

Motivations, Prospects and Challenges for Inter-Korean Economic Relations in a New Era

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I. Introduction

At the conclusion of the historic summit held in Pyongyang in mid-June 2000, the two leaders, Kim Dae-Jung from the South and Kim Jong-Il of the host country, signed a five-point declaration (see Box 1). Recognising the legitimacy of current political structures and systems of both countries, this declaration covers several basic issues relating to unification and the promotion of mutual understanding between the two Koreas.¹ In particular, intensive economic cooperation has been again confirmed as a crucial prerequisite for the promotion of inter-Korean relations, peaceful coexistence and eventual unification (see item 4 in Box 1).²

Since the follow-up negotiations regarding the institutional settlement of investment protection for South Korean firms are being intensively carried out and some success has already been achieved in the construction of transport infrastructure in the North³, economic transactions between the two Koreas are expected to become more lively, becoming transformed from the type of simple (barter style) processing trade to the Heckscher-Ohlin style of trade and direct investment including joint ventures. In other words, major inter-Korean economic exchange is likely to occur mostly in the combination of the South's capital and technological and management know-how with the North's land, manpower and natural resources. In addition, large-scale, direct financial assistance from the Seoul government is also

¹ Former South Korean presidents have also tried to hold talks with the North to promote peaceful coexistence and lay a foundation for unification (see the Joint Communiqué of 1972 and the North-South Basic Agreement in 1992). But North Korea has consistently refused to recognise the legitimacy of the South Korean government, and thus has long resisted the idea of holding a summit meeting with Seoul (Han 2000).

² In addition, many have argued that the expansion of economic exchanges and cooperation between the South and the North will reduce unification costs (Jo 1998: 364).

³ The limited reunion of separated family members also took place in August and November 2000 as well as in February 2001.

planned in the form of urgent humanitarian aid (rice and fertilisers) and transfers aimed at supporting the expansion of infrastructure in the North (also partly in the form of long-term, low interest loans).⁴

Box 1

The June 15th North and South Korean Joint Declaration

In accordance with the noble will of the entire people who yearn for the peaceful unification of the nation, President Kim Dae-Jung of the Republic of Korea and National Defence Commission Chairman Kim Jong-Il of the Democratic People's Republic of Korea held a historic meeting and summit talks in Pyongyang from June 13 to June 15, 2000. The leaders of the South and the North, recognising that the meeting and the summit talks were of great significance in promoting mutual understanding, developing South-North relations and realising peaceful unification, declared as follows:

1. The South and the North have agreed to resolve the question of reunification independently and through the joint efforts of the Korean people, who are the masters of the country.
 2. For the achievement of reunification, we have agreed that there is a common element in the South's concept of a confederation and the North's formula for a loose form of federation. The South and the North agreed to promote reunification in that direction.⁵
 3. The South and the North have agreed to promptly resolve humanitarian issues such as exchange visits by separated family members and relatives on the occasion of the August 15 National Liberation Day and the question of unswerving Communists serving prison sentences in the South.
 4. The South and the North have agreed to consolidate mutual trust by promoting balanced development of the national economy through economic cooperation and by stimulating cooperation and exchanges in civic, cultural, sports, health, environmental and all other fields.
 5. The South and the North have agreed to hold a dialogue between relevant authorities in the near future to implement the above agreements expeditiously.
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⁴ In order to carry out this task, the Seoul government plans to expand its North-South Economic Cooperation Fund, restructure the existing Small- and Medium-sized Companies Fund and make the Economic Development Cooperation Fund available for supporting the South-North transactions.

⁵ If the North's loose form of federation were to denote a political system which lets diplomatic and military powers reside in 'regional' (i.e. the North and the South) governments, then it would not be much different from the confederation model proposed by the Seoul government. The only difference would be whether a formal central government without any substantive powers exists or not. However, North Korea should clarify what the loose form of federation means exactly (Lee 2000c: 9).

This study primarily tackles the motivations, problems and prospects surrounding such types of future private and public economic relations between the two Koreas. More importantly, taking into account the North's specific political structure and depressed economic situation as well as its poor location quality and the unfavourable business experiences previously made by foreign firms, this study recommends that the ideal and efficient inter-Korean economic cooperation should be shaped and/or accompanied by

- the North's gradual economic reform combined with an active open-door policy,
- the achievement of co-prosperity led by the continuous growth of the North Korean economy,
- the limitation of South Korea's financial burden to an affordable level,
- the prudent market-oriented calculation and sectoral as well as regional targeting of South Korean investments in the North, and
- the immediate reduction of military tension on the Korean peninsula and the diversion of military expenditures to more productive purposes.

