

Theory and Practice: Kaesong and Inter-Korean Economic Cooperation

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INTRODUCTION

The landmark June 15 inter-Korean summit was all the more dramatic and meaningful, given North Korea's unresponsive attitude in the past. Politically, Seoul's consistent "sunshine policy" certainly contributed to changes in the North. More importantly, however, it appears that the dire economic situation in the North played a large role in shifting North Korea's stance.

Ever since the 1990s, Pyongyang has experienced enormous economic hardship. This was in large part due to the collapse of the former Soviet Union and the East European Communist bloc, as well as the ever-increasing inconsistencies in the Socialist regime. Faced with difficulties greater than they expected, North Korea desperately needed external assistance, especially from South Korea. Consequently, it became a national priority for the North to improve its relations with the South, while strengthening the ideological education of its citizens. In the year 1999, the North recorded a positive growth rate of 6.2 percent for the first time in nine years, thanks to aid provided by South Korea and the international

community.

Under these circumstances, it became very important for the two Koreas to create a form of economic cooperation that would be beneficial to both the South and the North. In other words, both sides needed to share the view that cooperation, rather than unilateral assistance, would best serve the interests of both sides. It seemed that the most desirable form of economic cooperation was the exchange of production factors in which each side had relative advantages. Seoul and Pyongyang would have to combine the South's capital and technology with the North's labor and land, produce internationally competitive goods and then divide the profits. Simply selling South Korean products or introducing capitalist service industry in North Korea would not be feasible, since North Korea does not have markets for such economic activities due to lack of capital. The idea of North Korea selling its goods to South Koreans would be even more unfeasible considering the poor quality of North Korean made products.

Given this fact, the most ideal and realistic form of economic cooperation for both South and North Korea would be to construct a special industrial complex in which goods would be jointly produced by the two sides. To ensure the success of such economic cooperation, the industrial complex should be located in an area where an efficient distribution system could be put in place within a short period of time. Here, an efficient distribution system would necessitate the relatively easy establishment of social infrastructure and the low cost transport of produced goods to the South.

As National Defense Commission Chairman Kim Jong-il has shown great interest in developing an industrial complex, constructing an industrial park as a means of inter-Korean economic cooperation stands an excellent chance for success. After Chairman Kim's secret visit to China on January 15, North Korea experts forecast that there is a good possibility that North Korea will adopt reform and open-door policies. And they point to the Kaesong area as a likely starting point. While in China, Chairman Kim Jong-il

spent four days in Shanghai and Pudong, rather than in Beijing. In Shanghai, a symbol of China's reform and open-door policy, Kim toured the Stock Exchange, and IT facilities—as well as the Japanese chipproducer NEC, and GM, American automotive giant. His visit to the Shanghai Stock Exchange, the so-called “flower of capitalism,” indicates his realization of the fact that bringing change to the North is an inevitable choice.

Based on his tour to Shanghai and Pudong, Kim Jong-il is expected to introduce a new type of development model in North Korea. If he decides to pursue a full-scale economic opening, entirely different from the Rajin-Sonbong special economic zones, which ended in failure, Kaesong will most likely be the venue. What distinguishes Kaesong from Rajin, Sonbong or Shinuiju is its proximity to capitalist regions and other diverse favorable conditions that could make it possible for it to become a successful economic special zone comparable to Shanghai or Shenzhen. Kim will face an uphill battle to devise a thorough plan that does not repeat the mistakes of the Rajin-Sonbong projects. He will concentrate his efforts on drawing up a well-organized development model that can match the one at Pudong.

INTER-KOREAN ECONOMIC COOPERATION: PAST AND PRESENT

The idea of inter-Korean economic cooperation was first broached at a press conference on August 20, 1984 by former South Korean president Chun Doo-hwan. At that time, President Chun proposed that the North begin trade and economic cooperation with the South, expressing his willingness to offer, if agreed to by the North, free technology and goods which would contribute substantially to improving the standard of living of North Korea's citizens. During the period between September 29 and October 4, 1984, aid for flood victims were transported from the South to the North via the truce village of Panmunjom, and the ports of Incheon

and Pukpyong.

