

THE MATTER OF THE KAESONG INDUSTRIAL COMPLEX IN THE KOREA-U.S. FREE TRADE AGREEMENT NEGOTIATIONS

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CONTENTS

- I. Introduction
- II. Why Did the SEZs in China Work?
- III. Does the China Experience Matter to North Korea?
- IV. Is the U.S. Position on Kaesong in the FTA Negotiations Wrong?
- V. Is the Issue of Kaesong in the FTA a Deal Breaker?
- VI. Next Steps in Negotiations between the United States and South Korea about Kaesong

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I. Introduction

An issue under discussion in the negotiation of the Korea-U.S. Free Trade Agreement (FTA) is whether items produced in the Kaesong Industrial Complex (henceforth, just “Kaesong”) in North Korea will be subject to preferential treatment under the FTA. The South Korean position is that such items should be eligible for FTA preferences. The U.S. position is that, because Kaesong is located in North Korea, which is not under the effective sovereignty of South Korea and, furthermore, is designated as a “rogue state,” such items should not be thusly eligible. Both sides have, thus far, been quite insistent upon the position they have taken. Some analysts (see especially Schott et al. [2006] and Noland [2006a]) believe that this issue has the potential to be a deal breaker, one that could derail the negotiation or U.S. congressional ratification of an agreement such that the FTA never comes to fruition.

Kaesong is one of three such zones that have been announced in North Korea but is the only of the three to show much signs of life and, also, the only zone whose products South Korea seeks to have included in the FTA.¹ The genesis of Kaesong lies in the Sunshine Policy of former South Korean president Kim Dae-jung, which was meant to improve relations between the two Koreas. The Kaesong complex thus was formally announced in late 2002.² Kaesong is located just north of the border with South Korea and takes its name from a nearby and ancient city that is the burial place of many Korean kings. The complex is directly on the route an army invading the North from the South, or vice versa, would likely take, and straddling the likely invasion routes with a cooperative endeavor between the two Koreas was a deliberate symbolic act. In practice, Kaesong has been developed jointly by the South Korean government and by the Hyundai Asan firm, and it has formally been in operation since late 2004. The role of the government has largely been to subsidize investments there.

Development of the complex has been hampered by the financial difficulties of the Hyundai firm and South Korean government participation has occurred in some measure to compensate for the inability of Hyundai to finance the undertaking. At the current time, the scale of operations is modest but, by 2007, the South Korean government anticipates that some 300 South Korean companies will have operations

1. The other two zones are at Sinuiju on the Chinese border and at Rajin-Songbon in the northeast. Rajin-Songbon has drawn something like \$88 million in investment, but this is a small sum. The area is unfavorably situated and seems unlikely to be developed further. Sinuiju’s development was undertaken by Yang Bin, a Chinese-Dutch tycoon who seems to have in mind to develop a casino-resort complex there, with Chinese money and oriented toward the Chinese market. At last report, Yang was under arrest in China on charges of corruption, and Sinuiju was not being developed.

2. At the same time, the Mt. Kumgang area of North Korea was designated as a special tourist zone and the special administrative region was designated at Sinuiju.

in Kaesong employing as many as 150,000 workers. Noland (2006a) indicates that Kaesong could, if developed as intensively as planned, earn as much as \$1.7 billion per annum for the North Korean government, an amount that, if realized, almost surely would dwarf the revenues to this government from its current illicit activities. However, there has been expressed skepticism in the business press as to whether Kaesong will be developed as fast as the South Korean government has indicated it will be.

That products from Kaesong should be subject to preferential treatment under an FTA in which South Korea participates is not an idea unique to the Korea-U.S. FTA (Schott et al. 2006). Indeed, under an FTA under negotiation between South Korea and the Association of Southeast Asia Nations (ASEAN), products made in Kaesong would be subject to preferential arrangements.

In its essence, the U.S. position is based on political considerations, albeit ones with economic overtones. In a word, the United States believes that to allow FTA preferences for items produced in Kaesong would convey economic benefit to North Korea, which is seen by the United States as a rogue nation that has been attempting to develop nuclear weapons and long-range missiles that (again from a U.S. perspective, at least) would be destabilizing to the world order. Moreover, the United States maintains that the North Korean government has engaged in criminal activity such as the counterfeiting of U.S. currency, drug trafficking, trafficking in prohibited products (for example, animal parts from endangered species), and money laundering.³ In U.S. eyes, nothing then should be undertaken that would convey economic benefit to this state, because economic benefits might then translate into capacity to do further mischief of the sort that North Korea is already engaged in. Thus, the United States has not only signaled that it cannot accept that products from Kaesong be subject to FTA preferences; the U.S. government has, for the most part, shown no enthusiasm whatsoever toward the zone or South Korea's plans for it.

3. On these activities, see Noland (2006a) and Asher (2005). Noland notes that North Korea has long engaged in such activities but that they were stepped up during the mid-1990s when the North Korean state began experiencing severe economic difficulties, including cessation of aid that previously had been received from then-socialist countries, and food shortages that led to famine conditions. It is not known how much revenue North Korea derives from these activities, but a U.S. government estimate in 2001 was that these revenues are about \$560 million a year; Noland stresses that this number is subject to considerable uncertainty, and he implies that the number is likely on the high side. Moreover, there is some evidence that, since the late 1990s, illicit trafficking by North Korea has become "privatized" such that the revenues from at least some of this trafficking do not accrue to the government there. One thing that is clear is, if Kaesong were to be successful, it would seem highly likely that revenues from Kaesong to the North Korea government then would greatly surpass those from illicit activities. This in turn suggests that some sort of bargain whereby North Korea would cease its illicit activities in exchange for some sort of U.S. acceptance of Kaesong might be possible. See conclusion of this article.

The U.S. stance in this matter is consistent with U.S. policy applied to other nations whose governments are seen as pariahs or rogue states. Typical U.S. policy toward such states has included application of economic sanctions, which come down mostly to bans on trade between these states and the United States. The United States currently maintains economic sanctions against North Korea as well as a number of other nations, including Burma (Myanmar), Syria, Cuba, and Iran. A point that has been made is that these sanctions have accumulated a poor record of achieving what presumably is their goal, notably alteration of the behavior of the nation in question or regime change in the nation, or both (Hufbauer, Schott, and Elliott 1990). A number of analysts, including Hufbauer, Schott, and Elliott (1990) argue that U.S. sanctions have enabled dictatorial regimes actually to intensify their hold on the nations noted above, because the regimes have been able to point to the sanctions, rather than their own failings, as the source of poor economic performance by these nations.

In addition, U.S. analysts note that inclusion of products produced in Kaesong under FTA preferences would raise concerns regarding treatment of labor. Noland (2006a) notes that these concerns are of two types, substantive and procedural. Substantive concerns center on the fact that North Korea does not adhere to core labor standards as per the International Labor Organization (ILO). Such concerns have been addressed in other FTAs negotiated by the United States but also have, in some cases, led to difficulties obtaining passage of the required enabling legislation from the U.S. Congress.⁴ Procedural concerns center on the fact that, even if the FTA were to include language so as to bring Kaesong into conformity with ILO standards, neither the United States nor South Korea would be in a position to enforce such standards. On the labor issue, South Koreans have retorted that the United States trades with Vietnam and China and that wages in Kaesong would not be lower than those paid in the export sectors in Vietnam or parts of China and, moreover, labor conditions are generally as favorable in Kaesong as in these nations. The U.S. counterretort has that, even though the United States might trade with these nations, the U.S. government is not considering entering into FTAs with Vietnam or China, and one reason for U.S. reluctance to consider such agreements is concern over labor-related issues.

