

Korea's Economy 2008

Korea's Economic Achievements and Prospects

The Graying of Korea: Addressing the Challenges of Aging

Financial Asia Rising: Asian Stock Markets in the New Millennium

Korea's Money Market

Ingredients for a Well-functioning Capital Market

The Capital Market Consolidation Act and the Korean Financial Market

Progress in Corporate Governance

Tax Issues Affecting Foreign Invested Companies and Foreign Investors

U.S.-Korea Economic Relations: View from Seoul

U.S.-Korea Economic Relations: A Washington Perspective

Peering into the Future: Korea's Response to the New Trading Landscape

North Korea's External Resources and Constraints

The Roles of China and South Korea in North Korean Economic Change

Realistic Expectations of the Future Role of the IFIs on the Peninsula

a publication of
the Korea Economic
Institute and the
Korea Institute for
International
Economic Policy

Volume 24

CONTENTS

Part I: Overview and Macroeconomic Issues

Korea's Economic Achievements and Prospects
Pyo Hak-kil 1

The Graying of Korea: Addressing the Challenges of Aging
Jerald Schiff and Murtaza Syed 7

Part II: Financial Institutions and Markets

Financial Asia Rising: Asian Stock Markets in the New Millennium
Karim Pakravan 15

Korea's Money Market
Dominique Dwor-Frécaut 21

Ingredients for a Well-Functioning Capital Market
John Burger, Francis Warnock, Veronica Cacdac Warnock 31

The Capital Market Consolidation Act and the Korean Financial Market
Kim Dong-hwan 39

Part III: Structural Reform

Progress in Corporate Governance
Stijn Claessens 45

Tax Issues Affecting Foreign-Invested Companies and Foreign Investors
Henry An and David Jin-Young Lee 54

Part IV: External Issues

U.S.-Korea Economic Relations: View from Seoul
Han Dongman 61

A Washington Perspective
Jordan Heiber 69

Peering into the Future: Korea's Response to the New Trading Landscape
Troy Stangarone 74

Part V: North Korea's Economic Development and External Relations

North Korea's External Resources and Constraints
Stephan Haggard and Marcus Noland 83

The Roles of China and South Korea in North Korean Economic Change
Mika Marumoto 92

Realistic Expectations of the Future Role of the IFIs on the Korean Peninsula
Bradley Babson 106

THE ROLES OF CHINA AND SOUTH KOREA IN NORTH KOREAN ECONOMIC CHANGE

By Mika Marumoto

Introduction

The year 2007 demonstrated more clearly than ever that external economic engagement provides a chance to help convince North Korea to abandon isolation and take specific actions toward denuclearization that could enable it to become a full member of the international community. In February 2007, a major breakthrough in the deadlocked six-nation nuclear talks, reconvening after a 13-month hiatus, accelerated North Korea's denuclearization process in exchange for economic benefits provided by other member countries based on the action-for-action principle. In October 2007, a second South-North summit between the two Koreas, held seven years after the first, landmark 2000 summit, demonstrated North Korea's willingness to engage in hopes of reviving its failing economy. North Korea's intensified interactions with top-level leaders outside the region, including South-east Asian countries such as Vietnam and Malaysia, as well as New Zealand, Switzerland, and the European Union, also demonstrated the critically important and potentially larger role that can be played by the international community in opening up North Korea through economic engagement.¹

External Economic Engagement with North Korea

External economic engagement with North Korea is clearly growing more complex and calls for careful evaluation. But when and how can external economic engagement have the most positive impact in inducing North Korean opening and reform, and not merely prolong North Korea's regime survival? What sorts of external economic engagement are most likely to engender transformation to a market economy?

To shed light on this puzzle, it makes sense to focus on the two most significant external economic-engagement players during the Kim Jong-il era (1998–2007): China and South Korea. My central assumption is that, at the current stage of North Korea's economic transformation, the most important aspect of external economic engagement is demonstrating to North Koreans that markets are superior to a command-and-control system for organizing and promoting economic activity. Economic engagement by these two neighbors has often been bundled together by regional analysts, who sometimes criticize Chinese and South Korean engagement as merely prolonging North Korean regime survival. A closer look shows that, although China and South Korea are both having an impact on North Korean economic policy, they can be differentiated in terms of their transformative impact. As has been noted by some scholars,² China's engagement to date has been more commercial and, therefore, more transformative than South Korea's engagement.

If we examine the two countries' economic engagement, looking specifically and separately at engagement by actors at four distinct levels—central government, local government, enterprises, and grass roots—the picture becomes still clearer. In particular, it becomes possible to more precisely answer the questions of why and how China's economic engagement has been more commercial and transformative than South Korea's thus far.

A main finding of this four-level analysis is that Chinese economic engagement at the local government and business levels, primarily as organized by actors resident in China's northeast provinces, has served as

1. For example, see "Peters Briefs Rice on North Korea Trip," tvnz.co.nz, 20 November 2007, <http://tvnz.co.nz/view/page/411368/1454981>; and "North Korea Premier Arrives in Vietnam to seek Financing, Mining Cooperation," Yonhap News Agency (Seoul), 26 October 2007. At the private sector level, it was noteworthy that an Australia-based trust company, Maranatha Sinyong Ltd., planned to provide micro credits to local business in North Korea.

2. Stephan Haggard and Marcus Noland, "North Korea's External Economic Relations," Working Paper 07-7 (Washington, D.C.: Peterson Institute for International Economics, August 2007), 19–20, 28, www.petersoninstitute.org/publications/wp/wp07-7.pdf.

an especially potent catalyst in North Korean economic change. These provinces can also serve as a model for North Korea's future economic development.

As for South Korea's economic engagement, it has also had some influence on North Korean economic policy, but it is apparent that historical and geopolitical conditions as well as different national interests and goals have produced markedly different engagement patterns by China and South Korea. South Korea in particular faces difficult hurdles that have prevented it from making its engagement more relevant to North Korea's economic market development or its policymaking conducive to a more market-based economy.

Four Channels for Inducing Economic Change

North Korea's economic policy can be influenced via four key channels:

1. Central government economic policy dialogue and nationally organized trade and investment programs, which could be conducive to the expansion of the North Korean market economy and legal foreign trade and investment;
2. Organized economic activity and learning, including foreign trade, handled by local governments;
3. Economic interaction at the enterprise level, linking foreign industrial concerns to the North Korean domestic economy; and
4. The expansion of grassroots-level cross-border economic interaction, including barter trade by private citizens using markets to obtain daily necessities.

