Internationales Asienforum, Vol. 30 (1999), No. 1-2, p. 153-170

Najin-Sonbong Free Economic and Trade Area in North Korea

Plans, Problems and Progress

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I. Introduction

The establishment of Free Economic and Trade Area (FETA) is one of the most significant institutional innovations in the world economy within the past years. The FETA as a territorial enclave in which foreign firms (in many cases also in co-operation with indigenous companies), benefiting from generous incentives and privileges, produce industrial goods mainly for export, found popularity in developing countries, notably in the newly industrialised countries in Asia. The diffusion of this concept as a growth-oriented policy instrument in developing countries is likely to continue in the near future. In recent years, however, this measure has also been adopted in the former centrally planned economies as an instrument of stimulating economic and structural transformation. It was first applied in China. Nowadays the FETA concept is increasingly gaining importance in other transformation countries in Europe including the former USSR, Poland, Hungary and Bulgaria as well as in Asian countries like Vietnam and North Korea (United Nations Centre on Transnational Corporations 1991: 2).

Although North Korea still maintains that the introduction of a Chinese-style market system is incompatible with *Juche* (self-sufficiency), the North Korean style of socialism, the persistent economic difficulties are increasingly forcing the ruling communist regime to adopt a kind of open-door policy. Though firmly denied by Pyongyang, it is quite clear that the setting-up of the Najin-Sonbong Free Economic and Trade Area in 1991 was largely modelled on the Chinese special economic zones which have been successfully playing the role of growth poles in the economic development and transformation in China. By contrast, however, the recent North Korean experience with Najin-Sonbong has unfortunately been very disappointing, although it is still premature to make an overall appraisal of the long-term economic impacts of the Najin-Sonbong FETA development project.

Apart from some crucial economic and infrastructure impediments which hinder large-scale foreign direct investment in North Korea, this study suggests that the political instability in the country and the inflexibility of the communist regime with its fear of a market system as well as the increasing political hostility between the two Koreas have been detrimental to the development potential and opportunities of the Najin-Sonbong FETA.

II. Major Characteristics of Free Economic and Trade Zones as an Instrument of System Transformation

It is well acknowledged that the introduction of market mechanisms and the modernisation of the economic structure of transformation countries can be more rapidly and efficiently carried out through comprehensive integration into the international economic and business system. The most typical and traditional ways of establishing international economic co-operation are trade and foreign direct investment which are also closely associated with the flow of technology and management techniques as well as access to international markets. In general, major objectives of FETAs in transformation countries appear to be (a) to create 'islands of competitiveness' in an economy which is not yet ready to submit itself fully to (market-oriented) international competition and (b) to transmit the advantages of the market system to the domestic economy so as to make the entire nation more prosperous and competitive (United Nations Centre on Transnational Corporations 1991: 345).

Apart from the countries in transition, a large number of developing (and also developed) countries have also established free economic and trade zones with the aim of attracting foreign capital by providing tax incentives, creating employment opportunities and promoting exports and regional development. Regarding the effects of tax incentives and other public policy measures (including easing of foreign currency regulations, decentralisation of development policy making) on the decision of firms to set themselves up in the FETA and other types of enterprise zones, it has been generally argued that there are positive relationships between the presence of such incentives and increased economic activity (Ge 1995: 228). In this context, the success of a zone is frequently measured by the amount of investment undertaken after the designation, the increase in the number of firms in the zone, and the change in zone employment (Papke 1992: 14). In many cases, the zone's achievements have also been assessed in terms of exports, technology transfer and industrial modernisation, diversification of local economies, etc. (Tuppen 1993: 264).[1]

Besides, major theoretical justifications for the establishment of such economic zones generally maintain that there are economies of scale in the development of land and in the provision of common services and utilities as well as external economies of agglomeration by having similar industries grouped together.[2] Furthermore, governments may wish to impose a geographical limit on the operation of some policies and to restrict certain activities to specific areas (Wall 1993: 248). As regards the latter justification in the transformation countries, it is additionally suggested that, with the enclave nature of a FETA, the process of gradual opening of former command economies to the outside world can be controlled and modulated in a much more subtle and sophisticated way than through a rapid global

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1 For example, in the context of the so-called open-door policy implemented in 1978, the central government of China granted the special economic zones (SEZs) more autonomy in foreign trade and allowed them to charge foreign-invested firms lower taxes than in other regions. In the SEZ the corporate tax rate presently amounts to 15%. This compares with the 55% Chinese firms pay elsewhere in the country and the 33% levied on foreign-funded enterprises in the hinterland. Furthermore, (a) regions and provinces are authorised to set up various types of trading corporations for their own territories, (b) selected enterprises can conduct foreign trade negotiations independently, (c) local governments at different levels and enterprises can retain part of their foreign currency earnings, and (d) provinces such as Guangdong and Fujian were allowed to transfer a smaller share of tax revenue to the central government. The SEZs have undoubtedly made major contributions to the remarkable growth of Chinese exports and national income and have attracted investments from abroad, providing access to business know-how in light industry and the service sector, as well as having a significant impact on the inflow of modern high-technology (Wall 1993: 251).