South Korea's position regarding Kaesong is that, if a high degree of economic success were to be achieved in this zone, this success would have the potential to induce the North Korean state to alter its behavior so as to comport better with international standards than currently is the case. A high degree of economic success, the South Korean government believes, is more likely to be achieved if output of the Kaesong special economic zone (SEZ) were to be granted preferences under the Korea-U.S.

4. This was especially so with respect to the U.S. FTA with Central America (CAFTA), the enabling legislation for which only marginally passed in both the U.S. House of Representatives and the U.S. Senate.

FTA than if not. Moreover, South Koreans argue that if the South Korean position were to be proved correct, that is, if a success at Kaesong were to lead to a changed behavior of North Korea, this outcome would concord with U.S. policy aims with respect to North Korea. After all, above all else, the U.S. goal with respect to the North Korean state is for it to cease its rogue activities.

The main objective of this paper thus is to probe whether there is any basis for believing that the South Korean position might in fact be correct, notably that an economic success in Kaesong could trigger a constructive transformation in North Korea. The reader should note the use of the word “probe”; the author is not presumptuous enough to claim to be able to answer the implicit question: Is the U.S. or the South Korean position the correct one? Rather, all that is meant here is to explore the issue of whether the South Korean position has any merit.

The main reason, in fact, to believe that the South Korean position indeed is of merit is simply this: The success of SEZs in China, a country that neighbors both South and North Korea, during the past two decades or so did eventually lead to (or at least significantly contribute to) a major change in the international behavior of that country.⁵ Four SEZs were designated in a number of locations in China during 1980 under circumstances to be described later in this paper, and a fifth SEZ was created in 1988. In addition, 14 coastal cities were in 1984 designated as “economic and technical development zones” (ETDZs), essentially becoming additional SEZs albeit that, while most privileges granted to exporters in the SEZs were also granted to exporters in the ETDZs, the latter did not benefit from all privileges granted to the former. By most (but not all) criteria the SEZs and the ETDZs were quite successful, indeed so much so that, in announcing a number of important reforms in China in 1992, then-premier Deng Xiaoping cited the prosperity being created in and around these zones as the major reason for the reforms. Following implementation of these reforms, there was a notable surge of economic growth that began during the early to mid-1990s and has continued into the first decade of the 2000s. Moreover, much of the growth in China continues to take place in and around the zones.

Moreover, during the 30 or so years between the end of the Cultural Revolution in China and the accession of China to membership in the World Trade Organization (WTO), the international behavior of this country has clearly changed markedly. From the late 1950s through the early 1970s, a goal of China was to export Maoist-Marxist revolution to developing nations around the world and, during these years, China might fairly have been branded as a rogue nation, as is North Korea today. Similar to North

5. Moreover, a number of authors have suggested that the Chinese experience is what induced North Korea's leadership, up to and including the head of state, Kim Jong-il, to allow the zones to be established.

Korea today, the Chinese military then exercised a pervasive influence over the policy and conduct of the country. But, since sometime in the 1970s, the goal of China to export revolution ceased to be operational, the scope of influence of the military on national policy has been reduced, and in most regards China has become a “good world citizen.”

One can, however, argue about causality: Did China’s abandoning its goal of exporting revolution come about as an effect of the SEZs and the ensuing economic growth? Or was it the other way around: By abandoning rogue-nation behavior did China make itself, in some sense, ready for the SEZs and the economic growth and rising prosperity that followed? This last question is in fact quite difficult to answer, but it is a rather crucial question if China is to be seen as a model for how and why North Korea might come out of rogue-nation status and whether Kaesong is likely to play a definitive role in such a change of status. The timing of events as depicted above in fact would indicate that China ceased being, in any true sense, a rogue nation prior to the establishment of the SEZs. However, it is arguable that well into the 1980s and even into the 1990s, there remained important factions within the Chinese leadership that were backed by the military and that would have continued to “export revolution” but whose voices diminished as economic growth took hold in China. Thus, in the pages that follow, the question of the extent that the SEZs contributed to China’s moving away from export of revolution is explored, but, alas, at the end of the day, a definitive answer proves elusive.

An even more basic question is as follows: Is it likely that Kaesong has the potential to do economically for North Korea what the SEZs did for China, that is, to foster reforms that lead to high economic growth and rising prosperity? On this question, in fact, the available evidence with regard to the success of export processing zones in fostering economic development in countries other than China is somewhat discouraging (see, for example, Madani [1998]); indeed, China seems in many ways to be a singular case. However, the case can be made that a successful experience with export processing facilities (*maquiladora*) also occurred in Mexico during the 1970s and 1980s.⁶ This experience helped propel Mexico toward adopting important economic reforms and also paved the way for Mexico’s seeking to enter into an FTA with the United States, what now is the North American Free Trade Agreement (NAFTA) (Hufbauer and Schott 1992). Export processing zones in Vietnam have also proved quite successful, and this success might lead to further economic reform there, although in this case probably only time will tell. Thus, while the case of China is in some ways

6. The Mexican *maquiladora* were, as indicated, export processing facilities and not export processing zones. However, these facilities received preferences typical of those received by enterprises operating in export processing zones.

singular, it is not the only case where SEZs have played a constructive role in economic development. Indeed, the World Bank (2001) has proclaimed that “The literature on EPZs (export processing zones) shows that EPZs are a second-best solution compared with generalized country-wide reforms, but that, where country-wide reforms are difficult to implement, they can be a useful weapon in the development arsenal.”

Given these considerations, the next section of this paper⁷ explores the reasons why the SEZs and ETDZs in China can be judged successful from an economic perspective, and possibly from a political perspective, with an eye to whether Kaesong represents a potential for the same success to be realized in North Korea. As already noted, this exploration is just that: an exploration; no effort is made to reach an unequivocal conclusion. The final section then does offer some concluding remarks, but anyone who attempts to draw a firm conclusion from this section will be, to paraphrase Mark Twain, prosecuted or worse.

II. Why Did the SEZs in China Work?

A quick, albeit doubtlessly too simple, answer to the above question is: “The SEZs worked because there was a broad consensus among the Chinese leadership, even though this leadership was divided on many issues, that the SEZs would be allowed to work and, moreover, that local authorities would allow leeway to experiment with the SEZs in order to make them work.” In this matter, it must be remembered that, when the SEZs were enabled, in 1980, China had been through a long period of economic stagnation and even reversal, brought on first by the Cultural Revolution of 1966–76 and then, following the death of Mao Zedong in 1976 and the arrest of the Gang of Four in early 1977, a period of struggle for power among several would-be successors to Mao.⁸ During this struggle for power, long-time member of the Chinese leadership Deng Xiaoping⁹ emerged as the *de facto* winner, elbowing aside Mao’s chosen successor, Hua Guofeng.

7. The next section draws heavily from two previously published articles by this author (Graham 2004; Graham 2005) and the references therein.