II. Economic Motivations behind the June 2000 Summit Meeting

For a large number of South Koreans the June 2000 summit is the result of the South's ongoing rapprochement efforts made since 1998 in the context of the so-called 'sunshine policy' which was originally aimed at bringing the Pyongyang communist government to peace talks. Apart from the South's promises to guarantee the security of North Korea and help its integration into the international community, the provision of economic aid without preconditions has been the crucial feature of the sunshine policy, which is most often in the form of fertilisers to support the North's agriculture – seriously damaged by natural disasters, mismanagement and failure of the collectivist economic policy (Kimura 1999: 69) –, rice to feed those most disadvantaged by food shortages⁶, and surplus electricity to help the North's

⁶ At the end of 1998 ca. 62 % of North Korean children under the age of seven had stunted growth due to malnutrition. The youngest and the oldest are most vulnerable to food shortages. In addition, shortages of medicine and hospital supplies have created an unprecedented health crisis in the country. Although they do not appear in official statistics, the total market value of the South's rice donations to the North is estimated to exceed US\$ 240 million (Winder 2000: 13). Furthermore, an estimated 200 million US\$ worth of food was delivered from China to North Korea annually in the period 1995–98, while foreign governments and international organisations provided ca. US\$ 1 billion in food aid in the same period (Oh and Hassig 1999: 287). After the June 2000 summit meeting,

industrial recovery.⁷ This policy has also promoted the engagement of South Korean private firms in the North. For example, the ceiling on the size of investment in North Korea was lifted and the transfer of less competitive production activities to the North has been encouraged (Jo 1998: 369).

In return, the South has been demanding that North Korea abandon its military provocations and promise to freeze its programmes for developing nuclear weapons and missiles (Ko 2000: 38). In spite of numerous predictions made by South Korean and Western experts in previous years, the recent economic disaster and food shortages did not lead to a popular revolt or the regime's collapse in North Korea (Zhebin 1998: 152; Cho and Zang 1999: 52). The sunshine policy can thus also be interpreted as a defensive action on the part of the South to safeguard political stability on the Korean peninsula, for in her weakened economic condition the North appears to be more inclined to threaten coexistence with the South by a military attack (Oh and Hassig 1999: 288).

Furthermore, Kim Dae-Jung, in his 'Berlin Declaration' of March 2000, urged North Korea to expand the social infrastructure of the North including highways, harbours, railroads and electric and communication networks so as to attract (South Korean and foreign) private investors and realise meaningful inter-Korean economic cooperation. He also argued that the governments of the two Koreas have important roles to play in creating secure environments including the conclusion of bilateral agreements on investment guarantees and the prevention of double taxation etc. (Kim 2000a: 33; Duerden 2000: 16; Winder 2000: 17). To a certain extent, this measure can be considered as an imitation of the famous West German *Ostpolitik* toward the former GDR which lasted approximately twenty years until unification.⁸ More precisely, by recognising the legitimacy of the North's communist regime the Seoul government officially sent a signal to Pyongyang about its

the Seoul government decided to provide the North with 600,000 tons of fertilisers, seeds and other agricultural materials so as to broaden the future inter-Korean economic exchange programme (Kim 2000b: 21).

⁷ Less than 30 % of North Korean state-owned factories are currently operating, reflecting serious shortages in energy, raw materials and spare parts (Oh and Hassig 1999: 289). The North's electricity production declined from 27.2 to 19.3 billion kWh between 1990 and 1997, while coal production decreased from 33.2 to 20.6 million tons in the same period (Cho and Zang 1999: 23).

⁸ Prior to unification, West Germany implemented a number of support programmes for East Germany including the special tax regimes for importing East German goods, promotion of West German consumption from the East, supporting relocation of production sites from the West to the East, financial transfers for infrastructure construction, provision of funds for environmental protection in the East, etc. (Giessmann 1999: 235).

willingness to provide financial support for infrastructure construction and to further stimulate South Korean private investment in the North.