Remembering the above four channels, we now look for evidence of influence on North Korea policy by looking at four metrics:

1. Pattern of top-leader interactions and subsequent policy changes or attempts at changes such as adjustments in incentive structures, expansion of the market segment of the economy, or shifting of

resources from the planned sector (including the military) to the market sector;

2. Frequency and outcome of interactions at the local government level, including any resulting impact on trade and investment patterns;
3. Commercial interaction between foreign enterprises and domestic industrial concerns; and
4. Grassroots interaction including informal trade and the resulting expansion of general markets.

A quick examination of Chinese and South Korean interaction with North Korea at each level of economic engagement can shed light on what sorts of economic engagement have proved most effective in inducing reform and opening in North Korea thus far.

Central Government Engagement and Policy Change

Chinese and South Korean economic engagement at the national or leadership level is motivated by core national interests and priorities—economic gain and stability in the case of China, and reconciliation and eventual reunification in the case of South Korea. These priorities naturally influence the character and impact of these countries' respective economic engagement activities with North Korea.

China–North Korea Top Leadership and Central Government Interactions

Economic policy discussions between Chinese and North Korean top leaders actually predate the Kim Jong-il era.³ North Korea's most important economic policy reform ideas can in fact be traced to North Korea's interactions with China's pro-reform top leaders starting as early as the 1980s, immediately after China embarked on its reform and opening policy in 1978.

Official meetings and visits. At least five top leadership meetings between China and North Korea in the early 1980s specifically focused on economic matters. For example, Kim Il-sung's last visit to China,

3. For a full treatment of this topic see, Mika Marumoto, "North Korea and the China Model: The Switch from Hostility to Acquiescence," Academic Paper Series 2, no. 5 (Washington, D.C.: Korea Economic Institute, May 2007), www.keia.org/2-Publications/Marumoto.pdf.

in October 1991, included a side trip to Shandong to study China's strategy for its special economic zones. Adoption of North Korea's new foreign trade promotion policy in 1984 as well as the enactment of the Joint Venture Law in 1984 and the creation of special economic zones at Rajin-Sonbong and the Tumen River in early 1990s directly followed trips to China where these initiatives were discussed in some detail.

Since Kim Jong-il assumed full control of North Korean affairs in 1998, he has made four trips to China: Beijing in May 2000, Shanghai in January 2001, Beijing and Tianjin in April 2004, and Guangdong in January 2006. Each time, Kim conducted site visits to successful Chinese industrial concerns and joint ventures. Following each visit, North Korea appeared to attempt certain Chinese-style reforms, and policy experiments expanded to include new special economic zones and new economic incentives set forth in the July 2002 reforms. In 2004, in particular, Kim Jong-il and President Hu Jintao pledged that the two countries would continue high-level contacts to further develop trade and economic cooperation. At the meeting, Kim also expressed his interest in "mutual learning and an exchange of experiences."

Transformative impact of China's aid. China has also historically been a critical provider of aid to North Korea. China consistently provided food and energy, even after the socialist bloc's demise in the late 1980s and early 1990s (except in 1994 when Chinese food production suffered and food exports were banned as a result), apparently without much linkage to bilateral policy agendas. More recently, however, China's aid to the Kim Jong-il regime appears to be aimed more strategically at having a transformative impact, especially in terms of its "policy conditionality."

Amid the nuclear crisis, China is said to have negotiated with North Korea certain conditions for provision of food and fuel aid by linking its aid to economic

reform and opening measures or the six-party talks.⁴ President Hu Jintao, during his visit to Pyongyang on 28–30 October 2005, for instance, made it clear to Kim Jong-il that, although China was considering plans to provide \$2 billion in assistance to North Korea, China would not provide the aid unless North Korea presented concrete reform and opening plans.⁵ Subsequently, North Korea floated the idea of setting up a new special economic zone in North P'yongan where Chinese firms would provide equipment and technology and North Korea would provide land and human resources.⁶

China's aid has also taken on some indirect aspects of "military restructuring." For example, China provided \$20 million in investment funds and food aid to facilitate the construction of the Daean glass factory in South P'yongan Province in October 2005. Retired and "excellent" military personnel selected by the Korean Workers' Party and the North Korean government have been put to work at the factory,⁷ apparently as a reward for prior service as well as to facilitate converting military labor to more productive uses. Awarding medals to military personnel has long been a political tool used by Kim Jong-il to solidify his legitimacy and gain support from the military, but this may be the first time Kim has rewarded military officers for contributing to economic reconstruction. Although the scale and overall impact of this one project is small, the endeavor echoes Deng Xiaoping's decisive military restructuring in the 1980s, when Deng sought to reassign military cadres to nonmilitary work without humiliating those losing their military status.

Inter-Korean Top Leadership and Central Government Interactions

Thus far, only two summits have taken place between South Korean and North Korean leaders. The first summit, between President Kim Dae-jung and Kim Jong-il in June 2000, was primarily symbolic in nature,

4. Gendai Korea [Modern Korea; publication of Modern Korea Institute, Tokyo], March 2006, 20.

5. Ibid., 20–21.

6. Nikkei Shimbun, 1 December 2005.

7. "North Korean Economic Dynamics [in Chinese]," Chaoxian Jingji Dongtai he Xinwen (online publication of the Small China-DPRK Investor Association, Dandong), 12 June 2006, http://kortr.cn/main/home/ns_detail.php?id=16&nowmenuid=3&cpath=&catid=0.

but it was historically significant in affirming mutual recognition of each Korea's existence and legitimacy. Subsequent to the Kim-Kim summit, high-level government interactions were institutionalized, including the Inter-Korean Ministerial Talks and the Inter-Korean Economic Cooperation Promotion Committee. Economic cooperation projects such as the Kaesong industrial complex, Mt. Kumgang tourism resort, and the inter-Korean railway and road reconnection efforts followed thereafter.