8. The Great Proletariat Cultural Revolution represented more than anything an effort by Mao Zedong, who during the early 1960s had effectively gone into retirement, to reassert power and to reimpose his own ideas on China. The result was 10 years of civil disorder that at times bordered on civil war, accompanied by economic backsliding. China’s economic growth rate during these years was probably negative. The Gang of Four, who included Mao Zedong’s (fourth) wife, Jiang Qing, were four political leaders who played an increasingly dominant role in the later years of the Cultural Revolution (during which time Mao himself was becoming increasingly ill) and who attempted to seize power following Mao’s death. Instead, in early 1977, they were arrested and tried for “anti-(Communist) party deeds.”

9. Deng became a member of the Central Committee of the Chinese Communist Party—the formal body of leadership—in 1945.

Deng was what came to be known as a “reformist,” one who believed that a de facto switch from socialism to a more market-driven economy would be in the best interests of China, albeit that the Communist Party would maintain a monopoly on political power there. Perhaps for his reformist views, he had been “purged” from the Communist leadership during the Cultural Revolution. He survived this purge, however, and was appointed deputy premier by Zhou Enlai in 1973, only to be purged again in 1976 following Zhou’s death.¹⁰ But, following Mao’s death in 1977, Deng was back as deputy premier; and during the 1980s he became the de facto, but never the de jure, top leader of China. His titular position until 1989 was deputy chairman of the Communist Party. But, as had Mao during certain periods, Deng in fact led via proxy. In 1980, he was able to place a protégé and strong advocate of reform, Zhao Ziyang, in the position of premier of China, and then, in 1981, Deng successfully engineered the replacement of Hua Guofeng as Communist Party chairman by Hu Yaobang, another Deng protégé. By then, having two protégés in the two most powerful positions in China, Deng clearly had become the real head of the Communist Party (and of China).

Deng’s hold on power was not absolute, however, and he did not head a leadership that had reached a consensus on reform. There continued to exist a faction of the leadership that included the top military commanders in China who favored a continuation of Maoist policies, albeit with course corrections. Moreover, during the 1980s, this faction was able to reestablish itself and to wrench some power back from Deng. In particular, the adopted son of Zhou Enlai, Li Peng, emerged as the leader of this faction, which we might dub the hard-liner faction. Li Peng became a member of the Central Committee of the Communist Party in 1982 and premier of China in 1988, replacing Zhao Ziyang.

Thus, there emerged two major factions in the Chinese leadership during the 1980s: the reformists headed by Deng Xiaoping and the hard-liners eventually headed by Li Peng. The former sought major changes in the way China managed its economy, including a major scaling back of the role of the military in the economy, while the latter favored minimal changes and a continued role for the military.¹¹ Both factions could agree on two things, however: the desirability of faster economic growth and the desirability of vastly increased exports. On the matter of the desirability of exports, everyone in the Chinese leadership could see across the Yellow Sea (to the Koreans,

10. Zhou Enlai became China’s premier following the establishment of the Communist state in 1949 and remained so during his entire life. However, he was a “moderate” among the Chinese leadership, and during the Cultural Revolution a number of the more radical leadership sought his ouster. Mao, however, refused to remove him from the premiership, apparently out of friendship and loyalty that dated from the days of the Long March.

11. On the evolution of the role of the military in China, see Cheung (2001).

the West Sea) and witness the example of South Korea, where the export-driven “economic miracle” was taking place. Moreover, both factions realized that, to achieve something like export-driven growth, it would be desirable to have foreign-firm participation of some sort in China. Both factions recognized, in 1980, that state-owned Chinese firms simply did not possess the technology, the marketing capabilities, or indeed virtually any of the attributes necessary to achieve success in export markets for any goods save raw materials and perhaps very simple manufactures.¹²

But the consensus ended just about there. Hard-liners disfavored any extensive foreign-firm participation in China and were fearful in particular that such participation would put at risk the extensive state-owned enterprises that dominated the economy. For reasons cited in the previous paragraph, the hard-liners did not want to exclude such participation altogether, but they wanted it to be as limited as possible. The reformists, by contrast, might have relaxed many of the existing restrictions on foreign participation in the Chinese economy as early as 1979 and implemented other, market-oriented reform as well. But they were willing to compromise with the hard-liners. Indeed, in 1979 and into the 1980s, the general attitude in the Chinese leadership was that compromise solutions to internal disagreements were a good thing; after all, the alternative of civil disorder that had so wracked China during the Cultural Revolution was a recent memory for both factions.¹³

Thus, in 1980, the two factions were able to agree on the desirability of establishing the SEZs, which would serve as “laboratories” for foreign-firm participation in the Chinese economy. Moreover, both factions wanted these zones to be effective, albeit for different reasons: The hard-liners hoped to prove that export-driven growth could be achieved by means of the SEZs alone, such that there would be no need to extend the privileges granted to firms operating in these zones to the rest of the Chinese economy, nor would there be any reason to allow foreign firms participating in the zones to extend their operations beyond the zones. The reformists, by contrast, hoped that success in the zones would, via a “demonstration effect,” convince the recalcitrant hard-liners that further and more extensive reform would be highly beneficial. Indeed,

12. On a key political issue there was also consensus: The leaders of both factions favored continuation of the monopoly of the Communist Party on political power in China. Deng Xiaoping himself might have been a reformist who, as noted above, was twice purged from the leadership of the Communist Party for harboring bourgeois views, but, even during periods of fall from grace, he remained committed to the party.

13. This sense of compromise went only so far, however, and certainly it did not prevent a great deal of sniping from occurring during the 1980s. For example, the term “bourgeois liberalism” was often heard in China (in the Chinese language of course), and this was the code phrase of the hard-liners meant to imply that the ideas and policies of the reformists amounted to a threat to the Chinese culture and way of life. Ironically, some portion of the protesters at Tiananmen Square in 1989 was there to protest against “bourgeois liberalism.”

and this point is important to the discussion of North Korea that follows in the next section of this article, it is arguable that the hard-liners had, if anything, a greater interest in the SEZs becoming highly successful than did the reformists. The reformists needed only for the zones to be sufficiently successful so as to create a demonstration effect of what economic reforms, if more broadly extended in China, might be able to achieve in terms of generating economic benefits. But the hard-liners needed for these zones to be so successful that they could then make the case that there was no need for further change elsewhere in the society. This would be a major challenge: The zones, to serve well the hard-liner interests, had to generate enough benefit to raise the standard of living of virtually everyone in the country.

There were in fact two goals set for the SEZs. The first was that the zones would attract foreign investors who would then greatly expand China's exports, thus alleviating foreign exchange constraints that were then seen as a major impediment to growth. The second was that the zones would foster technological development, both via import of technology and via development of new technology within the zones (hence, when the zones were extended in 1984, the new zones were, as noted in the introduction, designated as ETDZs where of course the "technical development" designation explicitly was in recognition of the second goal).

To attract foreign investors specifically, three measures were implemented in the zones. First, export-oriented operations in the zones would be allowed duty-free entry of raw materials and intermediate goods if these were then processed into goods for export; at the time, duties on all imports into China were set very high. Second, these operations would not be subject to most requirements under Chinese law to provide what amounted to cradle-to-grave social services; such requirements were, by contrast, imposed on the large state-owned industrial sector throughout China. Third, these operations would have access to preferential credit arrangements that were not generally available in China at that time. We say "export-oriented operations" because, in principle, these measures were available to all firms with operations in the zones, including domestically owned ones, but in practice the measures were put in place mostly to attract foreign investors to the zones.