2 According to the traditional theory of agglomeration economies, economic growth and technology development is stimulated by the economies generated by spatial proximity and associated externalities. By being located near a number of various types of firms in agglomerations or free trade and economic zones, an easy business access (with low transportation costs) to other service and industrial firms (suppliers, distributors etc.) or research institutions is guaranteed. Additionally, in the case of expanding similar industrial branches in a given location, firms can realise economies of scale by using jointly supplied products (and raw materials) or by specialising in production. Furthermore, an intensive sharing of major capital investment and infrastructure by a number of firms is possible in a geographic enclave. Within an economic zone that has a concentration of rapidly growing (foreign and domestic) firms in an emerging dynamic industry and service sector, the recruitment of a specialised labour force is also convenient (Mills/McDonald 1992: 42). Finally, such a geographic proximity makes the inter-firm communication of new ideas, experiences and know-how more efficient and innovative. Consequently, such advantages of agglomeration economies provided by a FETA can have a positive effect on a local economy, stimulate efficient production and also generate productivity growth, leading to higher per capita income than in the rest of the country.

liberalisation of the total national economy (United Nations Centre on Transnational Corporations 1991: 7).

The concept of FETA has evolved and become diversified in recent years as illustrated by the following facts:

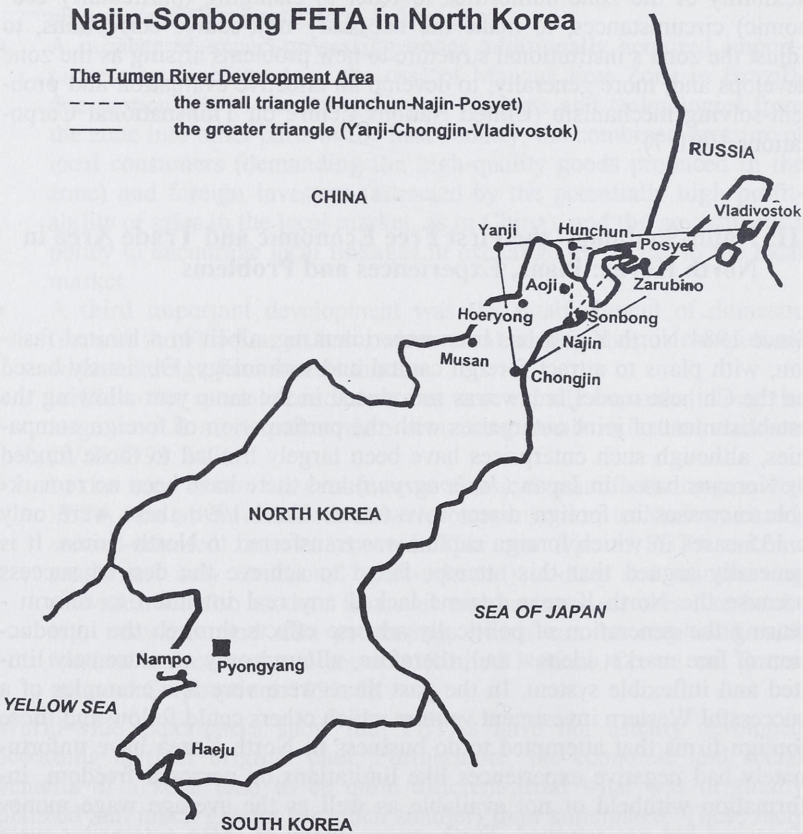
- Instead of being further concentrated in a well-defined territorial area, the investment and other incentives provided in a FETA were gradually extended to other (local or foreign-owned) enterprises, operating elsewhere in the country (e.g. in Hungary).
- A number of export-processing zones additionally acquired import-processing functions (e.g. the case of Manaus Free Zone in Brazil), due particularly to the smuggling of products and technologies from the zone into other parts of the host country, the combined pressure of local consumers (demanding the high-quality goods produced in the zone) and foreign investors (attracted by the potentially high profitability of sales in the local market, as in China), and the government's policy to encourage local linkages in exchange for access to the local market.
- A third important development was the establishment of domestic firms in the FETA as in India where local participation is compulsory when a foreign firm invests there.
- In China the special economic zones were rapidly expanded along the large coastal areas rather than remaining small industrial enclaves (Wall 1993: 247).
- In the near future the evolution of classical manufacturing-oriented FETA into an information and telecommunication technology-based, service-oriented zone is expected. This new type of FETA encompasses not only traditional (port-oriented) trading and transporting activities but also modern financial and business services like banking, insurance and data processing, which can be combined with tourism and educational services (United Nations Centre on Transnational Corporations 1991: 5).