The second summit, between President Roh Moo-hyun and Kim Jong-il in October 2007, increased the focus on inter-Korean economic cooperation and aimed at creating an enabling environment for the two Koreas to accelerate inter-Korean political reconciliation. A new economic cooperation package unveiled at the summit by President Roh included establishment of a "peace and cooperation zone" in the West Sea area, the building of a new joint industrial complex replicating the Kaesong complex, construction of additional infrastructure such as roads and railways linking the two Koreas, and joint efforts to develop underground mineral resources. The two Korean leaders simultaneously issued a joint statement emphasizing their agreement to resolve the issue of reunification according to the spirit of "by-the-Korean-people-themselves."⁸ This emphasis on exclusive Korean responsibility for peninsular reconciliation can be interpreted to result in part from the South Korean government's fear of growing Chinese influence over the North Korean economy.

South Korea faces a more daunting challenge than China in making its economic engagement with North Korea transformative in nature. Because Korea is a divided nation, North-South cooperation patterns that might highlight the disparity between South Korea's successes and North Korea's failures, or put South Korea in the position of tutor and North Korea in the position of pupil, are uniquely threatening to North Korea's leaders. As a result, the mandate of inter-Korean economic cooperation projects such as the

Kaesong industrial complex has been complicated, aiming at multiple objectives such as maintaining South Korean business competitiveness, facilitating peace on the Korean peninsula, and improving the North Korean economy—all while cushioning North Korea from the social and political impact of unfettered economic interchange with South Korea. In practice, North Korea has maintained greater control over the scope and speed of inter-Korean economic cooperation than it has over China–North Korea economic aid and cooperation.

The geographically segregated Kaesong industrial zone, for example, has thus far generated only limited demonstration effects or spillover effects for the North Korean internal economy. Direct wage payments to Kaesong workers have still not been implemented although four years have passed since the launch of the project. Meanwhile, North Korea's sudden and unilateral announcement of wage increases in the summer of 2007 was a blow to South Korean small- and medium-size investors in the project. North Korea also made only limited concessions concerning South Korean requests for easier physical access to the Kaesong economic zone, as sought during follow-up economic talks at the deputy-prime-minister level in early December 2007.⁹

In general, while many in South Korea are eager to expand and institutionalize more profound inter-Korean economic exchanges, North Korea appears to be most interested in obtaining economic benefits that can be used for the revival of its planned economy—without transforming the North Korean economy or its people's mind-set. Because South Korea is perpetually negotiating at a disadvantage—as the demander rather than the demandee—South Korean assistance has fallen into a pattern that does not call for significant conditionality related to opening and reform on North Korea's part. This of course stems from the North Korean leadership's psychological fear of opening the country's borders to South Korea, which exceeds its concern about North Korea's possibly deeper reliance

8. "Declaration on the Advancement of South-North Korean Relations, Peace and Prosperity," Ministry of Unification, Seoul, 4 October 2007, http://unikorea.go.kr/english/EPA/EPA0101R.jsp?main_uid=2181.

9. Heejin Koo, "North Korea, South Korea Fail to Agree on Economic Zone Access," Bloomberg.com, 7 December 2006, www.bloomberg.com/apps/news?pid=newsarchive&sid=aXIUAwkKQMbs.

on China.¹⁰ The “reunification pressure” or “existential threat” that North Korea perceives from South Korea remains palpable, even though two summit meetings have reaffirmed the two nations’ mutual recognition and parallel legitimacy.

Local Government Engagement and Policy Change

Engagement with North Korea by South Korean local government entities has thus far consisted mostly of sporadic humanitarian assistance in the form of food or medicine—occasionally extending to small development projects. Even so, the North Korean counterpart for South Korean local government economic aid has usually been the central government rather than lower-level entities.

In contrast, the main part of China’s commercial engagement with North Korea has been driven by Chinese local governments, and the North Korean cabinet has delegated authority to its local governments to deal directly with Chinese counterparts, including conducting negotiations on major Chinese investments.

Chinese municipal, prefectural, and provincial governments and government-affiliated entrepreneurs—particularly from China’s three northeastern provinces—are showing heightened enthusiasm about deepening their economic links to North Korea. As a result, North Korea’s exposure to Chinese economic policy and business norms has expanded rapidly via these channels in recent years. The trend temporarily subsided immediately after North Korea’s missile launch and nuclear test in 2006, but it persists as a fundamental trend.

From the perspective of China’s central government, the economic development of China’s northeastern region has been among its most challenging agendas,

as the regional economy remains dominated by state-owned heavy industries that are still going through a relatively slow and painful reform process. To tackle this problem, in October 2003 and May 2005 the Central Committee of the Chinese Communist Party announced revised guidelines for the development of China’s three northeastern provinces. Subsequently, the provincial governments themselves drafted a comprehensive development plan linking the country’s northeastern region not only with neighboring Chinese cities and provinces but also with key North Korean cities. In support of this concept, city officials in Dandong were quoted as saying, for example, that Dandong had been long neglected by Beijing owing to its close proximity to North Korea, which made it into a “danger zone.”¹¹ Now, they said, Dandong enjoyed many advantages because of its location on the border between North Korea and China.

In this milieu, Chinese local governments and enterprises are actively and independently pursuing commercially viable trade and investment deals with North Korea. This includes the acquisition of mineral rights, which is increasingly cited by some South Koreans as evidence of China’s “excessive” economic influence over North Korea. The most alarmist South Koreans worry that North Korea is “becoming the fourth Northeast province of China.”¹² By some estimates, Chinese groups have invested as much as \$100 million in improving the extractive capacity of North Korean mines.

In fact, Chinese local government engagement with North Korea has stimulated significant market-based trade, exposing North Korean officials to market norms and practices and serving as a catalyst in transforming the North Korean economy. Both official and unofficial visits at the municipal and provincial levels between China and North Korea have increased dramatically. Examples include not only major official visits to

10. See Liu Ming, “North Korean Economic Reform: An Uncertain Future for a Third-Way Exploration,” in Joint U.S.-Korea Academic Studies: Dynamic Forces on the Korean Peninsula: Strategic & Economic Implications 17 (2007): 93–94.

11. “China’s Northeast Plans Include Korea,” Dong-A Ilbo, 21 March 2006, http://english.donga.com/srv/service.php?biid=2006032125648&path_dir=20060321.