Importantly, and in contrast with Kaesong, investment in the zones in China was not directly subsidized, albeit that there were implemented tax breaks for investors that located in these zones. The most important of the tax breaks was that capital goods could be imported duty free.

Over the course of the 1980s, the first goal was in fact largely realized but the second was not. The reason for both the success of the first goal and failure to achieve the second was that, during that decade, China's comparative advantage lay clearly in the manufacture of labor-intensive goods, and foreign firms recognized this fact. Thus, as

is well documented, the SEZs succeeded in attracting quite a lot of export-oriented foreign direct investment (FDI), but mostly in low-end technology activities such as apparel assembly, toy manufacture, assembly of electronic products, and the like (see, on this, Lemoine and Ünal-Kesenci [2004]). Indeed, China's exports even into the current decade have been dominated by manufactures of high labor intensity and low technological content, albeit that a high-technology, export-oriented sector is rapidly evolving (on the latter, see Preeg 2006). The source of most of the investment was other nations within Asia, and the investors in fact were predominantly ethnic Chinese persons (or firms controlled by them) who were part of the vast Chinese diaspora that exists in much of East and Southeast Asia. During the 1980s, there in fact developed in the zones something of a dual economy, wherein the operations in the zones were not linked with activities located outside of the zones (Jia 1994), that is, non-zone activities by and large did not serve as suppliers to activities in the zones. This in fact impeded the realization of the goal of technological development because without such linkages, for example, potential technology transfer between an export-oriented firm and supplier firms simply could not occur.

Table 1 below documents the growth of FDI, exports, and exports by foreign-invested firms from 1980 to 1990. The reader must remember that, while the absolute amounts of all of these variables were quite low by the standards of today, in the late 1980s the amounts of FDI and new exports by foreign-invested firms seemed staggering; after all, just 10 years earlier, there had been virtually no foreign investment at all in China, and growth of Chinese exports had been scant. However, it is also clear that, even if all of the FDI and new exports by foreign-invested activity took place in the zones (the data don't allow us to test whether this was true, but certainly much of this activity occurred in the zones), the activity in the zones was not of sufficient magnitude to generate, by itself, a major economic miracle in China of the sort that had taken

Table 1: Foreign Direct Investment Flows into China, Total Chinese Exports, and Exports by Foreign Invested Enterprises in China, 1985–90, billions of dollars

Year	Foreign direct investment flows	Total Chinese exports	Exports by foreign invested enterprises
1985	1.26	27.35	0.32
1986	1.66	30.94	0.48
1987	1.87	39.44	1.20
1988	2.31	47.52	2.46
1989	3.19	52.54	4.92
1990	3.39	62.09	7.80

Source: NBS (various years).

place in Korea. The zones doubtlessly were creating a certain amount of localized prosperity (where prosperity must be measured against the bleak years of the immediate past), but this prosperity did not touch the vast majority of the Chinese people.

Did these results favor the hard-liners or the reformers? Until the Tiananmen Square protests during the spring of 1989, the answer was not clear. Indeed, in 1987, in the face of student protests demanding further liberalization of both the economy and the political structure of China, the hard-liners scored a number of victories. Blaming Hu Yaobang for the protests, hard-liners (and the military) sought and achieved his resignation as Communist Party chairman. Hu was replaced by another Deng protégé, Zhao Ziyang, who as we have seen had been premier from 1980; Zhao was more acceptable to the hard-liners than was Hu. The deposing of Hu was a minor victory for the hard-liners; a bigger victory came when Li Peng took over as premier. Even so, the 1987 protests spawned further protests, which took place in a number of cities and culminated in the Tiananmen Square protests in Beijing in the spring of 1989. These protests in turn would eventually lead to the cards being tilted toward the reformers, and where this tilt would largely be unopposed by the hard-liners. The zones would play a role in this tilt.

In the West, the Tiananmen Square protesters have largely been depicted as being students and intellectuals who believed that economic and political reforms under Deng Xiaoping had not gone far enough and that, moreover, China should move toward a more democratic form of governance. Students and intellectuals holding these beliefs did of course figure importantly in the protests and, indeed, student prodemocracy demonstrations in Tiananmen Square had been one element of the 1987 protests. The 1989 protests were triggered by the death in April of that year of former Communist Party chairman, Hu Yaobang, who, as we have just seen, had been forced to resign from this position in 1987; students and intellectuals correctly saw his resignation as a victory for the hard-liners; because Hu had, prior to his resignation, called for more extensive reform while he expressed disdain for the hard-liners. But, in 1989, the students and intellectuals were joined by urban workers whose position was that the economic reforms under Deng Xiaoping had in fact gone too far and were threatening their employment. The workers and the students found common cause over the matter of corruption, which was seen as endemic, and a general perception that much of the economic growth to date in China had served to enrich a tiny elite such that the benefits of this growth had not reached the ordinary person. That the economic benefits generated by the zones were highly localized doubtlessly reinforced this perception.

The Tiananmen protests continued for about two months while the Communist Party Central Committee dithered over what to do; some on the committee, especially the party chairman, Zhao Ziyang, believed that demands of the protesters were reasonable and should be met, while others (the hard-liners especially) believed that the protests

should be suppressed by force. In the end, the hard-liners won when Deng Xiaoping himself decided that a forcible suppression of the protests was the only way to deal with them. Thus, in June, Zhao was placed under house arrest and removed as party chairman, and the military, the Chinese People's Liberation Army (PLA), moved in to end forcibly the demonstrations in Tiananmen Square. At least 400 people, and maybe 10 times that number, died in the process. China immediately came under international disapprobation.

But while the outcome of Tiananmen Square thus represented another win in the short run for the hard-liners, it amounted to a Pyrrhic victory. The violent nature of the suppression of the protests caused the hard-liners and their military backers to be discredited in the eyes of both large numbers of the Chinese people, including many who actually were opposed to further reform (and hence part of the hard-liners' constituency; as noted, some such persons had actually taken part in the protests) and the international community. Deng Xiaoping himself came under widespread criticism as did, even more, Li Peng. Li Peng, with the support of other hard-liners such as Chen Yun responded by attempting to roll back market reform and to bring back a greater role for centralized administration of the Chinese economy. But the efforts by the hard-liners were resisted by most provincial governors as well as by the reformist faction in Beijing. Deng Xiaoping himself apparently had concluded that at least some of the demands of the protesters had to be met, lest a new series of protests be launched, ones that might then have led to ever more widespread social strife. Thus, beginning in 1991, Deng moved to introduce a number of economic reforms and, in 1992 on his now famous "trip to the South," he noted that prosperity was being created in and around the SEZs and ETDZs, and he wondered out loud why this prosperity should not be extended to China as a whole. This was widely interpreted as a rebuke to the hard-liners and a call for still more reforms.

There then followed a series of economic reforms that, among other things, largely enabled foreign firms to receive the same treatment anywhere in China that they then received in the zones. These reforms were hardly opposed by the hard-liners, including Li Peng, or by the military. Indeed, many of the hard-liners themselves now began to understand that to oppose reform was to court social unrest and perhaps to risk the undoing of the monopoly on political power held by the Communist Party in China. The implicit bargain came to be that China would move toward a more market-driven economy, whereby the Chinese people would be granted considerably more economic freedom than in the past, but the Communist Party would remain in power. Thus, while the hard-liners prevailed in putting down forcibly the Tiananmen Square protests, in doing so, they set in motion a process by which the reformers effectively won the long-simmering conflict over the extent of economic reform.

