due in part to the marked deterioration in inter-Korean relations since early 2008. On the other hand, the complex has continued to expand incrementally under Lee, and his government did not close it down despite the *Cheonan's* sinking and the shelling of Yeonpyeong Island in 2010. Lee's reluctance to shut down the KIC reflects not only the financial cost of doing so—a closure could make South Korea's government liable for hundreds of millions of dollars in insurance payments to the South Korean companies that use the complex—but also the political support that the KIC enjoys within South Korea. Lee's term in office ends in 2013, and by law he cannot run for reelection. A future South Korean leader could decide to dust off the KIC's major expansion plans or, alternatively, shut down the complex altogether.

The KIC represents a dilemma for U.S. and South Korean policymakers. On the one hand, the project provides an ongoing revenue stream to the Kim Jong-il regime in Pyongyang, by virtue of the share the government takes from the salaries paid to North Korean workers. South Korean and U.S. officials estimate this revenue stream to be around \$20 million per year. On the other hand, the KIC arguably helps maintain stability on the Korean Peninsula and provides a possible beachhead for market reforms in the DPRK that could eventually spill over to areas outside the complex and expose tens of thousands of North Koreans to outside influences, market-oriented businesses, and incentives.

As discussed below, the KORUS FTA provides for a Committee on Outward Processing Zones (OPZ) to be formed and to consider whether zones such as the KIC will receive preferential treatment.

²¹ South Korean Ministry of Unification data provided to CRS in March 2011.

Figure 1. The Kaesong Industrial Complex and the North-South Korean Border



Sources: Prepared by CRS based on ESRI Data and Maps 9.3.1; IHS World Data.

China

Since the early 2000s, China has emerged as the key to North Korea's economic relations with the outside world. By the end of the decade, more than half of North Korea's imports and most of its foreign assistance came from China. North Korean exports to China rose nearly fivefold from 2001 to 2009, and in 2010, North Korea's \$1.2 billion in commercial shipments to China accounted for over 40% of its total annual exports.

North Korea's major export items to China include mineral fuels (coal), ores, woven apparel, iron and steel, fish and seafood, and zinc and articles thereof. Recently, North Korea has increased its exports of primary products (such as fish, shellfish and agro-forest products) and mineral products (such as base metallic minerals). Pyongyang reportedly has imported aquaculture technology (mainly from China) to increase production of cultivated fish and agricultural equipment to increase output of grains and livestock. North Korea also has imported equipment for its coal and mineral mines. Much of the coal and mineral exports have resulted from partnering with Chinese firms, through which the Chinese side provides modern equipment in exchange for a supply of the product being mined or manufactured. Thus, to the extent that North Korean content enters the global marketplace via China, it is likely to come from North Korean energy inputs (particularly coal) or mineral deposits. This is likely to be the case unless or until the North Korean manufacturing sector revives and begins to export to China.

One Chinese strategy with respect to the DPRK is to create an integrated industrial region focused on Jilin and Liaoning provinces in northeastern China and the bordering provinces in North Korea. The strategy includes building roads, investing in North Korean industries, connecting a North Korean port to industries in landlocked Jilin province, and creating a free trade zone.²² The two countries have been exploring the possibility of building an industrial park similar to the Kaesong Industrial Complex close to their mutual border. If they are successful, more Chinese companies would be engaged in manufacturing Chinese brand-name products in North Korea and could be interested in exporting them to the U.S. market.

Of the 86 Chinese trading companies and joint ventures in North Korea announced by China's Ministry of Commerce, 35 are in mining, 11 are in agriculture/timber, 17 are in industrial parts and materials, 7 are in apparel, 4 are in other consumer goods, 1 is in iron and steel, and 1 is in automotive vehicles and parts. The other nine companies are in transportation or trading.²³ North Korean exports of apparel, other consumer goods, automotive parts, and discrete industrial parts and materials (not products such as paint) conceivably could enter a Chinese supply chain and end up in a product sold in the United States in which the North Korean content could be identified. However, identifying Chinese products manufactured using ores, minerals, or coal from the DPRK would require extensive documentation and disclosure by the manufacturer.