12. “China’s Colonization of North Korea,” ChosunIlbo, 9 March 2007, <http://english.chosun.com/w21data/html/news/200703/200703090036.html>; “China Feared Grabbing Up Resources in North Korea,” Chosun Ilbo, 22 November 2007, <http://english.chosun.com/w21data/html/news/200711/200711220005.html>; and “North Korea Becoming China’s ‘Fourth Northeastern Province,’” Chosun Ilbo, 20 November 2007, <http://English.chosun.com/w21data/html/news/200711/200711230025.html>.

promote trade and investment in North Korea but also various functional exchanges including, for example, a visit in 2005 that resulted in a bilateral agreement on enhancing product quality control.

Unlike in South Korea, no Chinese entity compiles and publicly releases information tracking engagement with North Korea. Anecdotes of Chinese local government economic interaction with North Korea are numerous and constantly multiplying. One notable example took place in September 2005 when a 110-member delegation (including delegates from 30 North Korean enterprises) headed by the North Korean minister of foreign trade participated in the first Northeast Asia Trade and Investment Exhibition at Changchun, Jilin Province. The aim was to induce Chinese enterprises to actively participate in North Korean economic construction, infrastructure and industrial development, and the improvement of North Korean agricultural technology. The Changchun event was the first North Korean investment promotion forum held in China in 10 years, apparently signaling increased interest on the part of North Korea to open up the country from within. Only two years later, in 2007, Chinese participants in the third Jilin-based Northeast Asia Trade and Investment Exhibition were reportedly surprised by the North Korean participants' aggressive attitude toward business promotion. For the first time, the Chinese dealmakers witnessed the North Koreans outlining specific project proposals and offering video presentations of their export products.¹³

Business-to-Business Engagement and Its Impact

China and North Korea have had significant contact during the six decades since the division of the Korean peninsula, so it is only natural that North Korean entities feel more comfortable dealing with Chinese

government officials or business entities than they do working with their South Korean counterparts. At the enterprise level as well, it is not surprising that China–North Korea interaction, linking Chinese industrial concerns with North Korean domestic companies, remains broader and deeper than North Korea's dealings with South Korean counterparts. Up until now, in fact, South Korean corporate activity in North Korea has for the most part been confined to relatively simple contracts aimed at taking advantage of North Korea's low-wage labor force.

Chinese Entrepreneurs and the Northeast China Model

Chinese businesspeople express the view that China–North Korea business-to-business relationships have deepened in recent years—driven by market opportunities and imperatives rather than by top-down political intentions. In fact, Chinese entrepreneurs have long kept their eyes on potential emerging-market opportunities in North Korea. During the past 10 years, for instance, Chinese representatives have consistently attended North Korea's annual trade fairs in Pyongyang, sending by far the largest number of companies. At the ninth Pyongyang Spring International Trade Fair in 2006, 179 out of 196 participating companies were from China.¹⁴ The following year's trade fair attracted more than 200 companies from 13 countries, of which more than half were from China.¹⁵ South Korean participants were relative newcomers, attending the fair for just the second time in 2007.

Among the most notable anecdotal examples of business-to-business engagement between China and North Korea was the establishment in 1997 of Hwaryo Bank, a Chinese–North Korean joint venture. Hwaryo Bank offers fund management services to North Koreans abroad as well as to Chinese and other foreign na-

13. Tetsuya Suetsugu, "North Korea Becoming More Proactive over Trade with China," Daily Yomiuri Online, 7 September 2007.

14. "North Korea International Trade Fair Welcomes Foreign Participants: Glass Products Produced by the Factory Assisted by China Received Favorable Reaction [in Chinese]," Chaoxian Jingji Dongtai he Xinwen, 9 June 2006, http://www.kortr.cn/main/home/ns_detail.php?id=8&nowmenuid=3&cpath=&catid=0.

15. Korea Central News Agency, 14 May 2007; quoted in "Major Development—North Korea Holds Annual Trade Fair with More Than 200 Companies," Vantage Point (Yonhap News Agency, Seoul) 30, no. 6 (June 2007): 31–32.

tionals residing in North Korea, and it invests capital in high-profit ventures.¹⁶ Another prominent case was the December 2005 contract reached by a Chinese state-owned trading company with North Korea's Central Import Goods Exchange General Company to jointly establish a new general market in Pyongyang where goods imported from more than 20 Chinese companies would be exhibited and sold.¹⁷ More recently, in 2007, North Korea's Daepung Investment Group boldly announced that it would set up a major investment fund with the help of the China Development Bank to provide financing to Chinese companies as they build roads, railways, and ports in North Korea.¹⁸

Some Chinese investors apparently believe that investing in North Korea now will enable them to enjoy trailblazers' advantages in North Korea in the future,¹⁹ as they expect that North Korea will inevitably embark on a path toward economic reform and recovery similar to China's experience following the end of the Cultural Revolution in the 1970s. Chinese residing in China's three northeastern provinces, in particular, tend to view North Korea's current economic conditions and personal consumption level as similar to the situation in China in the early 1980s, with its great potential for future growth.²⁰ This intuitive expectation of an eventual North Korean takeoff may also be related to the fact that China's northeastern provinces share not only geographical proximity with North Korea but also similar initial conditions in terms of their economic size and industrial structure (*Table 1*).

Observers of North Korea often argue that the transition models of China and Vietnam, which as generally understood depended critically on agricultural reform as a key to their success, cannot serve as a reference for industry-dominated North Korea's future develop-

ment. But a close look at China's three northeastern provinces could tell a different story. North Korea's current industrial structure is, for example, remarkably similar to what existed in Jilin Province 20 years ago, in terms of both output and employment. Both Jilin and North Korea featured a pronounced bias toward heavy industry and large state-owned operations as opposed to more diverse light industry. Jilin's economic size in 1985 as well as its trade and foreign direct investment inflows were much smaller than the current totals for North Korea. Yet, during those 20 years, Jilin's economy grew to enjoy twice as much trade as North Korea and six times as much foreign investment while it has rapidly expanded its service sector in terms of employment creation. This lends hope and credence to the idea that North Korea could successfully open and reform its economy by drawing upon lessons from northeast China—with those lessons being transmitted by Chinese enterprises (and local governments) based in the provinces of Liaoning, Jilin, and Heilongjiang (*Table 2*).