Li Peng would remain as premier until 1998, and would then continue to hold the lesser but still powerful position of chairman of the National Peoples' Congress.

However, in 1993, Li reportedly suffered a heart attack, and many of the powers of the premier were transferred to the reformist vice premier, Zhu Rongji, who in fact would succeed Li as premier. Zhu was not simply a reformist; he sought to remove the military from any major role in economic policymaking in China. In the meantime, during his final five years as premier, Li Peng's overriding concern was for the controversial Three Gorges dam to be built, which eventually it was (or, rather, at the time of this writing, it is nearing completion). Deng Xiaoping, following the Tiananmen suppression, resigned his position as deputy chairman of the Communist Party. However, he succeeded in placing yet another of his proreformist protégés, Zhang Zemin, as party chairman. Thus, Deng remained the “power behind the throne” and, indeed, the de facto top leader of China until his death in 1997. Zhao Ziyang remained under house arrest until his death in 2005; however, most of the reforms that he advocated had been put in place by the time of his death.

Following the reforms, FDI in China soared as did the economic growth rate of China. *Table 2* below provides some relevant data. As can be seen in particular, following 1991, exports from foreign-invested enterprises began growing at a far faster rate than total Chinese exports, indeed so much so that foreign-invested firms during the

Table 2: Foreign Direct Investment Flows into China, Total Chinese Exports, and Exports by Foreign Invested Firms in China, 1991–2004, billions of dollars

Year	Foreign direct investment flows	Total Chinese exports	Exports by foreign invested firms
1991	11.55	71.84	12.10
1992	19.20	84.94	17.40
1993	38.96	91.74	25.24
1994	43.21	121.04	34.71
1995	37.52	148.78	46.88
1996	41.73	151.05	61.51
1997	45.26	182.70	74.90
1998	45.46	183.76	80.96
1999	40.32	194.90	88.60
2000	40.72	249.20	119.40
2001	46.88	266.16	133.24
2002	52.74	325.57	169.94
2003	53.51	438.37	240.34
2004	60.63	593.40	338.61

Source: NBS (various years).

decade of the 1990s contributed to more than two-thirds of total Chinese export growth. Arguably, then, the story of the export-led “Chinese economic miracle” that began in the 1990s would never have been told had it not been for the demonstration effects of the SEZs during the late 1980s.

So, when all is said and done, what was the role of the zones in the economic and political transformations that took place in China between roughly 1980 and current times? At the end of the day, mostly this role was to demonstrate during the late 1980s what might be the impact of economic reform if this reform were to be undertaken more widely than it was at the time. By themselves, the zones did not foster an “economic miracle” in China during their first years, but they did demonstrate that much better performance of the Chinese economy was feasible.

But the big question is (and after all this is the subject of this paper): Is the Chinese experience of relevance to the issue of whether Kaesong might lead to similar transformations in North Korea? We take up these issues in the next section.

III. Does the China Experience Matter to North Korea?

A first, and big, question to be addressed here is: If a success is made of Kaesong, what chance is there then that this success will help foster larger and deeper changes in North Korea, changes that could lead to a more acceptable international behavior of the Korean state? As argued in the previous section, success of the SEZs in China during the late 1980s helped propel major transformations in that country that mostly took place following 1991, although a multitude of other factors also lay behind the changes. So, to restate the question: If Kaesong is a success, is there even as much as a remote chance that North Korea will then eventually proceed along a path similar to that of China since 1991? A second question is: What is the probability that Kaesong will indeed reach a level of success sufficiently great so as to make the first question a serious one? Otherwise put, what is the probability that Kaesong actually turns into an economic success story, which it in fact has not yet? This second question is of course of extreme importance because, if the probability of success at Kaesong is low, whatever the answer to the first question largely becomes moot. But let’s address the first question first.

Perhaps the first point to be made about Kaesong and North Korea, when compared with the SEZs in China, is that the Chinese SEZs were established as a compromise between two factions, each struggling for ascendancy following the death of the charismatic Chinese leader Mao Zedong, founding father of the modern Communist Chinese state, but that Kaesong did not result as a compromise between two conflicting factions in North Korea. Rather, Kaesong resulted from the Sunshine Policy that was initiated by former South Korean president, Kim Dae-jung, in the very late 1990s, at a

time when North Korea was (and still is) headed by Kim Jong-il, the son of North Korea's founding father, Kim Il-sung. The Sunshine Policy was (and still is) meant to foster some sort of reconciliation between the two Korean states, which have remained technically at war with each other since the end of active hostilities during the Korean War of the early 1950s; this technical state of being at war still exists. Thus, Kaesong represents in large measure an outcome of South Korean diplomacy rather than an outcome of decisions taken by North Korean leaders. To be sure, for Kaesong even to exist, there had to have been some significant receptivity to the idea of an SEZ on the part of North Korean leaders (more on this shortly). Nonetheless, there was a dynamic underlying the Chinese SEZs that simply does not exist in Korea, notably that, in China, two competing factions for the leadership each sought that the SEZs be successful, albeit each faction sought for reasons different from those of the other faction. No similar dynamic seems to exist in North Korea.

Moreover, most observers in the West at least would categorize North Korean leader Kim Jong-il as a Korean equivalent of a Chinese hard-liner. In fact, if there is some sort of counterpart in today's North Korea to the reformist faction in Beijing, whose members emerged as serious candidates for top leadership positions in the late 1970s and early 1980s, it is difficult to see who is in this North Korean faction (on this, see Noland [2004]). Given that it was the reformist faction that gained ascendancy in China and drove most of the reforms that China eventually undertook, even though the reformers were not able completely to displace the hard-liners and, indeed, at times, the reformers during that period lost ground to the hard-liners, the lack of a similar cadre in North Korea's leadership would not seem to bode well for Kaesong now helping to propel North Korea on a trajectory similar to that taken by China following 1980.

As the previous section argues, however, the success of the SEZs in China was, at the end of the day, based on demonstration effects. By themselves, the SEZs did not usher in more than a limited prosperity in China. Thus, the SEZs did not fulfill the goals of the hard-liner faction, which had hoped that these zones would be so successful as to eliminate any call for further and deeper reform in China. Rather, what they did was to provide a demonstration of what might be possible on a more widespread basis were those reforms sought by the reformist faction actually to be implemented. As seen in the preceding section, however, even then the implementation of a wider reform did not take place until large-scale protests occurred, protests that made the leadership (including at least some of the hard-liners) realize that changes in the way China managed its internal affairs indeed were needed to head off social unrest. Arguably, following 1990, there was real fear even among hard-liners that further social unrest might prove destabilizing to the hold on power by the Communist Party; thus the opposition of the hard-liners was softened to a wider economic reform. This in turn enabled the reformers to gain power at the expense of the hard-liners, and to

cite the success of the SEZs as a rationale for fundamental changes in the Chinese economy and, indeed, in the way that China viewed its role in the world.

Thus, if the trajectory taken by China is in some way to repeat itself in North Korea, one would have to suppose the existence of a reformist faction that, if it exists at all, certainly is not very apparent.¹⁴ One might also have to suppose that dissatisfaction in North Korea with the status quo is strong enough that, some time in the future, popular protests against the government will erupt.