World-wide experiences show that FETAs have not usually developed according to their original plan. Furthermore, the economic and social benefits of a zone tend to be quite different from what was originally planned and much greater (or much smaller) than anticipated. These facts are well indicated by the development of a number of zones into industrial monocultures, rather than into the well-balanced and highly diversified industrial parks envisaged by the planners. The phenomenon is due to a number of complex sociological and economic factors which suggest that a FETA has a life of its own and an internal dynamism that one can hardly predict in the planning process. The mistakes made at the planning and design stage have also led to the failure of FETAs in many countries. These mistakes include, for example, the choice of an underdeveloped region with poor road and air communications; insufficient attention to the basic infrastructure (such as telecommunications or electricity supply, etc.) and to the overall (interregional and/or international) accessibility of the region; a mismatch between skills of indigenous work forces and those required for new production activities, etc. To an even greater extent, however, the successful development of a zone also seems to result from the ability and flexibility of the zone authorities to react to changing (particularly economic) circumstances, to make the necessary mid-course corrections, to adjust the zone's institutional structure to new problems arising as the zone develops and, more generally, to develop an effective evaluation and problem-solving mechanism (United Nations Centre on Transnational Corporations 1991: 7).

III. Najin-Sonbong - the First Free Economic and Trade Area in North Korea: Plans, Experiences and Problems

Since 1984 North Korea has been experimenting, albeit in a limited fashion, with plans to attract foreign capital and technology. Obviously based on the Chinese model, a law was introduced in the same year allowing the establishment of joint enterprises with the participation of foreign companies, although such enterprises have been largely limited to those funded by Koreans based in Japan (*Jochongryun*) and there have been no remarkable increases in foreign direct investment. Until 1990 there were only c. 135 cases in which foreign capital was transferred to North Korea. It is generally argued that this attempt failed to achieve the desired success because the North Korean regime lacked any real intention to reform - fearing the generation of politically adverse effects through the introduction of free market ideas - and, therefore, allowed only an extremely limited and inflexible system. In the past there were very few examples of a successful Western investment venture which others could follow and those foreign firms that attempted to do business in North Korea have unfortunately had negative experiences like limitations on personal freedom, information withheld or not available as well as the average wage money deposited but not returned. Furthermore, many of these enterprises were concerned with alleviating supply problems within North Korea (Cotton 1994: 225). Since the beginning of the 1990s the North Korean government had to change its negative attitude towards establishing free economic and trade zones. The reasons were both political and economic as may be seen from the following:

- the limited economic development caused by the centrally defined ineffective economic strategies and the existing inefficient production system,
- the success of China's gradual 'open-door' transformation policy and
- the disruption of trade with the former Soviet Union since the end of the 1980s.[3]



3 The economic growth rate of the country has been continuously negative since 1990 (-7.7% in 1992 and -6.8% in 1997), while its foreign trade has experienced little increase (Nam 1996: 20). North Korea is presently having difficulties in obtaining urgently needed food and energy. In addition, foreign exchange is also urgently required for buying fuel and spare parts and for paying off its foreign debts which reached US$11.8 billion (= around 53% of total GDP) in 1995 (Yang 1997: 2).