South Korea's Experimental Investments in North Korea

South Korean entrepreneurs and corporations, meanwhile, have made slower progress in deepening and broadening enterprise-level engagement with North Korean counterparts. Their engagement has been somewhat sporadic and random, depending on a range of motivations on the South Korean side that are not always related to expectations of quick profitability. Still, during the past 10 years, a certain set of South Korean companies has made significant efforts in engaging North Korea, including via the Kaesong industrial complex.

16. Trade and Chosun, January 2005; quoted by Kim Sung-jin, "Overseas Funds for Investment in North Korea," *Vantage Point* 30, no. 5 (May 2007): 21–22.

17. *Gendai Korea*, March 2006, 21. <?> *Gendai Korea*, March 2006, 21.

18. Bomi Lim, "North Korea, China Will Start \$10 Billion Fund, Yonhap Reports," *Bloomberg.com*, 13 November 2007, www.bloomberg.com/apps/news?pid=20601101&sid=aQoHi.iCFLBk.

19. Korea Trade-Investment Promotion Agency's Analysis Based on Heilongjiang Weekly News, 16 February 2005; quoted in "Chinese Enterprises Eye Investment Opportunities in North Korea [in Japanese]," *East Asia Economic Information* (East Asia Trade Research Board, Tokyo), no. 141, March 2005, 11–15.

20. *Ibid.*

Table 1: Economic Profiles of North Korea, China, and China's Northeastern Provinces, 1985 compared with 2005

| Characteristics | North Korea | | China | Jilin | | Heilongjiang | | Liaoning | |
|---|-------------|-------|---------|-------|------|--------------|------|----------|-------|
| | 2005-06 | 1985 | 2005 | 2005 | 1985 | 2005 | 1985 | 2005 | 1985 |
| Population (million) | 22 | 18.5 | 1,308 | 27 | 23 | 38 | 34 | 42 | 37 |
| GDP (U.S. dollars, billion) | 40 | 45 | 2,235 | 44 | 7 | 67 | 12 | 98 | 18 |
| Primary | 30% | — | 13% | 17% | 28% | 12% | 22% | 11% | 14% |
| Secondary | 34% | — | 48% | 44% | 48% | 54% | 58% | 49% | 63% |
| Tertiary | 36% | — | 40% | 39% | 24% | 34% | 21% | 40% | 22% |
| Exports (U.S. dollars, million) | 1,338 | 1,111 | 761,950 | 2,467 | 427 | 6,072 | 410 | 23,440 | 5,040 |
| Imports (U.S. dollars, million) | 2,718 | 1,290 | 659,950 | 4,061 | 124 | 3,500 | 100 | 17,570 | 350 |
| Inflow of foreign direct investment (U.S. dollars, million) | 135 | — | 60,325 | 661 | 25 | 1,447 | — | 3,590 | — |
| Data per capita (U.S. dollars) | | | | | | | | | |
| GDP | 1,788 | 2,432 | 1,709 | 1,634 | 297 | 1,761 | 360 | 2,322 | 479 |
| Exports | 60 | 60 | 583 | 91 | 19 | 159 | 12 | 557 | 137 |
| Imports | 122 | 70 | 505 | 150 | 5 | 92 | 3 | 417 | 9 |
| FDI | 6 | — | 46 | 24 | 1 | 38 | — | 85 | — |

Sources: North Korea's GDP and GDP per capita are 2006 estimates based on purchasing power parity (PPP); industrial structure figures are 2002 estimates; see "North Korea," *World Factbook* (Washington, D.C.: Central Intelligence Agency), <https://www.cia.gov/library/publications/the-world-factbook/geos/kn.html>; inflows of foreign direct investment to the DPRK are 2006 estimates: World Investment Report 2007 (Geneva: United Nations Conference on Trade and Development, 2007), www.unctad.org/Templates/Page.asp?intItemID=1485&lang=1; for North Korea's 1985 GDP and data per capita, see national incomes estimated by Eui-Gak Hwang, *The Korean Economies: A Comparison of North and South* (Oxford: Oxford University Press: 1993); data for China are based on Chinese government official statistics: *Chinese Statistical Yearbook 2006*; *Jilin Statistical Yearbook 2006*; *Heilongjiang Statistical Yearbook 2006*; *Liaoning Statistical Yearbook 2006*.

Note: China's GDP and GDP per capita, if based on PPP, are estimated to be \$10.2 trillion and \$7,800, respectively.

South Korea's Hyundai Group, following a path forged by the group's late founder, Chung Ju-yung, has played a particularly prominent role in promoting North-South business ties. Chung originally suggested the idea of the Kaesong industrial complex to Kim Jong-il in 1998, and North Korea promulgated a law establishing the complex and in late 2002 designated Hyundai Asan Corporation to be the main developer. Full-scale construction started in 2004, with the first stage completed in 2007. Thus far, approximately 52

small- and medium-size South Korean enterprises operate in the complex, employing about 20,000 North Korean laborers.²¹ According to plans endorsed by the South Korean Ministry of Unification, upon completion of three phases in 2012, up to 2,000 companies will be operating in the complex, with total investments amounting to \$8 billion, and will be employing more than 300,000 North Korean workers. Whether these ambitious plans will be realized remains to be seen.

21. "Completion Ceremony of Infrastructures in 1st Phase KIC," Hyundai Asan Newsletter (Hyundai Asan Corporation), October 2007, www.hyundai-asan.com/newsletter/eng_200710/sub3_03.html.

Table 2: Industrial Structure by Employment in North Korea, China, Liaoning, Heilongjiang, and Jilin, 1978–2005, percentage

| Jurisdiction | Year | Primary | Secondary | Tertiary |
|--------------|------|---------|-----------|----------|
| North Korea | 2002 | 36 | 64 | |
| China | 1978 | 71 | 17 | 12 |
| | 1985 | 62 | 21 | 17 |
| | 1992 | 59 | 22 | 20 |
| | 2005 | 45 | 24 | 31 |
| Liaoning | 1978 | 47 | 35 | 18 |
| | 1985 | 36 | 41 | 23 |
| | 1992 | 33 | 41 | 26 |
| | 2005 | 34 | 28 | 38 |
| Heilongjiang | 1978 | 53 | 29 | 18 |
| | 1985 | 41 | 35 | 24 |
| | 1992 | 37 | 36 | 27 |
| | 2005 | 46 | 21 | 33 |
| Jilin | 1978 | 49 | 32 | 19 |
| | 1985 | 45 | 31 | 24 |
| | 1992 | 48 | 29 | 24 |
| | 2005 | 46 | 19 | 36 |

Sources: “North Korea,” *World Factbook* (Washington, D.C.: Central Intelligence Agency), <https://www.cia.gov/library/publications/the-world-factbook/geos/kn.html>; *China Statistical Yearbook 2006*; *Liaoning Statistical Yearbook*; *Heilongjiang Statistical Yearbook 2006*; *Jilin Statistical Yearbook 2006*.