²² For information on Chinese investment in and strategy toward the DPRK, see Drew Thompson, *Silent Partners, Chinese Joint Ventures in North Korea* (Washington, DC: A U.S.-Korea Institute at SAIS Report, February 2011).

²³ Open Source Center, *Directory of PRC Enterprises in North Korea*, China—OSC Report in Chinese, English 19 April 11, Product FEA20110420016995, April 20, 2011.

The KORUS FTA's Possible Impact

Some critics of the KORUS FTA contend that the agreement will increase the chances that North Korean goods or components will enter the United States. Their arguments tend to fall into three categories:

1. The KORUS FTA in the future could allow products made in the Kaesong Industrial Complex to be covered by the agreement, thereby conferring preferential treatment to these products.
2. The KORUS FTA might constrain the U.S. government's ability to impose restrictions on imports from North Korea.
3. The KORUS FTA has insufficient "rules of origin" to determine the country of origin of imported products.

This section examines these issues point by point.

Annex 22-B and the Kaesong Industrial Complex

During the 2006-2007 KORUS FTA negotiations, the previous South Korean government sought to secure preferential treatment for products made in the Kaesong Industrial Complex (KIC) in North Korea. The United States adamantly opposed this position. In the final KORUS FTA agreement, the two sides reached a compromise on the KIC by creating a special committee to handle the issue.²⁴ As discussed below, incorporating the KIC into the KORUS FTA would require the U.S. executive branch and Congress to approve such a move.

The KORUS FTA's KIC-related provision is Annex 22-B, titled "Committee on Outward Processing Zones on the Korean Peninsula." It sets out a process under which the United States and Korea may "review whether conditions on the Korean Peninsula are appropriate for further economic development through the establishment and development of outward processing zones." An "outward processing zone" (OPZ) would be an area outside the FTA territory in which a certain amount of manufacturing or processing of a good could take place for purposes of deeming the good "originating" under the agreement and thus be eligible for preferential tariff treatment and other agreement benefits.²⁵

²⁴ In contrast, under the South Korea-ASEAN FTA, for example, preferential tariffs are applied to 100 items manufactured in the Kaesong Industrial Complex. The Korea-Singapore and Korea-European Free Trade Association (EFTA) FTA agreements also include products from the KIC. In the negotiations between South Korea and the European Union, Seoul requested products from Kaesong be covered by the proposed FTA. The final 2009 EU-South Korea FTA, however, contains a provision similar to that included in the KORUS FTA. Most EU countries have official relations with North Korea. Germany is North Korea's largest export market in the EU. In 2010, North Korean exports were approximately \$31.4 million, primarily clothing (\$19 million) and engines (\$6.2 million). Global Trade Atlas, accessed by CRS May 2010.

²⁵ The KORUS FTA defines the term "territory," with respect to 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 limits of the territorial seas over which it may exercise sovereign rights or jurisdiction in accordance with international law and its domestic law." KORUS FTA, art. 1.4. Note also that in defining the term "national" with respect to Korea, the KORUS FTA provides 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." Id.

To this end, the United States and South Korea would establish a Committee on Outward Processing Zones on the Korean Peninsula comprising officials of both countries. The kinds of people who will serve on the committee has not yet been determined. The committee would initially meet on the first anniversary of the entry into force of the KORUS FTA and at least once annually thereafter or at any other time mutually agreed upon by the committee. The committee is to identify geographic areas that may be designated OPZs and establish various political and economic criteria, including labor and environmental standards, that must be met before “goods from any outward processing zone” may be considered originating goods for FTA purposes. The committee would also determine whether the proposed OPZ has met the committee’s criteria. In addition, the committee “shall also establish a *maximum* threshold for the value of the total input of the ‘originating final good’ that may be added within the geographic area of the outward processing zone.”

Committee decisions reached by “unified consent” would be recommended to the United States and South Korea. The two countries would then be responsible “for seeking legislative approval for any amendments to the Agreement with respect to outward processing zones.” In March 2011, the Office of the United States Trade Representative (USTR) issued a statement that “Congress would need to pass, and the President would need to sign, a law to extend any KORUS tariff benefits to products made in Kaesong or any OPZ.”²⁶

To the extent that the United States maintains an import embargo on finished goods of North Korea and goods made elsewhere with North Korean components, the United States would first need to deem OPZ goods admissible before the question of applicable tariff treatment arises. Further, because Congress has express constitutional authority to impose duties under Article I, § 8, cl. 1, of the U.S. Constitution, Congress must either itself authorize specific tariff rates to be imposed on particular products or grant the President the authority to proclaim them.