It is well acknowledged that the South presently overwhelms the North in virtually every economic sphere (see Table 1) and the large difference in economic strength and capability has affected the attitude of the North to the peace process (Winder 2000: 2). More importantly, the persistent economic difficulties and the shortages of food and energy as well as the deteriorating or non-existent infrastructure mentioned above, are increasingly forcing the communist regime to adopt a kind of open-door policy.⁹ The Pyongyang regime is now aware that its survival and stability are largely dependent on expanding economic cooperation with other countries (Jo 1998: 374; Hong 1999: 55), and that it will be difficult to move in this direction without government-led support for the construction of such large-scale infrastructure improvements as roads, electricity networks and port facilities (Park 2000: 3). Food shortages appear to have been overcome to some extent thanks to international aid and China's support (see also footnote 6), but solutions to infrastructure shortcomings cannot be easily found without significant South Korean financial assistance (Ryoo 2000: 8).¹⁰

Furthermore, North Korea now hopes to restore its economy which has recently started to show signs of recovery, although the country still suffers from the lack of endogenous growth potential. According to the Bank of Korea, the real GDP of the North grew by 6.2 % in 1999 after nine consecutive years of negative growth, mainly thanks to an increase in grain production and the expanded support by South Korea and the international community.¹¹ Such a positive economic development has changed the deep-

⁹ North Korea's economic crisis was triggered by the sudden loss of the communist bloc as a market at the beginning of the 1990s, the failure of the so-called self-reliance policy and the unprecedented natural disasters in the last decade, the lack of hard currency for foreign exchange, etc. (Nam 1996: 20; Noland 1996: 128; Zhebin 1998: 136; Kim 1999: 42; Noland 1999: 255; Lanteigne 1999: 52).

¹⁰ North Korea has also calculated that an inter-Korean summit would yield additional diplomatic and political advantages. In particular, the country has recently been seeking possibilities to normalise its relations with Washington and Tokyo (Yoo 1998: 350; Hong 1999: 45). North Korea is also demanding compensation from Japan for damages suffered during the Japanese colonial rule of the Korean peninsula (approximately US\$ 5 billion) and from the US over delays in the construction of its promised light-water nuclear reactors, now being carried out under the supervision of the Korean Energy Development Organisation (KEDO). Improvement of relations between the two Koreas will also contribute to obtaining more financial support from other Western countries and international monetary institutions (Han 2000).

¹¹ North Korea's GDP growth rates were -2.1 % (1994), -4.1 % (1995), -3.6 % (1996), -6.3 % (1997) and -1.1 % (1998), while the corresponding rates for the South in the period 1994-98 amounted to 8.3 %, 8.9 %, 6.8 %, 5.0 % and -6.7 %, respectively.

rooted self-reliance attitude and makes economic cooperation with international partners increasingly attractive for North Korea. Full-fledged economic exchanges with foreign economies will surely help not only to develop the North's economy but also to upgrade its technological level and prepare North Koreans for life in a modern society (Zhebin 1998: 142).

Table 1: Comparison of Selected Economic Indicators between North and South Korea in 1999

	South Korea	North Korea	Ratio South/North
Population in 1000 persons	46,850	22,080	2:1
Gross domestic product (GDP) in billion US dollars	402.1	15.8	25:1
GDP per capita in US dollars	8,581	714	12:1
GDP growth rate in per cent	10.7	6.2	
Exports in million US dollars	143,600	520	276:1
Exchange rate won/US dollar	1,189.48	2.17	
Foreign debt in billion US dollars	136.4	12.4	11:1

Source: The Bank of Korea database

Since 1984 North Korea has been experimenting, albeit in a limited fashion, with plans to attract foreign capital and technology. In this context, the Najin-Sonbong Free Economic and Trade Area was established in the far Northeast of the country in 1994. Although the conditions and incentives offered in this area¹² are more favourable for foreign investors than in the

¹² For example, the so-called 1992 North Korean Free Economic Trade Zone Law includes a guarantee of freedom of foreign investment and price determination; the right to choose freely the form of investment, although joint venture is preferred; the right to use land for 50 years, permission for the tax-free overseas repatriation of profits and other legitimate revenues, etc. Additionally, foreign enterprises are required to pay income tax at the rate of 14 % and 10 % for certain preferred high-technology activities in the Najin-Sonbong area, compared to 25 % resp. 20 % in other parts of North Korea. Furthermore, such enterprises (excluding 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 in this free economic and trade area. In addition, 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 (Nam and Yoo 1999: 161).