Given the geographical proximity of their corporate headquarters, the absence of language barriers, and low wage costs in North Korea, South Korean enterprises—especially small- and medium-size companies involved in labor-intensive manufacturing—have started to express increased interest in investing in North Korea. Several hundred have applied to join the Kaesong project, with more than 50 enterprises reportedly saying they might withdraw investments

from other Asian countries such as China, Vietnam, and Indonesia in order to shift operations to North Korea.²² These firms, however, have not shown the ability to reach out directly to North Korea with the protective umbrella of the Hyundai project.

In contrast with the cautious yet somewhat positive attitude shown by smaller South Korean companies toward investing in North Korea, South Korea’s larger corporations have been decidedly unenthusiastic about investing or trading with North Korea. For example, when the Kaesong industrial complex support team of the Ministry of Unification visited the Federation of Korean Industries in May 2006 to encourage large member corporations to move into the complex, an executive of a large corporation was quoted as saying that it would be “difficult” to enter the complex; he cited the nuclear issue as well as restrictions on shipping strategic technologies to North Korea.²³ President Roh Moo-hyun recruited major South Korean corporations to join him at the second inter-Korean summit in October 2007, but after the event business representatives stressed mainly the difficulties of doing business in North Korea.²⁴ Inter-Korean trade and investment seem to be still characterized by top-down directives and government-led attempts to make institutional arrangements for future expansion of more organic North-South business ties.

There is, of course, huge potential for future engagement by South Korean enterprises in North Korea. Aside from the possible exception of the Pyeonghwa Motors project, however, there are remarkably few success stories to date of penetrating the so-called real North Korean economy in a normal way, without the benefit of participation in a central government-supported project. Pyeonghwa Motors was established in 2002 as an automobile assembly joint venture between South Korea’s Pyeonghwa Group (which is owned by the Unification Church) and North Korea’s Chosun People’s Leisure Group. At its factory in Nampo it

22. “North Korea Will Become Asia’s New Economic Performer [in Chinese],” *Chaoxian Jingji Dongtai he Xinwen*, 6 July 2007, www.kortr.cn/main/home/ns_detail.php?id=666&nowmenuid=3&cpath=&catid=0.

23. Jeong-hun Park, “Government Pressures Firms to Join Gaesong,” *Dong-A Ilbo*, 11 May 2006, http://english.donga.com/srv/service.php3?biid=2006051184048&path_dir=20060511.

24. Kim Deok-hyun, “Inter-Korean Business Cooperation: Will South’s Big Companies Try Their Luck?” *Yonhap News*, 30 September 2007; see also “Businessmen Worry That North Korea Is Unprepared for Further Economic Cooperation,” *Dong-A Ilbo*, 6 October 2007, http://english.donga.com/srv/service.php3?biid=2007100694828&path_dir=20071006.

assembles annually about 600–700 vehicles, including sedans, sport-utility vehicles, and minibuses, using imported parts and chassis. It plans to start producing pickups using frames and engines made in the Chinese city of Shenyang.²⁵ Pyeonghwa’s eventual (and ambitious) goal is to target export markets.

As for the Kaesong industrial complex, the long-term viability of the project and its contribution to North Korean economic development may depend on how much the current business model—using North Korean land and workers as inputs for foreign, mostly South Korean, manufacturers—can be diversified to allow internal linkages to North Korean contractors and input suppliers and to allow equity joint ventures with North Korean state-owned enterprises that would employ both North Korean and South Korean managers. Such changes could generate significant spillover benefits for the North Korean economy beyond Kaesong, improving productivity through technological, technical, and managerial knowledge transfer. South Korean investment in North Korea, both in Kaesong and elsewhere, would also be made more attractive if economic sanctions (limiting high-technology exports to North Korea and impeding imports of North Korea’s end products) imposed by the United States and other countries were lifted—a likelihood that is probably dependent on North Korean denuclearization. In short, true realization of the Kaesong dream depends on North Korea’s willingness to open its economy and society further.

Grassroots Engagement and Its Impact

South Korea’s grassroots-level interactions with North Korea are for the most part carried out by nongovernmental organizations and are aimed at easing tensions between the citizens of the two Koreas. The hope is that, by providing humanitarian assistance, South Korean citizens can help foster trust and deepen mutual understanding.

It is clear that grassroots activities conducted by South Korean private voluntary organizations have

become quite common in North Korea in recent years.²⁶ Typical projects entail provision of foodstuffs or other commodities such as medicine, livestock, or agricultural machinery. But the activities of these groups remain sporadic and are tightly controlled by North Korean counterparts. It is also not uncommon for such activities to be subject to sudden cancellation, depending on the winds of overall inter-Korean relations. Thus, it is difficult for grassroots South Korean groups, even those providing economic aid, to have a meaningful impact on North Korea’s internal economic practices. Many other North-South cooperative grassroots activities are primarily academic, athletic, religious, or cultural in nature and therefore do not provide opportunities for South Koreans to “preach” market economics or provide a practical example of market-based economic activities for North Korean counterparts to observe.

In contrast with the nonprofit orientation of South Korean grassroots interaction with North Korea, China’s grassroots engagement has very much focused on generating a profit for its organizers. As a result, the most prominent forms of individually organized activity—cross-border barter trade and small-scale entrepreneurship—have had a direct impact on the expansion of the market economy segment in North Korea, including the emergence of informal markets. Farmers’ markets resembling China’s first appeared in North Korea as early as the 1980s, and they expanded significantly in the 1990s as places where North Korean citizens could access barter-trade goods and make quasi-legal purchases of food and other essentials, which were especially important during North Korea’s unprecedented famine in the mid-1990s.