As discussed earlier, goods from countries that are subject to Title IV of the Trade Act, such as those of North Korea, may only be accorded NTR (MFN) treatment under the specific requirements of that title.²⁷ Unless Congress by statute removes a country from the Title IV regime, as it has done with regard to countries entering the World Trade Organization, the President must abide by Title IV requirements in order to grant NTR tariff status to a Title IV country. Further, because Congress has provided that imports that are not subject to Title IV or other statutory restrictions are entitled at most to NTR tariff status under § 136 of the Trade Act of 1974, 19 U.S.C. § 2136, the extension of preferential tariff rates to imports from any country must be expressly authorized. Any grant of presidential proclamation authority in KORUS FTA implementing legislation will likely apply only to “originating goods” of the territory of South Korea as that term is defined in the implementing legislation. Thus, presidential authority to proclaim preferential rates with regard to goods other than those that would currently qualify as “originating” under the FTA would need to be provided in a separate enactment.²⁸

²⁶ Office of the U. S. Trade Representative, “Outward Processing Zones, Kaesong, and the U.S.-Korea Trade Agreement, Frequently Asked Questions,” at 2.

²⁷ It may be noted that if the amount of permitted processing in an OPZ is to be set at a maximum threshold and the threshold is low, it is likely that the finished product would not qualify as a North Korean-made product for purposes of Title IV, but would instead be a product of South Korea or the United States. This situation, however, would not affect the need for new legislation to authorize the President to proclaim preferential tariff rates for goods that would not currently qualify as “originating goods” under the FTA, as discussed in the text of this report.

²⁸ An example of a post-FTA delegation may be found in P.L. 104-234, which amended the United States-Israel Free Trade Agreement Implementation Act of 1985, 19 U.S.C. § 2112 note, to authorize the President to proclaim duty-free (continued...)

Some observers, particularly U.S. opponents of the KORUS FTA, have criticized the agreement for including Annex 22-B and have called for the agreement to be renegotiated so that the annex is deleted and/or products made in the Kaesong Industrial Complex are explicitly excluded from the terms of the agreement. Twice before—in the spring of 2007 and in the fall of 2010—South Korea agreed to modifications involving other portions of the KORUS FTA that were requested by the United States. The KORUS FTA’s supporters have rejected the argument that a further modification is needed on a number of grounds, principally that the South Korean government is unlikely to consider such a request and that existing U.S. rules are sufficient to restrict imports from North Korea.

Admissibility of Goods

The question has been raised whether the KORUS agreement could constrain the United States’ ability to restrict imports from South Korea (or other countries) of finished goods that contain North Korean components. As discussed below, the KORUS FTA contains provisions that make this prospect highly unlikely.

Article 2.8.1 of the KORUS FTA incorporates an obligation that the United States and South Korea currently have under Article XI:1 of the General Agreement on Tariffs and Trade 1994 (GATT), a World Trade Organization (WTO) agreement, not to adopt or maintain any quantitative prohibition or restriction on the importation of each other’s goods.²⁹ The obligation covers prohibitions or restrictions other than duties, taxes, or other charges and includes such measures as quotas or import licenses. Import prohibitions or restrictions may not be applied to “the goods of the other Party,” a category that would include not only originating goods, but also any good that qualifies as a good of South Korea under U.S. non-preferential rules of origin.³⁰ Thus, goods covered by Article 2.8.1 could include final goods of South Korea manufactured with components from a third country. The obligation in Article 2.8.1 would apply, however, “[e]xcept as otherwise provided” in the agreement.