comparable zones in China and Vietnam, the recent experience of the North with Najin-Sonbong has unfortunately been quite disappointing, for it attracted only limited foreign investments (Nam and Yoo 1999: 154; Yoo 1998: 345; Lanteigne 1999: 57).¹³ Besides, due in part to the loss of foreign markets in the former communist bloc countries, North Korea's foreign trade declined by more than 50 % from US\$ 4.7 to US\$ 2.2 billion between 1990 and 1997 (Oh and Hassig 1999: 297). By contrast, the bilateral economic cooperation between the two Koreas privately led by South Korean firms has recently been quite lively and successful, thereby contributing to the change in the North's attitude toward cooperation with the South. A notable example is the Mt. Kumgang tourism project initiated by the Hyundai corporation.¹⁴ In addition, North-South trade gradually rose from US\$ 227 million in 1994 to US\$ 333 million in 1999 and, as a consequence, South Korea is currently the North's third largest trade partner (Cho and Zang 1999: 35). The South's recent exports to the North (ca. US\$ 212 million in 1999) consist of machinery and transport equipment, textiles, non-metal mineral products and primary consumer goods including foodstuffs, while the country has been importing mainly textiles, agricultural, forestry and fishery products as well as steel and other metal products from the North to the value of approx. US\$ 121 million in 1999 (*Vantage Point*, Vol. 23, No. 2, February 2000: 25).¹⁵ In addition, more than 100 small and medium-sized South Korean firms are now doing business with North Korea. Apart from Daewoo, which currently produces wearing apparel in Nampo, larger companies are also exploring opportunities for large-scale factories to manufacture electronic products and assemble automobiles in the Pyongyang-Nampo area, as indicated in Table 2 (Kim 2000a: 33; see also footnote 21).

¹³ Almost 80 companies, mainly from China, Hong Kong, Thailand and Japan, have taken advantage of incentives to invest US\$ 150 million in the Najin-Sonbong area (Duerden 2000: 18). Together with the port of Chungjin, this area is most likely to be developed in the future as a tourism area and transport centre for exporting heavy industrial and chemical products to be produced in its surroundings (Nam and Yoo 1999: 160).

¹⁴ Hyundai pays the North US\$ 12 million every month for the right to operate this tourism project, a franchise granted to the company for 30 years. However, it was reported in November 2000 that the company has suffered a total loss of ca. US\$ 200 million which has accumulated since the creation of this project in 1998 (*The Chosun-Ilbo*, November 1, 2000).

¹⁵ In addition, non-commercial inter-Korean transactions amounting to US\$ 144 million includes US\$ 43 million for the South's aid to the North, US\$ 41 million for payments to the North for tourism projects and US\$ 40 million in heavy oil shipped by the Korean Energy Development Organisation (KEDO) to the North in 1999 (*Vantage Point*, Vol. 23, No. 2, February 2000: 24).

Table 2: South Korean Private Sector Statements and Intentions of Economic Activity in the North: A Selection

Companies	Cooperation activities
Samsung Electronics	Expansion of a facility to assemble TVs at the Taedong River Complex. Software development
Hyundai Corporation	Industrial complex specialising in manufacturing footwear. Ore processing plant
South Korean Banks	Exploring plans to expand ties with its North Korean partners
Pyonghwa Motor Company	Broke ground on a plant to assemble Fiat cars for domestic consumption and export to China
Korean Electrical Contractors Association	Electric bulb factory
Korean Electronics Industries Cooperative	Production of condensers
Korean Software Industry Association	Joint project with North Korea's Computer Centre in Beijing
Kumho Tire	Regional tyre plant
Elcanto	Production of shoes & leather goods
Cheil Jedang Co.	Production of foodstuffs, medicines and animal fodder
Tongyang Group	Facility for food processing

Source: Winder (2000), *The Economic Dynamics of the Korean Peninsula Peace Process*; Kim (2000b), *South-North Summit to Spur Special Boom in Inter-Korean Economic Ties*

III. Major Impediments, Business Opportunities and Recent Progress of South-North Economic Cooperation

After the summit meeting both Korean governments established inter-agency task force groups to come up with specific proposals for implementing the declaration. The follow-up talks have been taking place at the senior official level, although the North quite often postponed the negotiations. Private firms of the South also responded enthusiastically to the success of the first summit meeting (Kim 2000b: 22) but, at the same time, demanded rapid changes in the business environment in the North which

are necessary to improve their involvement there. The list of well-known major obstacles to economic cooperation on the Korean peninsula include:

- the lack of legal and institutional framework required for the protection of South Korean investment,
- North Korea's inadequate infrastructure and costly logistics,
- its existing rules and business practice, for example regarding labour procurement and currency convertibility, which are quite often unacceptable for external economic cooperation¹⁶,
- less-competitive indigenous industries with obsolete capital stock, rudimentary manufacturing and management skills and low technology,
- immature domestic markets for products manufactured in the North,
- the uncertainty of future South-North political relations, military tension, etc. (Nam 1996: 20; Cho and Zang 1999: 37).