In the relatively remote[4] Najin-Sonbong region c. 140,000 people live in an area of approximately 750 km^2. Apart from the iron, steel and chemical industries, there are a number of large traditional mining areas near the FETA which include Musan (iron), Aoji (coal), Onsung (copper), etc. The establishment of this region as the first North Korean FETA was practically begun at the instigation of the UNDP (United Nations Development Programme) in the context of the international Tumen River Project. Since the beginning of the 1990s the UNDP has been promoting this project which aims at exploring the economic potential of a geo-strategically important region bordered by the Korean Peninsula, China and Russia and transforming it into a new growth triangle in Northeast Asia (Kim 1996: 105). With a view to advancing to the Sea of Japan and economically developing three north-eastern provinces, China initially proposed the development of a special economic district connecting Hunchun (China), Posyet (Russia) and Sonbong or Najin (North Korea) and the dredging of the mouth of the Tumen in order to construct a port (the so-called small triangle). Since it attracted the interest of Mongolia, Japan and South Korea as well as North Korea and Russia, China's plan was expanded into a multilateral co-operative undertaking managed by the UNDP. Later the area to be developed in the context of the Tumen River Project was expanded and a larger triangle was created, which connects Chonjin (North Korea), Yanji (China) and Vladivostok-Nahodka (Russia). The primary goals of the nations participating were to improve the investment climate through co-operative efforts; to cultivate industries which have a relative advantage over other sub-regions; and to energise intra-regional and intermediary trade. In other words, this international project has aimed at taking advantage of the large bordering East Asian markets (Japan, Korea and China), the abundant low-cost labour (China, North Korea), technical manpower (particularly from the Russian Maritime Province), utilising the possibility of becoming the eastern end of a new international transportation network linking Europe and the Asia-Pacific region and exploiting the various natural resources and the potential as an international touristic area (Kim 1996: 109-110). Particularly, the provision of 'hard' infrastructure such as transport and telecommunication networks as well as water and energy supply was considered to be the major aim of this international development project.[5] In this context, the North Korean government de-

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4 The Najin-Sonbong region is located in the eastern part of the country and is at a distance of over 750 km from the capital, Pyongyang.

5 According to the initial UNDP report in 1991, the duration of the Tumen development project was estimated at c. 20 years and the total cost of the entire project was assumed to be approx. US $ 30 billion, of which US $ 11 billion would be spent on the construction of transport infrastructure (Miller/Holm/Kelleher 1991: 2).

clared in 1991 the two cities Najin and Sonbong and their surroundings as the first FETA in North Korea, which would turn to be - within 20 years from 1993 to 2010 as originally estimated - not only a major logistic centre but also a modern export-oriented industrial region with additional touristic attractions.

1. The Original Najin-Sonbong Area Development Schedule

The original schedule for the establishment of the Najin-Sonbong FETA which was modified in 1994, consisted of three stages. Between 1993 and 1995 the endowment of infrastructure was to be rapidly improved as an urgent necessity for developing the FETA as a future intermediate cargo zone.[6] In addition, North Korea originally planned to establish nine industrial parks for firms and foreign investors in the FETA, in which particularly light industry (textile, toys, etc.), electronics (TV, micro-chips, etc.) and auto parts would be located. It was, however, clear that technology and know-how, as well as capital and labour necessary for those industrial activities would all have to be imported either from other parts of North Korea or from abroad, as the existing industries in the Najin-Sonbong area are poorly developed. Furthermore, the attempts of around twenty indigenous manufacturing firms (active in the fields of foods, textiles, chemical goods, etc.) to attract foreign participation in their capacity expansion and modernisation proved fruitless, mainly due to the obsolete capital stocks.[7]

In the second stage between 1996 and 2000, further immense efforts were to be concentrated on attracting foreign investment in Najin-Sonbong and on developing this area into a transit and export-processing zone. In the final phase from 2001 to 2010, Najin-Sonbong was expected to grow as an international, (financial and logistic) service-oriented modern manufacturing centre in north-east Asia. According to this ambitious initial development plan, it was also suggested that the region would additionally act as a growth engine for the entire North Korean economy in the 21st century (Table 1).

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6 This action would also stimulate foreign direct investment in infrastructure and the setting up of production facilities.

7 According to the initial estimation made by the North Korean authorities, the total sum of around US $ 15 million was necessary for this purpose (Yang 1997: 15).

Table 1: The Originally Expected Scale of Private and Infrastructure Investment in Najin-Sonbong Area (in million US $)

	Major industrial specialisation	1st stage 1993-1995	2nd stage 1996-2000	3rd stage 2001-2010	Total investment 1993-2010
Investment in infrastructure:					
Harbours		375.6	405.5	876.0	1657.1
Railways		158.1			158.1
Roads			206.8	139.7	346.5
Airports		467.7	260.9		728.6
Telecommunication		40.9	147.7		188.6
Energy		160.0			160.0
Tourism		87.6			87.6
Private investment in industrial complexes:					
Sinheung	Light industries	201.0			201.0
Dongmyung	Shoes, textiles and other basic commodities	8.5			8.5
Changpyung	Ship reparation, machinery	25.5			25.5
Chungkae	Leather	51.4			51.4
Baekhak	Electronics, auto-parts	943.5			943.5
Ungsang	Timber, furniture		65.9		65.9
Kwangok	Chemical engineering		45.5		45.5
Huchang	Food, wearing apparel			226.2	226.2
Hongeu	Metal, machinery			480.0	480.0
Other areas		1615.1			1615.1
Total sum of infrastructure and private investment:		4134.9	1132.3	1721.9	6989.1