One such exception may be found in Article 2.8.4(a), which provides that, in the event that “a KORUS Party adopts or maintains a prohibition on the importation from ... a non-Party of a good, no provision of this Agreement shall be construed to prevent the Party from ... limiting or prohibiting the importation of the good of the non-Party from the territory of the other Party.”³¹ This provision contemplates that a country may impose or maintain an import embargo against

(...continued)

treatment for goods of the West Bank, the Gaza Strip, or a “qualifying industrial zone,” as the term is defined in the statute, provided the goods meet detailed qualifications spelled out in the statute. See also H.Rept. 104-495, at 2, for a discussion of the need for new presidential proclamation authority to extend the preferential tariff benefits of the U.S.-Israel Free Trade Agreement to articles of the above-mentioned areas.

²⁹ General Agreement on Tariffs and Trade 1994, art. XI:1, at http://www.wto.org/english/docs_e/legal_e/06-gatt.pdf.

³⁰ The agreement defines the term “goods of a Party” as “domestic goods as these are understood under the GATT 1994 or such goods as the Parties may agree, and includes originating goods of that Party.” KORUS FTA, art. 1.4. Regarding the difference in treatment of originating goods and other goods of Parties to the North American Free Trade Agreement (NAFTA), for example, U.S. Customs and Border Protection has noted that “[e]ven though a good may be sufficiently processed in Canada, Mexico or the United States to be marked with that country of origin, it may not be sufficiently manufactured to ‘originate’ under the rules of origin for NAFTA tariff treatment purposes.” U.S. Customs & Border Protection, *Importing into the United States 51* (2006 ed. at <http://www.cbp.gov/linkhandler/cgov/newsroom/publications/trade/iius.ctt/iius.pdf>).

³¹ KORUS FTA, art. 2.8.4(a).

the goods of a non-signatory country and that the embargo may be implemented without violating the agreement even though it may affect trade with the other KORUS FTA Party. Thus, in the event that the United States were to prohibit the importation of a good from North Korea, the KORUS FTA would not preclude the United States from prohibiting the importation of that North Korean good from the territory of South Korea as well.³² Further, because Article 2.8.4 would apply with respect to restrictions or prohibitions on the importation of goods of any third country, it would apply with respect to all U.S. import embargoes, including, among others, those with Cuba and Iran.³³

The United States has long taken the position that an FTA provision of this type protects U.S. trade sanctions programs. Although Article 2.8.4 does not expressly state that a “good of the non-Party” includes a non-Party component used in the manufacture of a finished good in another country, the United States has traditionally understood the term “good” in this context to include not only final products of the non-Party but also non-Party components used in third-country production. For example, when the U.S.-Canada Free Trade Agreement (CFTA) was submitted to Congress for approval in 1988, the Cuban Assets Control Regulations—as they continue to do today—made it unlawful for a person subject to U.S. jurisdiction, unless authorized by the Treasury Department, to import merchandise of Cuban origin or merchandise “made or derived in whole or in part of any article that is the growth, produce or manufacture of Cuba.”³⁴ In submitting the agreement to Congress, the Administration emphasized that the CFTA would not affect the existing Cuban sanctions program, stating that the CFTA rules of origin “would not operate to override” the above-quoted regulation and adding that the CFTA contained a provision—similar to Article 2.8.4 of the KORUS FTA—that permitted the United States and Canada to impose restrictions on the importation of products of a third country.³⁵ The United States took the same position with respect to the North American Free Trade Agreement (NAFTA), noting that a similar NAFTA provision “permits the United States to ensure that Cuban products or goods made from Cuban materials are not imported into the United States from Mexico or Canada.”³⁶

Chapter 6 of the KORUS FTA further separates admissibility from tariff treatment by providing that “whether a good is originating is not determinative of whether the good is also admissible.”³⁷ This statement appears in a note to Article 6.1, the KORUS FTA provision containing the basic requirements for what constitutes an “originating good.” Thus, it would appear that if a good with some North Korean content were to qualify as an “originating good” under the agreement, this status would not necessitate that it be admitted into the territory of the United States or South Korea.

³² If the United States were to impose an import prohibition or restriction on a non-Party good, however, the United States and Korea, at the request of either, would need to “consult with a view to avoiding undue interference with or distortion of pricing, marketing, or distribution arrangements in the territory of” Korea. KORUS FTA, art. 2.8.5.

³³ See Cuban Assets Control Regulations, 31 C.F.R. § 515.204; Iranian Transaction Regulations, 31 C.F.R. §§ 560.201, 560.407.