Recalling the recent German experience with unification and the consequent excessive fiscal transfers from the West to the East¹⁷, some critics emphasise that the South should now concentrate more on improving its less stable economic condition, because the country's present economic power is unfortunately not strong enough to adequately provide the capital that the North urgently needs. In addition, South Korea has not yet completely recovered from the 1997 financial crisis and the follow-up structural changes. From their point of view, the South-North economic cooperation in the medium to the long term will most probably cause serious financial burdens for South Koreans, although such cooperation appears to be stimulating the South Korean economy to a certain extent (Kim 2000a: 38).¹⁸

¹⁶ Basically North Korea is reluctant to participate in joint ventures with foreign partners (see its 1984 Joint Management Law). Although joint ventures are allowed, foreign investors can retain management rights – based on their equity interest – only for a set period of time, after which they are required to turn over management control to the North Korean authorities. Moreover, an agency of the North Korean government is responsible for labour procurement for those joint ventures, which enables the state to keep some proportion of the wages paid to labourers and prevent enterprises from recruiting experienced labour from other areas of the country. In addition, the North Korean currency is not freely convertible at present, with the won pegged to the US dollar at an arbitrary rate (1 US dollar = around 2.2 won), as shown in Table 1.

¹⁷ According to the official statistics of the German Federal Ministry of Finance, the total average annual net transfers from the West to the East amounted to ca. DM 131 billion between 1991 and 1999, to which the *Bund* contributed on average of DM 76 billion per year.

¹⁸ According to the German experience, such a type of economic boom lasted less than five years in the West, which was mainly triggered by the fiscal transfers from the West and the 1 to 1 swap between the two German marks after unification.

It is quite often said in South Korea that approximately US\$ 9 billion will be required just for realising short-term infrastructure projects in North Korea, whereas the South's financial resources available for such purposes in the North are estimated to be less than US\$ 2 billion. For this reason, external means should be additionally secured in the near future for financing the construction of infrastructure in the North including support from Japan's Overseas Development Assistance Fund and large international monetary institutions like the Asian Development Bank, the International Monetary Fund and the World Bank (Ryoo 2000: 23).

According to the macro-economic estimation of the Independent Strategy, an international policy analysis institute in London, a stable political coexistence between the two Koreas could only be guaranteed if the disparity of living standards between the North and the South were reduced from the present ratio of 1 to 12 to a relation of 1 to 3 within ten years. South Korea's total contribution to the achievement of this goal would reach approximately US\$ 1 trillion, compared to the country's GDP of US\$ 418 billion in 1999. Even more pessimistically, the US Investment Bank Goldman Sachs calculated capital transfers of US\$ 3 trillion required from the World Bank in addition to US\$ 2.5 trillion from the South for the achievement of the same purpose. On the other hand, the Hoover Institution, Stanford University considers the short-term convergence of living standards between the two Koreas unnecessary and the prospect of intensive migration from the North to the South unlikely in the next five years. And extra financial resources of approximately US\$ 200 billion would be sufficient to meet the immediate needs of North Korean economic recovery in the same period of time. The relaxation of military tension and disarmament on the Korean peninsula would lead to the reduction of defence expenses in the North and the South, thereby saving an estimated ca. US\$ 15 billion resp. ca. US\$ 3 billion annually.¹⁹ Provided that Japan, the US and the World Bank would supply transfers of around US\$ 60 billion to the North, the South's total financial burden would amount to around US\$ 50 billion in the next five years (Köhler 2000: 80).