After that, Seoul proposed to Pyongyang that a permanent body be set up to deal with matters related to inter-Korean trade and economic cooperation and to hold inter-Korean economic talks in which government and private-level economic delegations from each side would participate. In a message from the Deputy Premier of the State Administration Council on October 16, 1984, the North responded positively to the proposal, saying it would hold economic talks with the South.

Subsequently, five rounds of South-North economic talks were held at the Neutral Nations Supervisory Commission in Panmunjom, starting from November 15, 1984. However, on January 20, 1986, the North Korean delegation unilaterally announced its decision to postpone indefinitely the sixth round of meetings, citing as the reason, the ROK-U.S. team spirit military training. As a result, the bilateral economic talks were halted.

Economic exchanges between the two Koreas was reestablished in the early 1990s. At the sixth round of high-level talks held in Pyongyang in February 1992, the two sides signed the Inter-Korean Basic Agreement, and the subsidiary agreement on exchange and cooperation was adopted in August.

The Kim Young-sam government adopted a very generous approach toward North Korea in its early days, as evidenced by the provision of 150,000 tons of rice to the North in 1995. Nevertheless, this approach did not bear much fruit due to strained inter-Korean relations that were exacerbated by Pyongyang's nuclear program and the submarine infiltration incidents. In accordance with the government's policy of linking North Korea's nuclear issue to inter-Korean economic cooperation, only trade-on-commission and simple exchanges of goods were allowed, while joint investment projects were strictly prohibited. As a consequence, economic cooperation was pursued on a very limited scale.

The Kim Dae-jung government has, however, adopted a policy of engagement toward the North and promoted its vision of building a

national economic community through active inter-Korean economic cooperation. This policy was clearly reflected in last year's June 15 Joint Declaration, which envisioned the balanced development of the North and the South.

As of the end of 2000, the volume of inter-Korean trade stood at \$425.15 million, an increase of \$90 million from 1999 (\$333.44 million in total: \$121.6 million in exports and \$211.83 million in imports), exceeding the \$400 million mark for the first time. Such volume accounts for only 0.6% of South Korea's total trade in 1999, whereas it amounts to almost 22.5% of North Korea's total trade. For the past decade, from 1991 to 2000, the North recorded a surplus of \$115 million per year in its trade with the South. In particular, North Korea recorded a surplus of around \$50 million in the year 2000 from inter-Korean trade even excluding monies from South Korean aid, the Mt. Kumgang tourism project and construction of light water reactors. What is notable is that processing-on-commission trade reached \$140 million in volume, a 32.6% of increase compared to \$99.62 million in 1999. The processing-on-commission trade accounted for a staggering 53.5% of total trade between the South and the North, which was around \$228.5 million. At the end of 2000, a total of 18 cooperation projects were under way and the number of companies involved in the processing-on-commission trade reached almost 140. Moreover, many South Korean companies are exploring business opportunities in the North, particularly the Mt. Kumgang tourism project and the manufacture of textiles, footwear and electronics. These would benefit both the North and South, combining the cheap labor of the former and technology of the latter.

Nevertheless, the imbalance of the trade structure remains a problem. Even after ten years, inter-Korean trade is still handled in the form of simple exchanges of goods and limited trade-on-commission. Besides, there are other problems such as high distribution costs, an uncertain business environment, lack of North Korea's purchasing power, lack of business information, poor social infrastructure and the absence of a proper legal and institutional framework.¹⁾

CHINA'S ECONOMIC SUCCESS AND IMPLICATIONS REGARDING NORTH KOREA

Factors behind the Success of Special Economic Zones in Shenzhen and Pudong

China decided to open its economy to the outside world and boost its domestic economy at the 3rd plenary session of the 11th Central Committee of the Communist Party held in November 1978. Launching economic reforms, it allowed enterprises to do business without government intervention, rationalized prices and adopted a socialist commodity economy. As for external economic policy, China abandoned its isolationist policy to actively induce loans from other countries, international financial institutions and foreign private banks, to establish special economic zones and attract foreign investment.²⁾

As part of its strategy to open up its economy, China pushed for establishment of special economic zones, departing from its past approach of developing the country on its own. Special economic zones are referred to as government-designated areas that are open to investment by western countries. These areas were designed not only to draw foreign investment but also to introduce advanced technology.