³⁴ See 31 C.F.R. § 515.204(a)(2010) for the current provision.

³⁵ United States-Canada Free Trade Agreement, Statement of Administrative Action (CFTA SAA), H.Doc. 100-216, at 177.

³⁶ North American Free Trade Agreement, Statement of Administrative Action (NAFTA SAA), H.Doc. 103-159, at 498.

³⁷ Art. 6.1, n.1.

Further, given that national security considerations may be a factor in restricting imports from North Korea, the “essential security” exception of the KORUS FTA, set out at Article 23.2 of the agreement, may also come into play. Indeed, the United States considered that the security exceptions of the CFTA and the NAFTA could be used to justify its import embargo against Cuba in the event of a challenge.³⁸ The KORUS FTA security exception states, in pertinent part, that “[n]othing in this Agreement shall be construed ... (b) to preclude a Party from applying measures that it considers necessary for the fulfillment of its obligations with respect to the maintenance or restoration or international peace or security or the protection of its own essential security interests.”

Although the United States has considered clauses of this type to be self-judging—that is, not subject to third-party or arbitral scrutiny³⁹—the breadth of such a clause may lead it to be invoked in situations that adversely affected trading partners might not necessarily view as security-related.⁴⁰ The KORUS FTA provides, however, that if the essential security exception is invoked as a defense by a country in a KORUS FTA dispute settlement proceeding—be it a dispute between the United States and South Korea under the State-State provisions of Chapter 22 or a dispute brought against a Party by an investor of the other Party under the investor-State dispute provisions of Chapter 11—“the tribunal or panel hearing the matter shall find that the exception applies.”⁴¹ In other words, assume that South Korea or a South Korean investor alleged in a dispute settlement proceeding that the United States had implemented a particular sanction against North Korea in a manner that violated a KORUS FTA obligation owed either South Korea or the investor. If the United States defended its measure before the panel or tribunal on the ground that it was covered by the agreement’s “essential security” exception, the arbitral tribunal or dispute panel presumably could not examine whether the U.S. measure fell within the scope of the exception. Rather, it would instead be required to find that the exception could be used to justify the measure in question. Further, it is also possible that dispute settlement proceedings may not be instituted at the outset if, in informal consultations, the responding Party conveys to the complainant that it intends to invoke this exception in any such proceeding.

³⁸ CFTA SAA at 177; NAFTA SAA at 498. The NAFTA SAA states that in negotiating the security exception to the NAFTA, “the United States made clear that it would be invoked, if necessary, to prevent any circumvention of the Cuba sanctions program.” NAFTA SAA at 498. In 1962, the United States invoked Article XXI of the GATT, the agreement’s national security exception, to justify the Cuban trade embargo before GATT Contracting Parties. WTO, *Analytical Index: Guide to GATT Law and Practice* 605 (updated 6th ed. 1995).

³⁹ See, e.g., NAFTA SAA at 666 (“The national security exception is self-judging in nature, although each government would expect the provisions to be applied by the other in good faith”).

⁴⁰ See generally John. H. Jackson & Andreas F. Lowenfeld, *Helms-Burton, the U.S., and the WTO*, ASIL Insight (Mar. 1997), at <http://www.asil.org/insight7.cfm>; Hammes L. Schloemann & Stefan Ohlhoff, “Constitutionalization” and Dispute Settlement in the WTO: National Security as an Issue of Competence, 93 *Am. J. In’tl L.* 424 (1999).

⁴¹ KORUS FTA, art. 23.2, n. 2. For further discussion of dispute settlement provisions in the agreement, see CRS Report R41779, *Dispute Settlement in the Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA)*, by Jeanne J. Grimmett. It should be noted that it is U.S. policy not to grant a private right of action in U.S. courts under free trade agreements. In other words, a private individual or firm would not have a cause of action under the agreement, nor could the individual or firm sue any U.S. department or agency, state, or local government on the ground that an action or inaction of the governmental entity was inconsistent with the agreement. See, e.g., United States-Peru Trade Promotion Agreement Implementation Act, P.L. 110-138, § 102(c), 19 U.S.C. § 3805 note.