Due partly to the anticipated serious financial burdens, many South Korean experts foresee that economic cooperation between the two Koreas will initially proceed rather cautiously and gradually, beginning with branches of industry preferred by the North (Kim 2000a: 35). Economic cooperation to date between South and North Korea has been in the form of processing

¹⁹ North Korea devotes substantial resources to its military. A commonly accepted figure is 25% of GNP. In addition, the military poses a huge drain on labour supplies: Roughly more than 6% of the total population is on active military duty (Barna 1998: 269 and see below).

trade, which involves the shipment of raw and subsidiary materials from the North to the South for processing. The processed goods are then delivered to North Korea for finishing or final assembly, and once again brought back to the South as completed products. Also, in the future, major inter-Korean economic exchange is expected to take place mostly in the combination of South Korea's capital and technological and managerial know-how with North Korea's land, manpower and natural resources (Kim 1999: 54; Ahn 2000: 19). Moreover, economic cooperation between the two Koreas will switch from indirect trade, in the form of simple processing trade, to direct trade and investment (Lee 2000a: 15–16). In the short term, export-oriented industries aimed at serving the markets of South Korea, China and other countries²⁰ will have a better chance than investors targeting the domestic market of the North, although in the medium or long term some business opportunities for telecommunication industries, insurance firms and financial service providers will be available.

A large number of detailed proposals and plans have already been presented for the realisation of future South-North economic cooperation. At the initial stage, the Federation of Korean Industries (FKI) desires, for example, cooperation in the construction of infrastructure, including projects like building cargo-handling facilities at the port of Nampo (near Pyongyang)²¹, a highway linking Panmunjom and Haeju city²², and some power generation plants. Other plans include the establishment of a trade centre at Panmunjom, construction of direct South-North railroad systems and the opening up of air routes for commercial aircraft, particularly to reduce transport costs. Furthermore, joint development of the demilitarised zones (DMZ), a flood control project along the Imjin River on the border, the establishment of several industrial parks (including Kaesong near the South) and mutual exchange of electric power resources are also widely discussed in South Korea (Ryoo 2000: 22).

²⁰ As relations between North Korea and the US further improve, trade sanctions will be relaxed and firms from Western countries are expected to invest in manufacturing in the North with the Chinese market in mind.

²¹ Pyongyang and Nampo are areas with the most extensive infrastructure endowment in North Korea and provide an attractive, comprehensive industrial base where both heavy and light industries are concentrated – Pyongyang with light industries like textile and apparel, electrical appliances, electronics, information and communications, also machinery, cement, non-ferrous metals and food and Nampo with electrical appliances, electronics, shipbuilding, non-ferrous metals and steel (Lee 2000b: 43).

²² Haeju, endowed with cement and non-ferrous metal industries, and Kaesong with food and textile industries are favourable cities for food manufacturing and processing, light industries and electrical engineering and electronics. These products could be easily delivered to the Seoul and other South Korean markets when inter-Korean transport facilities are restored (see also Lee 2000b: 43).

Parallel to the improvement of infrastructure in North Korea, South Korean construction companies are reluctant to expand their business activities in the North by jointly participating in government-sponsored projects, together with other firms producing cement and construction materials. Business cooperation between firms in the two Koreas is judged to be promising in the short term for light industries like textiles, clothing, footwear, leather goods, bags, toys, wood products and assembly of electronic items. More importantly, North Korea has always been looking for foreign investment in order to expand production capacities for daily necessities (soap, paper and medical supplies) and foodstuffs (including salt, sugar, processed agricultural and fishery goods). Particularly promising for investment by the South appears to be the exploitation of natural resources like iron, gold, silver, copper, uranium, coal, etc. which can also be processed for export, provided the necessary infrastructure (electricity and transportation) is adequately developed. Since the South's industrial structure is in the process of transformation into a more sophisticated (information and communication oriented), knowledge-based digital economy, some capital-intensive, heavy and chemical industries including shipbuilding, automobile manufacturing, machinery, steel and chemicals also seem to be production areas that can be transferred to North Korea in the medium and long term. Such relocation to the North can also occur in the short term in the form of manufacturing simple intermediate products and/or assembling parts provided by South Korean firms. Nowadays, it is difficult to expect light and heavy industries to develop efficiently without the concurrent development of electronics, computer and telecommunication industries. Hence, the beginning of cooperation in these high-tech industries (through assembly of home appliances and computer hardware parts, joint development of software, etc.) is also conceivable in the early stages of South-North collaboration (Lee 2000b: 36–38).²³

In order to minimise the related risks of business involvement in the North, the following strategies have been recommended in the South:

²³ Inter-Korean cooperation in the high-tech sector can be disturbed, because many items and technologies are presently prohibited from being transferred to North Korea under the so-called Wassenaar arrangement which replaced the former Coordinating Committee for Export to the Communist Area (COCOM). This arrangement forbids the transfer of conventional weapons and other goods and technologies with dual (civil and military) applications to areas where the outbreak of war is likely. The list covers nine types of dual-use goods related to advanced materials, material processing, electronics, computers, telecommunications, information security, sensors and lasers, navigation and avionics, marine technology and propulsion devices – as well as software and other technologies that can be used to develop, manufacture and operate these items (Jung 1999: 38; Lee 2000b: 39).