Source: Korea Institute for National Unification; Calculations of the Ifo Institute for Economic Research

2. Major Incentives and Regulations for Foreign Investors

The so-called North Korean Free Economic Trade Zone Law which was officially presented in Hong Kong in 1992 includes, for example:

- a guarantee of freedom of investment (in every industrial and service sector) and safety of carrying out profit-making business activities within the FETA,
- freedom of price determination in the context of the market mechanism
- the requirement that economic activity be export-oriented,
- the permission to possess 100 % of the capital invested and the elimination of any possibility of nationalisation of foreign property,
- the right to choose freely the form of investment: between individual firms, joint venture and joint management,
- the right to use land for 50 years, which can also be transferred and traded, and the possibility of extending the period of land usage,
- permission to bring raw materials, semi-finished goods and assembly parts into the FETA duty-free, if the final goods are to be exported,
- permission for the tax-free overseas repatriation of profits and other legitimate revenues as well as of assets invested and the proceeds from their sale, and
- a non-visa system permitting foreigners' free access to the FETA and free entry into the harbour for foreign ships (see also Park 1996: 14-15).

The conditions offered in Najin-Sonbong are quite attractive, in many ways comparable to those available to investors in China. The legislation relating to the FETA distinguishes between equity and contractual joint ventures (i.e. ventures managed jointly or exclusively by the Korean partner) and foreign enterprises. Foreign enterprises may only operate within the FETA, whereas the other categories may operate in any approved venue on North Korean territory. While the regulations pertaining to the operation of equity and contractual ventures are somewhat general in nature, those regulating foreign enterprises contain a detailed account of the concessions available. While foreign enterprises are required to pay income tax, the rate is set at 14 % within the FETA, and 10 % for certain preferred high-technology activities, compared to 25 % and 20 % respectively in other parts of North Korea. Further, such enterprises (apart from those in the service sector) are exempted from income tax for three years after the first profit-making year, provided they operate for a period of at least ten years. A taxation reduction of up to 50 % (which may be discretionary) is also applicable. Other taxation incentives are offered regarding funds reinvested or used for the provision of infrastructure. Such tax concessions are not allowed in other parts of North Korea.

3. Moderate Achievements in the First Stage of Development Plan and Major Persisting Problems

Although there have recently been some enhancements in the physical infrastructure in the Najin-Sonbong FETA, its serious bottleneck, particularly the interregional and international transport network, has improved rather slowly. In the initial phase of the plan investments by Russian companies and the North Korean-Chinese joint ventures have led to an expansion of the Najin port cargo facilities, the construction of an international hotel in Najin, the electrification of the Hoeryong-Namyang-Haksong railroad, all of which have been completed. Other works are underway such as the extension of the Najin-Wonjong (51 km) and the Chonjin-Hoeryong (100 km) highways and construction of a telecommunication centre in Najin (Kim 1996: 112). The most promising event was the opening of direct container shipping services between Yanbian (China) and Pusan (South Korea) via Najin port. Chongjin, a city some 130 km from the FETA, is also attractive as an export harbour for China. The loading capacity of the harbour will be enhanced by 4 million tons (from 3 million to 7 million tons) in the future.

The major reason why North Korea was not able to significantly improve infrastructure endowment in the Najin-Sonbong area according to the original schedule is that the government has fallen far short of meeting the huge capital requirements. What North Korea desired most, therefore, was to obtain financial support through the UNDP's Tumen River Area Development Project, so as to cover the financial shortage in providing necessary infrastructure in the Najin-Sonbong FETA. But the country has been disappointed by the small amount of foreign capital received. In the future, North Korea will possibly use domestic funds for highways and railroads, but for docking and cargo facilities as well as industrial complexes it will not generate domestic funds if foreign investment is possible (Kim 1996: 115). For this reason, North Korea supported the creation of the Tumen Trust Fund by the UNDP and has been seeking to become a member of the Asian Development Bank (ADB), which will eventually stimulate other international agencies to lend the funds necessary for infrastructure development in the Najin-Sonbong FETA.

Moreover, it was reported in 1996 that Japan was negotiating in support of the expansion and modernisation of the harbour in Zarubino from which a direct railway connection was recently made to Hunchun in China. Indeed, the successful development of neighbouring Zarubino in Russia as the transit centre will not only endanger the potential role of Najin-Sonbong as the export-gate for Chinese products to the world but also further reduce the region's attractiveness as the production site of international firms.