Rules of Origin (ROO)⁴²

A number of U.S. critics of the KORUS FTA have argued that under the agreement's rules of origin (ROO), South Korean manufacturers will be able to incorporate North Korean components into their exports to the United States.⁴³ ROO are important because they are used to determine the country of origin of imported products for a variety of governmental purposes. Customs officials use them to enforce trade restrictions, properly assess tariffs, apply trade remedies, and collect statistics. Other commercial trade policies are also linked to ROO, such as country-of-origin marking and government procurement. ROO are fairly straightforward when a product is "wholly obtained" from one country.⁴⁴ However, when a finished product's component parts are manufactured in many countries, as is often the case in today's global trading environment, determining origin can be a complex process.⁴⁵ The automotive sector is a prime example because the global supply chain is extensive. A single passenger vehicle can incorporate as many as 15,000 individual components.

For the present discussion of imports from North Korea, the KORUS FTA's ROO are relevant only in those cases where an importer has received permission from OFAC to bring in a South Korean good that contains North Korean components. However, the North Korean content would be considered as non-originating—in other words, not of South Korean or U.S. origin—and thus would not help to qualify the finished good to receive the benefits of the FTA.

The KORUS FTA's rules of origin are examples of preferential ROO, which are used to determine the eligibility of products to receive preferential treatment (duty-free status or reduced tariffs) as a result of an FTA.⁴⁶ One of the primary trade policy goals of preferential ROO is to *exclude* products from countries that are not signatories of the FTA. A second goal is to limit the impact of the FTA on any domestic industry sector that either FTA signatory regards as particularly import-sensitive.⁴⁷ Therefore, in order for goods to receive favorable tariff treatment, importers must be prepared to demonstrate that their products meet certain criteria. Preferential rules of origin are individually negotiated and tailored to meet the needs of each party to the agreement; they vary from FTA to FTA.

Regional value content rules in the KORUS FTA specify that a percentage of inputs must be sourced from either the United States or South Korea. Thus, the KORUS FTA contains incentives that could encourage manufacturers to use parts, labor, and other inputs from either the United

⁴² For more information, see CRS Report R41868, *The Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA): Automobile Rules of Origin*, by Vivian C. Jones and Michaela D. Platzer, and CRS Report RL34524, *International Trade: Rules of Origin*, by Vivian C. Jones and Michael F. Martin. The latter report is out of print but available from the authors.

⁴³ Public Citizen, "Korea FTA: More North Korean "Kaesong" Sweatshop Goods, New Cash for the Kim Dictatorship and Weakened U.S. National Security," Undated Factsheet.

⁴⁴ CRS Report RL34524, *International Trade: Rules of Origin*, by Vivian C. Jones and Michael F. Martin. This report is out of print but available from the authors.

⁴⁵ Ibid. See also LaNassa, Joseph A. "Rules of Origin and the Uruguay Round's Effectiveness in Harmonizing and Regulating Them," *The American Journal of International Law*, 90:4 (October 1996), pp. 625-640.

⁴⁶ The other kind of rules of origin are non-preferential ROO, which are used to confer normal trade relations (i.e., nondiscriminatory or NTR) tariff treatment and to determine the country-of-origin of goods for labeling purposes.

⁴⁷ In the U.S.-South Korea FTA, specific ROO apply to textiles and apparel. Other means that are used to mitigate the adverse effects of an FTA include staging of tariffs and temporary safeguard measures. These measures appear in the proposed South Korea-U.S. FTA under Chapter Two, Annex 2-B and Chapter Ten, respectively.

States or South Korea rather than buying components from North Korea (assuming they are admissible), China, or other markets. The strength of these incentives depends, in part, on the size of the two countries' tariffs before the FTA goes into effect. When external tariffs are low, the cost for an FTA manufacturer of not meeting the ROO is small; when a tariff is higher, there is a greater incentive for a manufacturer to satisfy the ROO to save on tariffs.

As one example, under the KORUS FTA, a specified subset of costs of producing a passenger car or truck must originate in either the United States or South Korea in order to benefit from the lower (preferential) tariffs.⁴⁸ If the FTA's ROO requirements are met, cars imported from South Korea would no longer be subject to the 2.5% U.S. NTR duty on these products. South Korean light truck manufacturers⁴⁹ could gain an even greater price advantage if they meet the KORUS FTA rules of origin, while manufacturers located in China, Japan, or Europe would still be obligated to pay the higher 25% U.S. NTR tariff rates. There might also be similar gains for manufacturers in other industrial sectors.