But are these two suppositions anything more than dreams? Indeed, as already suggested, there is no evidence that either supposition reflects anything like actual circumstances in North Korea. But, then, it could also be argued that, if one had suggested in 1970 at the height of the Cultural Revolution, that in nine years a reformist faction would be on the ascendancy in Beijing (and, indeed, led by Deng Xiaoping, a Communist Party veteran of the Long March who was purged twice during the years 1966 and 1976), one would also have been accused of being a dreamer. Indeed, the same might have been said of anyone who as late as 1987 had predicted that the East German state would fall and a reunited Germany would exist just four years later. Times do change, and dictatorial regimes do fall. Moreover, Kim Jong-il is (apparently) 65 years of age and not in extremely good health.¹⁵ His time will eventually come to an end. Because there is no heir apparent in North Korea, when Kim does pass on, a power struggle seems likely, as occurred in the aftermath of Mao's death in China in 1976.

In a word, maybe a reformist faction will eventually emerge in North Korea. The problem is that its existence is, at the current time, difficult to see and, indeed, so difficult to see that emergence of a powerful reformist faction is difficult to fathom (Noland 2004).

Thus, to answer the first question as posed at the beginning of this section in the positive, one must be able to look into the future and see changed circumstances there. Any attempt to do so in an effort to predict future events is, under the best of circumstances, fraught with uncertainty. In the case of North Korea, the peril created by uncertainty is compounded by the fact that no one outside of North Korea knows

14. Not everyone would, however, agree with this statement. There are those, especially in South Korea, who maintain that the current North Korean leadership is more akin to the reformist faction in China than to the hard-liner faction. This matter is addressed later in this section.

15. He was born in Siberia on February 16, 1941, at which time his father was a battalion commander of the Soviet Union's 88th Brigade, or at least so according to Soviet records. Bizarrely, however, the North Korean government claims that he was born a year later, at Mt. Paektu in North Korea, and that his birth was an event heralded by a double rainbow over the mountain and the appearance of a new star in the sky. The inclinations of this author are to believe the Soviet account.

a lot about what is happening in this land even in current time. This is because, it would seem, the one thing that North Korea is truly good at is being secretive (Chong 2006). But, at the end of the day, the available evidence does not suggest a high likelihood of future emergence of a lively reformist movement within the North Korean leadership.

Thus, it seems safe to conclude that the current leadership views Kaesong in much the same way as the hard-liners viewed the SEZs in China, notably as a vehicle for improving the performance of the economy but one that needs to be contained.

Because reliable information on North Korea is so limited, it must be noted that views on what exactly is the state of affairs in North Korea vary widely and the viewpoint expressed in the paragraph just above is not shared by everyone who has studied North Korea. Furthermore, to determine which of these several views more correctly reflects reality is truly difficult for the simple reason that it is indeed difficult to obtain reliable information about the state of affairs in this state. Thus, for example, there are analysts and politicians, especially in South Korea, who maintain that North Korea already has embarked further down a reformist path that leads eventually to transformation of its economy from a centrally planned one to a market-driven one than the remarks in this section of this article might suggest. Indeed, a prevalent view in South Korea seems to be that North Korea has already gone down this path far enough to have reached a point of no return. Moreover, and certainly contrary to the view of this author expressed just above, there is a view in South Korea that the current leadership of North Korea should not be seen as a contemporary counterpart to the Chinese hard-liners but, rather, to something akin to the Chinese reformist faction. (This in spite of North Korea's test firing of missiles and development of nuclear weapons!)

Indeed, South Korea's current president, Roh Moo-hyun, has made statements roughly to the effect that reformists already are in charge in North Korea; in Los Angeles in late 2004 he said, "The North Koreans have accommodated market economics to the extent that they obviously cannot reverse the course any more" (MOFAT 2004). Roh went on to say that, given the changes that already have occurred in North Korea, the time has come for the United States to have a "more positive dialogue" with this state.

But, again, views on North Korea vary considerably. In considerable, but not complete, contrast with this view of considerable progress toward a market-based economy in North Korea, Noland (2006a) indicates that, while some market-oriented reforms indeed have been undertaken, the outcome is thus far a "mixed bag." Noland indicates that the "marketization of the North Korean economy over the past decade is best understood as a bottom-up process driven by the trauma of the famine" rather than as

a process initiated by the current leadership. In particular, Noland believes that it was in response to the government's failure to provide food at the height of the famine 10 years ago that there developed informal markets for foodstuffs (a point developed further in Noland [2006b]). These were, in Noland's words, "tolerated" but hardly condoned by the North Korean government. He acknowledges that, over the course of the next few years, markets and market institutions in North Korea subsequently developed for consumer goods imported from China. But, again, it is far from clear that these resulted from top-down reforms.

Noland notes, moreover, that the adoption of even a limited market system has stressed the North Korean government's ability to raise revenues, historically achieved via transaction taxes assessed through a central plan. Indeed, in 2005, North Korea took certain measures that suggest reinsertion of central planning and some backing away from a market-based system (Noland 2006b). Noland thus suggests that, as a result of partial marketization of its economy, the North Korean state is "perched precariously atop a changing, dynamic foundation." Thus, while President Roh Moo-hyun seems to believe that market reform in North Korea has become irreversible, Noland seems to suggest that the trajectory could from here go either way, either toward further marketization or back toward more central control over the economy.

Vorontsov's (2006) and Paik's (2006) depictions of the changes in the North Korean economy that have occurred in the past 10 years or so provide some contrast with the views of Noland, however. Paik in particular notes that, along with limited market-oriented reform in North Korea, there has been a de-emphasis on *juche*, the North Korean socialist ideology that emphasizes self-reliance. In its place has come a new philosophy, termed by Paik "practical gain socialism," which stresses means of making a success of the North Korean economy, including some opening to the outside world. However, Paik does suggest that "it will be of much benefit to us all to encourage North Korea to go down the road to another critical choice: an expanded and deepened reform and opening." This of course suggests, consistent with Noland, that the reform and opening of North Korea is, at this point, not very deep. Vorontsov notes also that Kim Jong-il apparently has sought to soften the ideology of *juche*; but, consistent with Noland, Vorontsov paints a picture of a creeping and rather unsteady movement toward market-based reform in North Korea, and Vorontsov notes that many senior officials there have embraced reform with considerable reluctance. The characterizations of Noland, Paik, and Vorontsov of the North Korean economy as it presently stands are in fact quite consistent; the latter two authors, however, seem more confident than Noland that the current level of reform will lead to further reform.

Both Paik and Vorontsov note the widening income and wealth gap in North Korea. This can be seen as one sign of a more market-driven economy, of course. Both authors stress that, associated with this gap, there is a new class of persons arising in

North Korea who have become, in Vorontsov's words, "oriented toward pure pragmatism in business and household relations." Vorontsov notes that this class includes top-ranking military personnel and high members of the government and of the North Korean Workers' Party. Both authors note, however, that North Korea is driven by a military-first strategy and, indeed, that the superclass in North Korea is the military. Somewhat curiously, Vorontsov argues that an increased emphasis on the military creates stronger incentives than earlier that North Korea will adopt market-driven reform; the argument is that the military seeks results and is prepared to abandon the rhetoric and policies of *juche* in order to achieve these results. Maybe so, but as was demonstrated in the preceding section, the pace toward market-driven reform in China accelerated only after the influence of the military on economic policy became considerably diminished (Cheung 2001).