In 2003, North Korea transformed the nation’s quasi-legal farmers’ markets into roughly 300 legalized general markets. A substantial proportion of the items on sale at these markets are imported from China, and many of those have been carried into the country as “backpack” trade organized by entrepreneurial individuals rather than handled by established agents. Some experts estimate that official statistics on China–

25. “Pyeonghwa Motors, China’s Brilliance in Talks to Produce Trucks in North Korea,” Yonhap News Agency, 1 August 2007, <http://english.yonhapnews.co.kr/northkorea/2007/08/01/21/0401000000AEN20070801001700320F.HTML>.

26. For details, see “Expansion of Inter-Korean Exchanges and Cooperation,” chap. 3 of “White Paper” (Seoul: Ministry of Unification, June 2005), www.unikorea.go.kr/english/EUL/EUL0301L.jsp.

North Korea trade may underestimate actual trade volumes by as much as 30 percent because those statistics fail to capture the informal cross-border trade. Thus, from the supply side, Chinese individuals are having a big impact on the development of market mechanisms in North Korea.

This grassroots engagement is sometimes supported and encouraged by Chinese local governments. China's Tumen City, for example, with the blessing of the North Korean cabinet this year negotiated the joint establishment of a general market together with a county government in North Korea's North Hamgyong Province. This is the second such joint market, emulating a prior initiative between North Korea's Sinuiju and China's neighboring Dandong City.²⁷

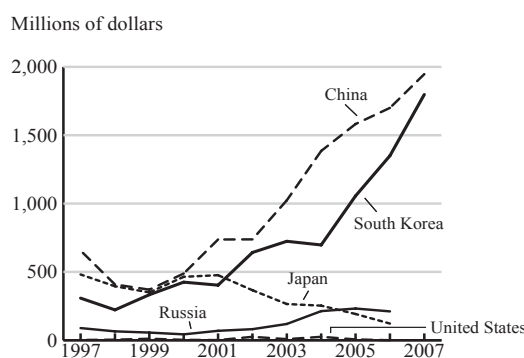
In response to its growing informal cross-border trade with China, Pyongyang is sending mixed signals, however, perhaps out of concern about a loss of control over profit-making activity or because the North Korean authorities seek to hoard foreign currency. At any rate, soon after the inter-Korean summit of October 2007, North Korea raised the minimum age for female salespersons in markets from 35 to 49.²⁸ Market patrols aimed at enforcing fixed prices also appear to be increasing. In the border areas, Chinese merchants are speculating that North Korean authorities may start to limit or prohibit the sale of industrial goods in general markets.²⁹ If imposed, the attempt to prohibit trading of industrial goods in general markets would imply a reversal aimed at strengthening planned economy functions.

External Economic Engagement Reflected in North Korea's Economic Data

Trade data clearly indicate that China and South Korea have become the two dominant foreign economic partners for North Korea under Kim Jong-il

(*Figure 1*). North Korea's international trade, including inter-Korean trade, has expanded since 1998 at a 12 percent compound annual growth rate, increasing from about \$1.7 billion to \$4.35 billion in 2006. Figure 1 shows that China has been North Korea's largest trading partner since 1997, and that its primacy has been very much unrivaled—except by South Korea—since 2002. Taken together, the two are responsible for about two-thirds of North Korea's international trade by 2007.

Figure 1: North Korea's Trade with Nations Participating in the Six-Party Talks, 1997–2007, in millions of dollars



Sources: Customs Statistics, People's Republic of China; Korea Trade-Investment Promotion Agency, Republic of Korea; Customs Statistics, Ministry of Finance of Japan; Census Bureau, U.S. Department of Commerce; Customs Commission, Russia; Radio Press; *D.P.R. Korea Export and Import 2007* (Kyoto: World Trade Search, 2007).

Note: China 2007 is an estimate; it is an annualized figure based on January–November data.

Along with their shared prominence in North Korea's overall trade, what is most striking to analysts is the sharp difference in the two countries' trading patterns, as reflected in the data. China's engagement in North Korea has been pervasive across the four levels of actors described above, but the data also clearly indicate

27. "China-North Korea Joint Establishment of the Second General Distribution Markets at Border City [in Japanese]," Yonhap News Agency, 2 November 2007, <http://Japanese.yonhapnews.co.kr/northkorea/2007/11/02/0300000000AJP2007110200240082.HTML>.

28. Yang Jung-a and Jung Kwon-ho, "Update on North Korea Markets and Market Regulations," Daily NK, 5 December 2007, www.dailynk.com/english/read.php?catald=nk00400&num=2991; see also "North Korea Will Turn the Jangmadang into Agricultural Market? [in Chinese]," Daily NK, 10 December 2007, www.dailynk.com/chinese/read.php?catald=nk00600&num=1358.

29. Jung Kwon-ho and Yang Jung-a, "NK Forced to Revert to Agricultural Market System?" Daily NK, 11 December 2007, www.dailynk.com/english/read.php?catald=nk01500&num=3011.

the pronounced role played by China's three north-eastern provinces. Table 3 shows that North Korea's trade with northeast China has consistently occupied large portions of the DPRK's international trade. In 2004, North Korean trade with Liaoning, Jilin, and Heilongjiang reached \$1 billion, accounting for 32 percent of North Korea's total trade and 81 percent of its trade with China. In following years, despite the 2006 missile launch and nuclear test, this steady trend did not change. China's trade with North Korea reached \$1.7 billion, of which the three provinces accounted for 66% in 2006.³⁰

In the case of South Korea, the Ministry of Unification's stance supporting strengthened ties between the two Koreas through economic assistance, while also promoting purely commercial trade, comes through plainly in the data. Inter-Korean trade data as officially announced are categorized into commercial and noncommercial trade. According to that classification, commercial trade and government-organized projects accounted for 56 percent and 44 percent, respectively, in 2000. A more useful classification would be (1) commercial trade, comprising both general trade and processing-on-commission (POC) trade, which is commission based and uses North Korean labor but no North Korean industrial inputs; (2) government-sponsored trade, covering the inputs and product output of the Kaesong industrial complex; and (3) government-organized transactions, comprising humanitarian aid, social and cultural cooperation projects, and the erstwhile light-water reactor project. During the first nine months of 2007, by this breakdown, commercial trade, government-sponsored trade, and government-organized transactions accounted for 46 percent, 24 percent, and 30 percent, respectively.