Apart from the poor endowment of infrastructure and its remoteness, there are several economic reasons why foreign firms have been reluctant to invest in the Najin-Sonbong FETA despite the generous tax concessions and other non-tariff incentives. Firstly, the original plan did not adequately consider that neighbouring FETAs like Hunchun in China and Posyet and Vladivostok in Russia competed as potential locations for foreign firms. In addition, efficient co-ordination of the interest conflicts among these FETAs in three different countries has been difficult in the context of the international Tumen River Area Development Project. For example, according to the report of the UNDP and the UNIDO, until the first half of 1995 total foreign investment in the Tumen River Economic Development Area region amounted to US $ 220 million, US $ 140 million in China, US $ 60 million in Russia and US $ 20 million in North Korea. These statistics clearly show that foreign firms have strongly preferred to invest in the Tumen River regions in the former two countries. To be sure, such foreign direct investments particularly in the fields of manufacturing have not only been export-oriented but also significantly affected by the size of the potential domestic markets. However, this UN report does not tally with the official (but less reliable) information from North Korea: As of the end of 1995 foreign investment in the Najin-Sonbong area totalled US $ 330 million in 33 projects on a contractual basis, with actual investment amounting to US $ 200 million in 16 cases (Kim 1996: 113).[8] Even though the information from North Korea is assumed to be correct, a comparison of these figures with the total sum of private and infrastructure investment of approx. US $ 4135 million (US $ 2845 million alone for manufacturing activities) expected in the period 1993-1995 according to the plan (Table 1) clearly shows that the realisation of the Najin-Sonbong FETA development programme has been in trouble. In the early 1990s, foreign investments in real estate, tourism, trade and transportation were quite lively in the Najin-Sonbong FETA but gradually lost momentum thereafter. Foreign investments in the industrial sector have been mainly concentrated on labour-intensive manufacturing in electronics, auto-parts, textiles and clothing, etc.

The second major difficulty involves quality and recruitment of labour. Although enterprises in Najin-Sonbong have the right to hire and fire, an

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8 According to the information given by the Najin-Sonbong International Investment and Business Forum in 1996 (see below), however, by the middle of 1996 total foreign direct investment in the Najin-Sonbong FETA reached approx. US $ 350 million in 49 projects on a contractual basis, with actual investment amounting to US $ 34 million in 22 cases (Yang 1997:10).

agency of the North Korean government is responsible for providing the labour. This enables the state to keep some proportion of the wages paid to labourers.[9] It also prevents enterprises from recruiting experienced labour from the rest of the country, or attracting individual workers by offering suitable terms and conditions. In addition, the wage level for unskilled North Korean labour is higher than that of comparably skilled labour in China and in Vietnam: The average monthly wage of an ordinary worker is estimated to be about US$ 80 in North Korea (Park 1996: 15), partly due to the artificial overvaluation of the North Korean won in relation to the US dollar (see below). At the end of 1996, however, a drastic reduction of the wage level by US $ 50 was reported to be under consideration, which would bring the North Korean wage level (especially for workers in Najin-Sonbong FETA) down to the Vietnamese level (US $ 30). Furthermore, due to the estimated low labour productivity, the transfer of advanced technology and (international) management skills that North Korea expects to achieve through the Najin-Sonbong FETA also seems to be difficult to realise in the short term.

Thirdly, the North Korean currency is not freely convertible, with the won pegged to the US dollar at an arbitrary rate (1 US $ = around 2.2 won[10]). There are no limits to importing foreign currency into the country, but transactions employing the currency must all be conducted in foreign exchange coupons. The system here operates in the manner of the *waihuijuan* used until January 1994 in China, except for the arbitrary rate of conversion, because there is not one but two systems of exchange coupons, the second being for soft currency (including the Russian rouble). These currency arrangements in combination with the underdeveloped banking system present some difficulties for business in North Korea. For example, foreign firms will bring capital into the country to start up the envisaged joint venture, at the present exchange rate; however, for the reasons outlined above, the amounts may exceed the anticipated sum. Though this difficulty is not insuperable, a negotiation for the special rate appears to be still necessary for investing enterprises (Cotton 1994: 225).

Just as overseas Chinese have played a decisive role in the economic development of the SEZ, it is likely that North Korea strongly reckoned with large-scale investment projects in the Najin-Sonbong area initiated by

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9 This same approach was used by China in the early days of the Chinese economic reforms and generated complaints from foreign investors. Until now, the social welfare payments and the total wage bill (in foreign currency) of the foreign companies operating in the Najin-Sonbong FETA are paid to the government which then pays salaries to the workers employed in those foreign companies in North Korean won (Park 1996: 15).