Among persons who have studied the North Korean economy, there is no consensus on the extent and likely future course of economic reform in North Korea if, as seems likely, the military keeps its current hold on power there. Thus, contrasting with Paik and Vorontsov are the views of Eberstadt (2004), who sees no possibility of rapid evolution of North Korea toward a true market economy as long as the military-first doctrine remains in place.

The probability of regression of North Korea away from marketization depends, of course, in some measure upon the intentions and goals of the present leadership, and these remain hard to fathom. My own view is that claims that the current leadership, including Kim Jong-il, are the equivalent of the reform faction in China of 1980 are overblown.¹⁶ In stating this opinion, I remind the reader that part of the reason why Kim and the North Korean government are seen as reformist by some South Koreans is their willingness to accept some degree of reform, including South Korean investment in Kaesong; but, as noted on several occasions earlier in this essay, the hard-liner faction in China also accepted some measures of reform and, with respect to the Chinese SEZs, was as committed and perhaps in a sense even more so than the reformist faction. Furthermore, if the North Korean leadership were to be truly reformist, the leadership would have no hard-liner faction to deal with, as did Deng in China in the 1980s, and thus no reason not to implement market-directed reforms, and an opening of the economy, at a much faster pace than is currently being undertaken in North Korea. During the 1980s, in China, market-driven reforms and the opening of the economy were, as covered in the preceding section, slowed because there was a clearly defined faction of the Chinese leadership that was not in favor of such reforms. A stance taken by these Chinese hard-liners was that any reform that was undertaken should be introduced very slowly, lest it prove counterproductive to the

16. I have even seen Internet sites that suggest that Kim Jong-il is the North Korean counterpart of Deng Xiaoping.

stated goal of improving the performance of the economy. But, in the case of North Korea, China has already demonstrated that such reforms do improve economic performance; thus, in North Korea, whatever the reasons might be for slow and cautious adoption of reform, they are much less compelling than was the case 25 years ago in China. Moreover, in China the hard-liner faction was backed by the military, which continues to exert a direct influence on policy through this faction, just as is so for Kim Jong-il in North Korea.

Thus, this author would submit that the facts, such as they are known, do not strongly support either the contention that the North Korean leadership is highly committed to further marketization and opening of the economy or indeed that North Korea will inevitably continue down the road toward such marketization. Again, however, this assessment is made in the face of a dearth of facts or empirical support about North Korea; as the U.S. comedian Dennis Miller used to say when signing off his television show (no longer aired): “That’s just my opinion, and I could be wrong.”

Moreover, this opinion might in some way be beside the point. As discussed earlier in this paper, the issue at hand is whether a success in Kaesong would serve significantly to foster future changes in the North Korean economy and perhaps even ultimately to bring about North Korea’s turning away from rogue-nation behavior. Thus, again offering what amounts to no more than a personal opinion, I would say that, although a success or even a high degree of success in Kaesong would not guarantee a trajectory in North Korea of the sort just suggested, were Kaesong to be a complete and utter failure, the likelihood of North Korea going down such a trajectory would be significantly reduced.

As for the second question posed at the beginning of this section—Will Kaesong be an economic success?—the best guess is “yes, it will be.” There are in fact a number of reasons to guess in a positive direction. To begin, the Chinese experience, if it does have relevance for North Korea, offers grounds for optimism with respect to the economic prospects for Kaesong. Just as foreign investment in the Chinese SEZs was, in the early years, heavily weighted toward overseas Chinese origin, it is clear that most (all?) investment in Kaesong will be by South Korean companies. And, just as overseas Chinese were able to surmount what might have been, for other investors at least, major obstacles to establishing successful operations in the zones, so should South Koreans in Kaesong. Such obstacles include language and culture. In spite of major differences that have arisen because of more than 50 years of separation, South and North Koreans do share a common language and, historically at least, a common culture. Moreover, there is no reason to think that the North Korean leadership is not committed to a success in Kaesong; indeed, just as was the case with the Chinese hard-liners during the 1980s with respect to the SEZs, the current North Korean leadership needs a success in Kaesong.

This is not to say that success is a slam dunk. There are reasons why SEZs have not borne much fruit in a number of countries, and, also, there are indications to suggest that some of these reasons might indeed apply to Kaesong. Thus, for example, excessive demands by North Korean officials for side payments (bluntly, too much corruption) could cause things in Kaesong to go downhill fast. However, the Chinese SEZs were not free of corruption, nor is dealing with corruption exactly an issue with which South Korean companies have no experience. It follows that there is a level of corruption with which foreign investors can live in SEZs and indeed still function well. But there also is a level of corruption above which these investors are more likely to withdraw their activities from the zones, or to scale down their operations, than to continue to operate at originally planned levels of output. Likewise, too much bureaucracy, regulation, or interference from local and central government authorities, even if not corrupt, can slow things down. One of the main sources of success in the Chinese SEZs derived from a willingness of central authorities in Beijing to allow local authorities to waive regulatory and other requirements placed on business activity in China inside the zones, but also to encourage different zones (and the relevant local authorities) to compete with one another in efforts to attract foreign investment. Competition between zones indeed likely prevented corruption from getting out of hand in China and also contributed to local authorities establishing what level of regulation was right. Alas, however, Kaesong would seem to be the only SEZ in North Korea whose prospects are bright and, thus, even though two other such zones in principle do exist, there might not be established any dynamic in North Korea toward policy competition among different zones, a dynamic that served China well.

Furthermore, the matter of the role of subsidy in Kaesong by the South Korean government is problematic. Perhaps it can be argued that, until Kaesong gets on its feet, some sort of subsidy is warranted to protect investors from the doubtlessly high risk of investing there. But even if this argument holds water—and whether it does could lead to a very long debate—the argument would hold for temporary subsidies only (and, indeed, the case might be strong that successful undertakings at Kaesong be required eventually to repay the subsidies, a requirement that does not seem to be in place). For Kaesong to be judged a success, at minimum, the subsidy element must over time be withdrawn.

In a word then, this author is somewhat optimistic with respect to whether Kaesong eventually can be made to function successfully in the way that the SEZs in China were made to work. Nothing is perfect and, as already said, success there is not guaranteed; indeed, matters just raised in the previous paragraph (lack of policy competition with other zones, subsidies) are worrisome. But there seems nonetheless a commitment in both South Korea and North Korea that the Kaesong complex will be turned into a success, and this double commitment just might be strong enough to make it happen.