Prominent here is the continuing leading role of the South Korean government in managing and organizing North-South trade, including through the Kaesong

project (which represents the fastest-growing segment of North-South transactions as well as the primary target of South-to-North direct investment). Even this breakdown, in fact, overestimates the importance of true commercial trade in the North-South economic picture because POC trade inputs are basically double counted as exports from North Korea even though the actual added value of the economic activity consists only of the export of fairly simple labor services by North Korea.³¹

Conclusions and Key Observations

A quick overview of Chinese and South Korean engagement with North Korea, then, suggests that economic engagement can have a substantive impact on North Korean economic policy as well as on the empirical characteristics of how the North Korean economy functions in practical terms. But external economic engagement works best to transform the North Korean economy when multiple channels of engagement are employed simultaneously in order to get past the rigid regime's dedicated gatekeepers and enforcers of communist orthodoxy. By encompassing central government-level policy dialogue, local government channels, significant and direct corporate interaction, and individual entrepreneurship, China's economic engagement with North Korea has thus far had the most meaningful impact on that country's closed system.

In particular, deepening economic ties between North Korea and China's northeastern provinces have great potential to serve as a catalyst and a guide to help bring about changes in the direction of a market economy in North Korea. Northeast China is exposing North Korean officials, entrepreneurs, and residents to market-oriented business norms and giving them a taste of a market economy. The three provinces also demonstrate the tragedy of North Korea's lost

30. D.P.R. Korea Export and Import 2007 (Kyoto: World Trade Search, 2007). This report covers data for the most recent two years, 2005 and 2006.

31. Note that South Korean efforts to help North Korea's light industrial development have just begun. These initiatives, encompassing dispatching South Korean industrial experts to North Korean light industry factories and arranging for shipment of raw materials such as polyester fiber to North Korea in exchange for access to mineral resources, could spur real trade. Seoul has offered to provide \$80 million in inputs for North Korea's light industries such as shoe and garment manufacturing, and North Korea reportedly repaid \$2.4 million of the loan by delivering 1,000 tons of zinc; see "Koreas Agree on Initial Economic Aid and Joint Mine Exploration," quoted in *Vantage Point* 30, no. 6 (June 2007): 41; see also "2007 Biggest Year Yet For Inter-Korean Exchange at 1.79 Billion USD," NK Brief (Institute for Far Eastern Studies, Seoul), no. 08-1-10-1, <http://ifes.kyungnam.ac.kr/eng/m05/s10/content.asp?nkbriefNO=177&GoP=%201>.

Table 3: North Korea–Northeast China Trade, 1998–2005, millions of dollars and percentage

| North Korean Trade | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | Compound annual growth rate or average |
|---------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|--|
| Total (a) | 1,664 | 1,814 | 2,398 | 2,673 | 2,902 | 3,115 | 3,554 | 4,055 | 14% |
| Total with China (b) | 408 | 371 | 488 | 738 | 738 | 1,024 | 1,385 | 1,580 | 21% |
| Ratio of China/North Korea (b)/(a) | 25% | 20% | 20% | 28% | 25% | 33% | 39% | 39% | 29% |
| Subtotal for northeast China | 300 | 241 | 364 | 574 | 629 | 903 | 1,125 | 1,090 | 21% |
| Liaoning | 204 | 157 | 236 | 390 | 462 | 622 | 786 | 823 | 22% |
| Jilin | 79 | 78 | 118 | 169 | 152 | 253 | 283 | 241 | 17% |
| Heilongjiang | 17 | 6 | 10 | 15 | 15 | 28 | 56 | 26 | 6% |
| Ratio for northeast China/North Korea | 18% | 13% | 15% | 21% | 22% | 29% | 32% | 27% | 22% |
| Ratio for northeast China/China | 74% | 65% | 75% | 78% | 85% | 88% | 81% | 69% | 77% |

Sources: Databases of the Ministry of Unification; Korea Trade-Investment Promotion Agency (KOTRA); and Korea International Trade Association (KITA); *Chinese Statistical Yearbook 2006*; *Jilin Statistical Yearbook 2006*; *Heilongjiang Statistical Yearbook 2006*; *Liaoning Statistical Yearbook 2006*; *Jilin Nianjian*, various years.

Notes: Jilin-DPRK trade data on table for 1998, 2001, 2003 are author's estimates. Compound annual growth rates for 1998–2005 were calculated for total and subtotal amounts of trade; average growth rates were calculated for the ratios of trade.

opportunities over the past several decades; given its similar initial conditions, North Korea could have realized similar or perhaps even better economic performance than northeast China if appropriate opening and reform policies and institutional arrangements had been implemented.

If they coordinate strategically, China and South Korea should be able to complement each other in helping to transform the North Korean economy. South Korea's engagement, which seeks reduction of military tensions and emphasizes trust-building, noncommercial interactions, should not be dismissed as entirely non-transformative; it can also help promote change in North Korea although perhaps not effectively as China's engagement.

China's engagement should not be viewed as a threat to inter-Korean economic cooperation or eventual

North-South reunification. No single foreign actor can alone achieve the daunting task of transforming the North Korean economy. Nor should any foreign actor seek or claim a monopoly on influencing North Korea. Convincing North Korea to open and reform its economy is the highest priority, regardless of interlocutor.

The ongoing six-party talks, which could eventually lead to more stable North Korean diplomatic relations with major powers such as the United States and Japan, may also end up playing a major catalytic role for North Korea's economic and institutional change. Even if North Korea accepts the grand bargain of denuclearization and opens its economy and society to the broader outside world, China—as an enormous neighbor, large market, increasingly significant source of capital, and increasingly important trading partner—will continue to play a prominent role in

North Korea's economic development in the future. South Korea, following its own path and imperatives, will not be far behind.

Dr. Marumoto conducted her dissertation research at Yonsei University and the Harvard-Yenching Institute. The views expressed in this essay, adapted from her July 2007 dissertation, are solely her own and do not necessarily reflect those of any institution or government.



Korea Economic Institute
1201 F Street, N.W. Suite 910
Washington D.C., 20004

PRESORTED STANDARD
U.S. POSTAGE
PAID
PERMIT #3777
WASHINGTON, DC

Korea's Economy