- South Korean companies – especially small and medium-sized enterprises – should start with small-scale projects with confidential partners in the North.
- It is wiser to begin with contract-based manufacturing activities with the provision of production facilities and equipment from the South and then shift gradually toward direct investment, as South Korean firms' experience in doing business in the North grows.
- To create synergy and to prevent excessive competition as well as to realise economies of scale for collecting information and improving negotiation power, it is advised that similar types of small and medium-sized firms or those companies with horizontal and vertical linkages invest together as a group or a consortium in a specific (promising) area or industrial park in the North.
- South Korean firms can take part in international investment projects with Chinese and Japanese firms as well as other Western companies (Lee 2000b: 45–46).

As mentioned above, various negotiations have already taken place between the governments of the South and the North – in the context of the South-North Joint Economic Committee – in order to solve the acute problems that have seriously disturbed intensive economic exchange between the two Koreas in the past. Some successes have already been achieved and more are expected for the expansion of infrastructure and the creation of a legal framework to secure a favourable investment environment for South Korean firms in the North. Since the summit in June 2000 the following steps have been taken:

- Intensive negotiation is now going on between the two Koreas in order to reach a mutual, concrete agreement on institutional matters related to the settlement of payments, investment protection, avoidance of double taxation, etc. A promising signal would be that North Korea provide more favourable conditions for South Korean investors than it has guaranteed to those foreign firms located in the Najin-Sonbong area.
- Instead of using the currencies of both countries, it has also recently been agreed to create a new monetary calculation unit in order to effectively administer transactions between the South and the North.
- The construction work for reconnecting the Gyeong-ui railroad between Seoul and Sinuiju²⁴ in the Northwest of North Korea (close to the Chinese border) has started. It will serve cargo transport not only between

²⁴ The Sinuiju area engages mainly in light industries such as textile and clothing, paper, machinery, electrical appliances and electronics, and has the potential to become a base for exports to China (Lee 2000b: 44).

the two Koreas but also between South Korea and China.²⁵ Under discussion is a further railway reconnection between Seoul and Wonsan²⁶ on the East Sea coast, which can be then further expanded via Najin to Russia.

IV. Future Strategies, Open Questions and Concluding Remarks

Economic cooperation between the South and the North is a vitally important task for the two Koreas, and this should not be interpreted as one-sided unconditional economic aid from the South to the North. Moreover, it should also be emphasised that the North is primarily responsible for solving its own acute economic problems by itself. The South should acknowledge its complementary role as a supporter of such a recovery process by providing financial aid (including long-term, low interest loans) and private direct investments, etc. necessary for accomplishing better balanced economic development on the Korean peninsula. More urgently, the South's efforts should be appreciated by the communists in the North. On the other hand, improvement of economic relations between the South and the North must basically aim at realising co-prosperity (i.e. mutual benefits) for both Koreas. By efficiently employing the South's and foreign financial support for profitable and productive projects (not pursuing the conventional military-first policy), the North Korean economy should be able to achieve a sounder recovery and strengthen its international competitiveness in the near future, which will, in turn, create medium to long-term benefits for the South. Unfortunately the majority of South Korean and international experts are not yet fully convinced about the rapid adoption of significant economic reforms and an ambitious open-door policy in the North, which is considered an absolute prerequisite for fast economic growth there (see also Oh and Hassig 1999: 305; Cho and Zhang 1999: 52).

Apart from the anticipated considerable direct assistance from the South Korean government, some additional (foreign) financial resources must be secured in order to achieve economic development and improve infrastruc-

²⁵ The high cost of maritime transportation significantly impedes the expansion of North-South transactions. When the Gyeong-ui railway line is fully restored, the cost of transporting goods between Nampo and Seoul, which currently involves maritime transportation between Nampo and Incheon, will be reduced by some two-thirds. (Lee 2000a: 15).