IV. Is the U.S. Position on Kaesong in the FTA Negotiations Wrong?

The quick answer to the question posed just above is “no, not necessarily.” The U.S. position—its position against products from Kaesong being eligible for preferences under the FTA—is meant to take into account that North Korea has engaged in rogue-nation activities, for example, the development of nuclear weapons. An economic success at Kaesong, as already developed in this article, could create a significantly increased stream of revenue for the North Korean state, and this revenue could enable acceleration of such development under the stated military-first policy of that state. Moreover, a fear of the current U.S. administration is that, if and when North Korea succeeds in developing workable nuclear weapons, it is not out of the question that this state would seek to export these weapons, perhaps even to terrorist organizations. This author is not in a position to assess whether this fear is warranted. However, he is in a position to assert (the reader might bear in mind that the author is a resident of Washington, D.C.) that even a very small probability of North Korea developing nuclear weapons and then selling these weapons to terrorist organizations that might then try to detonate them inside the United States is, from a U.S. point of view, simply and clearly unacceptable. And, as Hamlet says in his famous soliloquy: “Aye, there’s the rub.” The success of Kaesong might lead eventually to a transformed and reformed North Korea, and this would certainly be in U.S. interests were it to happen. But, alas, the likelihood and extent of such a transformation or reformation are unknown (and unknowable) quantities and, alas, as suggested in the previous section, there is really no guarantee that even quite a significant degree of success in Kaesong will foster such a transformation. And, if there exists even a very small probability that a success at Kaesong might help the North Korean state to develop and export nuclear weapons, this certainly tilts the preference of this author, and indeed almost surely the preference of almost all Americans, toward the position of doing nothing to support this undertaking (at Kaesong). A bottom line is that, if the United States were ever to change its position so as to support the development at Kaesong, including allowing products made in Kaesong to be subject to FTA preferences, this change of position would have to be linked to considerable progress being made on larger issues, ones being dealt with in the six-party talks (Spring and Hwang 2005).

V. Is the Issue of Kaesong in the FTA a Deal Breaker?

Again, the answer to the question posed just above is “no, not necessarily, or at least not if handled well by both sides.” The qualification is important. What follows from the line of thought developed thus far is that Kaesong is a complex issue with overtones that go well beyond the context of the Korea-U.S. FTA negotiation. Thus, if the United States could be assured that, if an economic success were to be achieved at

Kaesong, this would not lead to an enhanced danger of nuclear proliferation or the possibility that terrorist groups might gain access to nuclear weapons, some of the U.S. objection (indeed, perhaps the major part of this objection) to Kaesong would be considerably attenuated. And, if the long-run effect of a success at Kaesong were to prove to be a much better behaved North Korea, the United States would at some point have little reason to oppose inclusion of Kaesong products in FTA preferences. There would remain issues to be addressed—for example, the labor issue that was touched upon earlier in this essay and the matter of subsidies if these persist—but these issues are not irresolvable.

But the problem at the moment is simply that no credible assurance exists that success at Kaesong will lead to a much better behaved North Korea, and, without such assurance, any inclusion of products from Kaesong in the FTA preferences indeed is a nonstarter.

This is not to say that no such assurance will ever exist. Further discussions with the North Korean government in the six-party talks might ultimately resolve the nuclear issue and related issues in North Korea to the satisfaction of the United States and the other concerned parties. In what time frame such resolution might occur is difficult to say but, at the least, the preferred approach to settling these issues among these parties does seem to remain continued diplomacy rather than stark confrontation.

In the meantime, it is also clear that South Korea intends to continue to develop the Kaesong SEZ, whether or not its products are granted preferential treatment in the Korea-U.S. FTA. It is entirely possible that, as this development proceeds, demonstration effects of this undertaking indeed will, as the South Korean government hopes, lead to modified behavior by the North Koreans.

Even so, some positive steps by North Korea certainly could serve to increase the likelihood that the United States eventually comes to see Kaesong in a favorable light. Specifically, a useful first step would be for North Korea to stop its illicit counterfeiting and drug operations (and, where appropriate, to take measures against such activities where these have been effectively privatized in North Korea). As already noted, the revenues from these illicit activities could be dwarfed by Kaesong, and it could thus be fruitful for North Korea to take unilateral measures to end these activities and thus send a signal that North Korea is indeed capable of change for the better. The reasonable expectation of North Korea would be that, in exchange for such a meaningful signal, resistance to Kaesong by the United States and other interested parties would be reduced. The magnitude of benefits generated at Kaesong is likely to be significantly greater if the United States were at some point to become a market for goods made at Kaesong than if these products are excluded from the U.S. market. Thus, it seems apparent (to this author at least) that the prospect of achieving such benefits is worth

the cost (including loss of revenue) that the ending of illicit counterfeiting and drug operations might pose for North Korea.

What appears to be a favorable trade-off (ending illicit activities in order to increase the chances of success of Kaesong), or at least so to this author, might not however be apparent to the current North Korean leadership nor indeed, at the current time, to whomever the candidates in North Korea for future assumption of leadership might be. Indeed, in China, a certain amount of passage of time was needed for the benefits of the SEZs to be realized and thus for these benefits to serve as a demonstration of the value of the SEZs. Likewise, a few years of even modest success at Kaesong might be needed before the North Korean leadership becomes convinced that the first step, proposed above, might be indeed in North Korea's interest. Given this possibility, even though it is not an assured possibility, it might be in U.S. interests not to take steps designed overtly to reduce the chances that Kaesong is successful. Rather, a modicum of patience on the part of the United States might be in order.

VI. Next Steps in Negotiations between the United States and South Korea about Kaesong

What is clear from the previous two sections is that, for the United States to find it acceptable that products from Kaesong be included in the FTA preferences, some conditions will have to be met and some events will have to occur that fall outside the scope of the FTA negotiations. These negotiations, after all, are being conducted between the governments of South Korea and the United States, but the conditions and events just alluded to involve North Korea, which is not a party to the negotiations.

Even so, an objective of this paper is to argue that there is a scenario under which successful development of Kaesong could be in U.S. interests. The circumstances of this scenario have not yet come to pass. They might never come to pass. But "never" is a long time, and circumstances do with time change.

Given these considerations, then, it might seem advisable that, in the FTA negotiations, the United States and South Korea agree to disagree at the present time about the status of products from Kaesong in the FTA, and to do so in a way that does not preclude further negotiations over the status of these products in the future. In other words, the issue of Kaesong should simply be left open and undecided in the FTA. To do so would imply that products from Kaesong would not be granted preferential status under the agreement at the present time, but that reconsideration of the issue at some future time would be possible.

There is in fact precedent for leaving issues open and undecided in trade agreements. For example, NAFTA, chapter 15 (Competition Policy, Monopolies, and State

Enterprises) contains a provision (article 1504) whereby a working group is established to “make recommendations on further work as appropriate”; in a word, the chapter was left deliberately unfinished, but the possibility was left open of enlargement of the provisions of the chapter. Also, in the final text of the Marrakech Agreement that finalized the Uruguay Round of multilateral trade negotiations, there were a number of items that were left de facto unfinished, such that the agreement might in the future be modified to include provisions not included in the text of 1995.

It might prove difficult for South Korea and the United States even to agree to put Kaesong on ice, whereby the issue of the status of products produced at Kaesong is, by agreement, simply left unresolved at the current time. The U.S. administration seems prepared to kill the issue once and for all; but this is not entirely wise because, as noted, there is a scenario in which inclusion of Kaesong could serve U.S. interests, albeit that such a scenario is not the current one. Moreover, the very hard line taken by the United States does not address the South Korean sensitivities that are embodied in the Kaesong issue. The South Korean position seems to be that if Kaesong is not dealt with favorably now, it is an affront to the Korean people as a whole and it would be better if the FTA negotiation ended in failure than if Kaesong is not included in the final product. But this position is not constructive either; it certainly does not take into account legitimate U.S. (and international) concerns with the North Korean state and, rather, seems to be based on assumptions about the future trajectory of North Korea that are not well supported by currently available evidence. A wise solution to the impasse would therefore seem to be a compromise along the lines just suggested: that the two parties should agree not to implement provisions in the FTA pertaining to Kaesong now, but to leave open a possibility to do in the future.

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