CBP officials note that Chapter 7 of the KORUS FTA, "Customs Administration and Trade Facilitation" enhances an already mutually beneficial cooperation between U.S. and South Korean customs officials.⁵⁰ This chapter mandates the sharing of information and intelligence, including confidential information when either signatory suspects unlawful activity. Chapter 7 also provides for sharing technical advice, conducting joint training programs, and enforcing regulations that would make the enforcement of the mutual trading relationship more efficient.⁵¹ Since goods from the KIC must also pass through South Korean customs,⁵² to the extent that the KORUS FTA (1) further assists in the establishment of rules-based trade between the United States and South Korea, (2) continues to deepen the U.S.-South Korea economic relationship, and (3) continues to provide grounds and methods for customs cooperation and ongoing dialogue between officials of the two countries, one could argue that the proposed FTA may serve to further limit the entrance into the United States of North Korean-manufactured inputs.

If Members of Congress are not satisfied with these provisions, they might seek to direct CBP officials to discuss with South Korean customs officials the possibility of requiring additional certification from South Korean exporters to the United States. Congress could also consider directing the CBP to conduct a greater percentage of audits of importers that apply for preferences under the KORUS-FTA, either during the transition period or for the life of the agreement.

Conclusion

The KORUS FTA appears likely to have only a minimal impact on whether U.S. sanctions on North Korean imports are put to the test. The KORUS FTA's preferential terms would not apply

⁴⁸ Flexibility is extended to automobile assemblers, permitting them to use one of three methods to demonstrate that their product meets the regional value content requirements of the KORUS FTA. One method—the net cost method—requires that 35% of a specified subset of costs of producing an auto be from the United States or South Korea. The 35% requirement is not based on the entire content of an auto.

⁴⁹ As of 2011, South Korean auto producers were not making light trucks. Of course, this may change in future years.

⁵⁰ Meeting with CBP officials, May 3, 2010.

⁵¹ KORUS FTA, Article 7.5.

⁵² In private conversations with CRS, South Korean officials say that the fact that there is only one border crossing between the KIC and South Korea makes it easier to monitor what comes in and out of the complex.

to finished goods made in the KIC, and the provisions for bringing the KIC into the agreement include multiple opportunities for the United States, including Congress, to block such a move by a future South Korean government. The agreement also contains provisions that aim to help preserve the United States' ability to maintain its restrictions on imports of North Korean goods and components. As long as U.S. sanctions on North Korean imports remain in place and are adequately enforced, the KORUS FTA's rules of origin—which are used to determine the country of origin of imported products—would apply only in cases where an importer has received a license from OFAC to bring in a South Korean good that contains North Korean components.

Thus, the issue of how best to handle imports from North Korea appears to center on customs controls, cooperation, and enforcement. At present, because North Korea exports a minimal amount of manufactured goods to the outside world, the application of U.S. restrictions against North Korean imports has not been significantly challenged. However, this situation may change if at some future date North Korean industry revives and its manufacturers become more integrated into the global economy. The most likely ways this integration would occur would be through increased economic ties between the North Korean and Chinese provinces straddling the DPRK-Chinese border or through a decision by the South and North Korean governments to significantly expand the Kaesong Industrial Complex.

If either or both of these events occur, the possibility of circumventing U.S. import restrictions against North Korea could become a bigger problem than it is today. There is no means to determine with one hundred percent certainty that there are no goods or components originating in North Korea entering U.S. commerce without proper authorization. An example of the challenge faced is the automobile supply chain, in which Chinese or South Korean producers could source one of thousands of components from a low-wage North Korean producer and then seek to evade U.S. customs authorities by not reporting the item to OFAC or CBP. In the case of South Korea, these imports could receive preferential treatment if the KORUS FTA is passed and if the imports meet the agreement's rules of origin. The ability of the United States to enforce its restrictions would then depend to a large extent upon the level of U.S.-South Korea customs cooperation—which arguably would be enhanced by the KORUS FTA—and the severity of the penalties charged for non-compliance with U.S. import restrictions.

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