Furthermore, domestic companies were allowed free competition in the area and could engage in such economic activities as obtaining capital, raw materials, machinery and labor, and selling and disposing of their commodities without government intervention. The designation signaled that the Chinese government officially

1) The Federation of Korean Industries, "How Far Have South Korean Companies' North Korea Projects Progressed," CER-99-33 (August 1999)

2) Park Jung-dong, *China's Modern Economy* (Seoul: Bubmoon Publishing Co., 1993), p.9.

recognized special zones for commodity economy.³⁾ Between July 1979 and October 1980, four cities were selected as special economic zones, namely Shenzhen, Zhuhai and Shantou in Guangdong Province and Xiamen in Fujian Province. Since then Dalian and Tianjin, in the northern part of the country, have become special zones, followed by Hainan in April 1988 and Pudong in September 1990. As a result, there are now a total of 14 special economic zones, in China, among which Shenzhen and Pudong have achieved remarkable progress.

Deng Xiaoping, the architect of China's reform and opening, embarked on what was seen as his last achievement, the Pudong Development Project. The Pudong project transformed that zone into Asia's Manhattan. Located in the heart of Shanghai, a significant port serving inland China, Pudong covers 522 km². It consists of four development blocs; the Waigaoqiao bonded area, the Lujiazui financial and trade bloc, the Jinqiao export and processing bloc and the Changjiang high-tech development bloc. Seventy of the world's 500 top companies have established a presence in Pudong and their investments amount to \$30 billion.

Will North Korea Adopt the Chinese Model in Developing Its Special Economic Zones?

It has been 20 years since China began to build its special economic zones. Since then they have enjoyed rapid progress and comprehensive changes, including burgeoning revenues, success in attracting foreign investment, wider opportunities for employment, earning of foreign currency and higher living standards. It is noteworthy that the Shenzhen special economic zone has made remarkable progress. Its revenues had skyrocketed by 100 times and its foreign currency earnings by 20 times as of 1999, compared to

3) Kim Ha-ryong, "Characteristics and limitations in China's Reform policy," *Socialist Reform and North Korea* (Seoul: Asia Research Institute, Korea Univesity, 1992), p.85.

those of 1979 when it first opened to the outside world. Such drastic economic development transformed Shenzhen from a small fishing village into one of China's major industrial cities. On the other hand, there have been some downsides in the formation of special zones. Speedy industrialization and urbanization have replaced traditional industry and agriculture. In the commerce sector, even though the quality of services improved following diversification of distribution routes and facilitation of private businesses, crimes such as smuggling and monopolistic sales practices have emerged.⁴⁾

Nevertheless, it can be concluded that the Chinese strategy to construct special economic zone has been a success. China is a country with a population of 1.2 billion, an immense territory, a high population growth rate, a wide disparity between rich and poor and a socialist political system. Given the complicated variables, there was no alternative to the special economic zone project for China if it was to develop its economy to a certain level in a short period of time. China was able to open its economy gradually under strict government controls, while retaining its political system. The success of the strategy is attributable to well-planned reform programs, a huge domestic market, rich natural resources, immense land area and the extensive capital resources of ethnic Chinese residing abroad.

North Korea's circumstances are quite different to those of China, so there are bound to be question marks over whether North Korea can achieve economic development through the establishment of a special economic zone. North Korea has a small land area, scarce resources, a 50 year-old autocratic system of government, poor infrastructure, and an uncompetitive labor force. Consequently, from the investor's perspective, North Korea with only 23 million people, would be an unattractive market. Conversely, China was an attractive market even though the government proposed stringent conditions for opening, since it had a huge market with 1.2 billion

4) Park Jung-dong, *op.cit.*, pp.239-240.