10 The exchange rate on the black market was 1 US$ to approx. 100 won in 1996 (Yang 1997: 1).

South Korean firms and overseas Koreans. Indeed, North Korea has long been considering permitting South Korean financial institutions to establish their branches in Najin-Sonbong, as is already the case with the Dutch ING-Baring Banks and the Daesung-Peregrine Development Bank, a North Korean and Hong Kong joint venture. However, the stoppage of the North-South Korean dialogue on peace and security and the increasing political hostility towards each other in the beginning of the 1990s made South Korean firms (especially large conglomerates) hesitant to invest in the Najin-Sonbong area. At the same time, adopting more strict approval procedures, the South Korean government also discouraged the expansion of production facilities of large firms in the North.

Some positive signals were given by South Korea prior to the Najin-Sonbong International Investment and Business Forum held in autumn 1996, which aimed at improving the bilateral economic co-operation in the Najin-Sonbong FETA. For instance, its Trade Promotion Association (KOTRA) declared that it would open a trade office in the Najin-Sonbong area and the Korean Land Corporation reported its intention to invest approx. US $ 600 million for developing industrial sites, especially for South Korean SMEs interested in investing in the FETA. The South Korean government also encouraged several South Korean firms to enter into joint ventures in North Korea which had been withheld since 1995.[11] However, this thaw ended when North Korea, discontented with South Korea's choice of only 24 SMEs (without large Chaebols) to participate in the Forum[12], refused to allow South Korean journalists and government officials to attend the meeting. Emphasising the fact that journalists and government officials from Japan, the US and China were invited, Seoul interpreted this refusal as North Korea's strategy to isolate the South from economic co-operation and withdrew its participation in the Najin-Sonbong Forum after fruitless negotiations.[13] In the 1992-97 period only five joint

11 These positive gestures were made due in part to the successful formation of KEDO (Korea Energy Development Organisation) in 1995 as well as the progress of the proposal made by South Korea and the US to open Four-Party Talks with North Korea and China on the security issues in the Korean peninsular. In return for North Korea's freezing of nuclear activities as agreed in Geneva between the US and North Korea in 1994, KEDO, consisting of the US, South Korea, Japan and the EU (four executive board members) as well as seven other member countries, is now fulfilling the US promise of providing two 1,000-megawatt light-water nuclear reactors (in Shinpo) and 500,000 tons of heavy oil to North Korea annually.

12 Most of the South Korean SMEs interested in participating in the Forum are manufacturers of electronic parts, textiles and wearing apparel, chemical products as well as drinks and foods. The total amount of direct investment they were willing to make in the Najin-Sonbong FETA amounted to approx. US $ 66 million.

13 In spite of this unpleasant experience, the newly elected South Korean President Kim Dae-Jung promised in his election campaign in 1997 that he would strongly support - indirectly indicating in the context of his gradual unification strategy that it is not in the interest of South Korea

venture projects of four South Korean companies (including Samsung) were approved by the South Korean government, which were partly realised in the Najin-Sonbong FETA. The total sum authorised in this area under the South Korean investment plan amounted to c. US $ 23 million on a contractual basis and the major co-operation was to take place in the manufacture of cement, electronic parts, leather and wearing apparel (Yang 1997: 16).

4. Modification of the Original FETA Development Plan

Since the significant progress in realising the Najin-Sonbong plans and a sudden remarkable concentration of foreign direct investment in the first North Korean FETA was proving to be rather problematic, the communist regime started in 1994 to adjust the ambitious original multi-stage plan of attracting foreign direct investments in the FETA in a more practical way. The first stage, meant to be completed by 1995, has been extended to the year 2000 to encompass the improvement of infrastructure and promote the area as an intermediate cargo zone and an international touristic attraction. The second stage of the modified plan is to make the Najin-Sonbong area a second Singapore by 2010, developing the FETA primarily as a logistic centre, a tourist area and an export-processing base. The plans to develop it as an industrial region by establishing nine industrial complexes have been postponed (Kim 1996: 114).