²⁶ The city of Wonsan is well suited for tourism, light industry, assembly of electrical and electronic goods, food (especially fish) processing, shipbuilding and other industrial goods for export to the Japanese market (Lee 2000b: 43).

ture endowment in the North. North Korea should also be active in expanding its role in the international community and in acquiring extra financial support from other developed countries. In this context, the North's recent attempts to normalise its relationship with the US and Japan and its efforts to join international financial organisations should be appreciated and supported.²⁷ On the other hand, the South's economic and financial burden should be minimised and, at the same time, limited to a level which the country can afford, although such a level appears to be difficult to define. Therefore, it is desirable that both Koreas should not try to resolve all outstanding economic problems at once, and, instead, approach individual issues on a step-by-step basis (see also Park 2000: 15). For example, the type, scale and priorities of infrastructure construction should be decided after adequate consideration of what assistance North Korea immediately requests and/or accepts, and the South's financial capability to support such projects as well as the economic effectiveness and feasibility of the same. Furthermore, strategies of the Seoul government and South Korean private firms should be well coordinated so that (public and private) development projects can be – at least initially – concentrated on potential growth poles like Pyongyang, Haeju, Kaesong, Wonsan and Sinuiju.

Apart from the provision of urgent unconditional aid (fertilisers and rice) as well as financial support for infrastructure construction in the North, the South Korean government should concentrate on preparing relevant laws and institutional frameworks and simplifying procedures related to investing in and conducting transactions with the North. This will create important foundations for the involvement of South Korean companies in the North. However, relocating business activities from the South to the North is still assessed as risky (see also below), the country's location quality is rather poor²⁸ and many foreign investments made there in previous years turned out to be flops (Nam and Yoo 1999: 157). For these reasons, a more prudent (market- and profit-oriented) economic calculation is required for investment decision-making. Those who argue for excessive tax breaks as

²⁷ In particular, North Korea and the US agreed to establish liaison offices in Pyongyang and Washington DC in 2001, and are presently carrying out negotiations concerning the development stop of North Korean long-range missiles. Nevertheless, the import ban for North Korean products to the US market still prevails and the country remains on the US list of the so-called international terrorism supporting countries. Such US sanctions will be partially eased or removed when the ongoing negotiations achieve success (see also Jung 1999: 39).

²⁸ Apart from the already mentioned inadequate infrastructure, less competitive industries with obsolete capital stock, immature domestic markets, etc. the North Korean level appears to be higher than in Vietnam. Moreover, due to the estimated low labour productivity, the transfer of advanced technology also seems to be rather difficult in the short term (Nam and Yoo 1999: 165).

well as government financial support and debt payment guarantees for South Korean firms doing business in the North should recall the subsequent over-investment in unprofitable projects in the case of East Germany (Sinn 2000: 14) and the related moral hazard problems which caused the unforgettable economic crisis in South Korea a few years ago (Nam 2000: 29).

The North Korean army is currently the fifth largest in the world measured in terms of ground troops (far more than one million soldiers) and the country is also a potential nuclear threat (Zhebin 1998: 148; Eberstadt 1999: 83; Lanteigne 2000: 61; Smith 2000: 118).²⁹ In spite of the thaw on the Korean peninsula, the strength and importance of the North Korean armed forces appears unchanged as security for the communist regime. Furthermore, the military manoeuvres in the North which took place in summer 2000 were reported to be the largest in the country's history.³⁰ It is, therefore, not surprising that very few inter-Korean contacts and negotiations regarding disarmament have been arranged until now and no remarkable success has yet been achieved in this field. The persistent military tension on the Korean peninsula will not only make Southern private investment remain risky but also strongly disturb overall efforts at improving political and economic relations between the two Koreas. To be sure, a reduction in economic disparity between the two Koreas is an important condition for peaceful coexistence to which the South is now willing to financially contribute. On the other hand, Pyongyang should also recognise that the immediate reduction of military tension is the foremost precondition for successful economic cooperation with the South and eventual unification. Furthermore, alleviation of military tension will allow the diversion of military expenditures to more productive purposes, a *sine qua non* for rapid economic recovery in the North.

²⁹ The North Korean army is also currently endowed with 3,600 tanks, 9,500 artillery, 1,600 aircraft and a fleet of 440 ships. One of the major factors behind the army's increased importance is that at present Kim Jong-Il legally possesses only two top executive positions: as Chairman of the Defence Committee and Commander-in-Chief of the North Korean People's Army. So the military establishment is the only unquestionably legitimate power base for him. Another major reason may be the drastically changed domestic (death of his father, natural disasters) and international situation (the USSR's disintegration and the collapse of socialism in Eastern Europe). The lessons drawn by North Korean leaders from the events in Eastern Europe have made them rely even more on the armed forces (Zhebin 1998: 149).

³⁰ *The Chosun-Ilbo*, October 11, 2000.

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