According to this modified development schedule presented at the 1996 International Investment and Business Forum organised by North Korea in co-operation with the UNDP and the UNIDO, the anticipated total sum of foreign investments to be made - ideally - in the Najin-Sonbong area has, however, significantly increased to c. US $ 12.2 billion. This sum consists of approx. US $ 11.3 billion for 67 private investment projects in the industrial (notably chemical and oil-refining) sector, US $ 640 million for

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for the North to collapse economically and politically - the investment of South Korean firms in the Najin-Sonbong FETA in the future. In the middle of 1998, the Ministry of Unification in South Korea announced that government export permission would no longer be necessary and the number of items imported from North Korea would be reduced from 205 to 178, excluding food products like frozen fish, corn seed, soy beans etc. Before the declaration, South Korean exports of plants and machinery with an individual value of US $ 1 million or the combined value of US $ 3 million had required government permission. These measures aimed at encouraging trade relations with the North and making the joint ventures between the two Koreas easier. However, it is now the question, to what extent the President's political ambition and such government promotion measures will stimulate investment flows from the South to the North in the short term, for South Korean firms were badly hit by the abrupt economic and financial crisis in 1997 and have been suffering severely from rationalisation and structural changes.

construction and expansion of harbours (Najin and Chungjin) and US $ 77 million for roads, US $ 27 million for the establishment of a telecommunication network, US $ 32 million for modernisation of existing industrial plants and a further US $ 160 million for services and tourism (including construction of hotels).

The Forum mentioned above was quite successful and, at the same time, well attended by about 440 participants from 26 countries (including China, Hong Kong, Japan, the US, Russia and the Netherlands), representing 160 companies engaged in various industries such as road construction, hotel business, transportation, financial management, timber and motorcycle industries, etc. The total sum of new investments agreed or promised by the foreign firms participating was reported to be around US $ 570 million.[14]

Parallel to the adjustment of the Najin-Sonbong FETA plan, North Korea also showed its intention to develop urban centres in the western part of the country such as Pyongyang, Nampo and Haeju as further special economic areas so as to attract direct investments from South Korea, Japan, the US and Hong Kong, especially in the branches of textiles, electronics and food processing. South Korean direct investment has been more strongly concentrated on the Pyongyang-Nampo area which is not only more centrally located but also better endowed with infrastructure than Najin-Sonbong. In the period of 1992-97, more than 20 joint venture projects of South Korean firms with partners in the North were approved by the South Korean government, the total sum invested amounting to around US $ 133 million on a contractual basis. Excluding the authorised sum of US $ 45 million for the KEDO project in 1996, the share of investment made and/or planned in Pyongyang-Nampo reached approx. 57 % of the total of US $ 88 million (in comparison to 26 % in the Najin-Sonbong FETA as mentioned before). For example, two South Korean conglomerates have already established production facilities in the Pyongyang-Nampo region: Daewoo currently produces wearing apparel in Nampo, while LG has opened its factory for manufacturing TV-parts in Pyongyang. Hyundai was asked to build a power plant which will cover the electricity demand in the Pyongyang area. Furthermore, several additional investment projects proposed by South Korean SMEs for this central region were approved by the South Korean government in 1995-96. They include business cooperation with North Korean counterparts in producing textiles, wearing apparel and shoes, etc. A large-scale noodle factory was also newly set up in Nampo, with financial support of overseas Koreans.

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14 Yet some South Korean experts still doubt whether these foreign investment projects will be fully realised, according to schedule (Yang 1997: 11).

5. Political Impediments for the Development of Najin-Sonbong FETA

In spite of the intensive efforts recently made to attract foreign capital to the Najin-Sonbong area and the declared intention to create additional FETAs, many economists and politicians in South Korea and abroad still doubt that North Korea, which has indoctrinated its people in the *Juche* ideology, can abruptly introduce a market system and widely open its economy. The possibility of political destabilisation is another reason for this scepticism. To these sceptics, the setting-up of the Najin-Sonbong and other planned FETAs is more a strategy of safeguarding the existing communist system than a pursuit of Chinese-style economic transformation. Furthermore, they maintain that the North Korean regime, while aware of all the advantages that would accrue from the success of these zones, is fearful of the political consequences of any liberalisation of the economy. As a consequence, it is quite often suggested that the regime in North Korea has little interest in integrating the FETA into the rest of the economy and instead prefers the Najin-Sonbong area to remain an isolated enclave (Cotton 1994: 226).[15]

In addition, it is doubtful whether the North Korean bureaucrats, accustomed to a centralised administrative system, would accept the decentralisation of authority and the regionalisation of economic policy making which would follow the introduction of a market system as in China. Given the highly controlled political (and also economic) nature of North Korean society, it would appear to be a difficult task to make the Najin-Sonbong FETA work efficiently. The opening-up of the North Korean economy will thus remain limited.

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15 Recently North Korea erected barriers of approx. 40 km around the FETA. Although they are required for customs reasons, the construction of such barriers indirectly signals that the Najin-Sonbong FETA will be separated from the rest of the country.

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