people. From the perspective of governance, Beijing was in a better position for opening since the spillover from the reform process would be confined to a certain degree, given the vastness of the country. On the other hand, it is highly likely that capitalism will spread nationwide once Kaesong is opened to the outside world. If that happens, Pyongyang will have difficulty in imposing measures to contain the repercussions. Considering these points, North Korea will need a perfect plan for the successful establishment of a special economic zone that will enable them to overcome the country's unfavorable conditions and spare them the trial-and-error process of the Rajin-Sonbong special economic zone project. What is important is that investments from South Korea and other countries are essential for devising and implementing the plan. Decisions by foreign companies on whether or not to invest in the North will depend on the success of South Korean companies' investments. In order to achieve this, the North will have to produce not only the hardware for the construction of an industrial complex, but also the software, including decision-making methodology on wages based on a system that would satisfy South Korean investors.

**KAESONG INDUSTRIAL COMPLEX:
A PROSPECTIVE SPECIAL ECONOMIC ZONE IN NORTH KOREA**

Lessons of the Rajin-Sonbong Special Economic Zone Project

In 1984, North Korea began to follow the Chinese-style reform model, initially trying to attract direct foreign investment by enacting joint venture legislation. The Chinese model, characterized as "one center and two basic points," designed to implement a reform policy aimed at economic development by introducing capital and advanced technology, while, at the same time, retaining socialism. Rajin-Sonbong was the first area where this strategy was applied.

North Korea designated Rajin-Sonbong area as a special economic zone in December 1991. At the time, the North asserted that the area, abounding with natural resources, would serve as an entry point linking land and sea, since it bordered on Russia, China and Mongolia, and faced Japan across the East Sea. They predicted that as an ideally-located economic center in North Korea, the Rajin-Sonbong area would attract international interest. Kim Il-sung expressed his confidence in the prospect of the foreign investment zone when he talked to the heads of news agencies in Cuba and Russia, stating that “The area has already stirred foreign investors’ great interest due to its economic potential and favorable location and many countries desire to make investments.”⁵⁾

North Korea planned to establish a modernized international trade center in line with global economic development in the 21st century. It separated the Rajin-Sonbong area from other areas, improved the area’s managerial system and facilitated market functions.⁶⁾ In essence the North Korean model did not differ from the Chinese model—at least not from a legal aspect. What then are the factors that caused the former to fail⁷⁾ while the latter has been such a resounding success?

As of 1998, foreign companies from China, Hong Kong and Japan signed \$800 million worth of contracts with North Korea. However, only 10 percent (approximately \$88 million) of the promised investment was actually made. Furthermore, the investment was mainly focused on the infrastructure and service sectors, especially

5) Kim Il-sung University Press, *Investment Environment of Rajin-Sonbong Free Trade Area* (Pyongyang: Kim Il-sung University Press, 1995), p. 5.

6) Cho Myung-chul, *Economic Relations and Prospective between North Korea and China* (External Economic Policy Institute, October 1997), p. 20.

7) The total investment in the North between 1992 and the end of 2000 recorded less than \$100 million. Compared with \$342 million invested into the Mt. Kumgang tourism project, the total foreign investment amount illustrates North Korea failed in its bid to draw foreign investment. A total of \$942 million will be paid to North Korea from November 1998 to February 2005.

the communications, hotel, transportation, construction, and tourism sectors, while investment in the manufacturing sector accounted for a mere 4 percent as of 1997.

Since 1993, North Korea has held briefings on more than 30 occasions to lure foreign investors in more than ten countries, including Germany and Hong Kong. In September 1996 and 1998, it also hosted an investment forum in the Rajin-Sonbong economic zone, introducing free market elements into the nation. For example, Pyongyang opened a free market in Wonjungri, allowed private businesses and reflected real foreign exchange rates. As part of this effort, the North sent economic delegations to Australia and Singapore to learn capitalist economic management techniques and to attract foreign funds—but to no avail.⁸⁾

The reasons behind the failed Rajin-Sonbong economic zone are not so much related to North Korea's "hardware" as to its national "software," which runs through the country's economic policy. The course of international capital flow is determined by a thorough comparison and examination of many special economic zones and free trade areas all over the world. North Korea does offer incentives to prospective foreign investors, but overall, it falls short of their expectations. A host of political obstacles coupled with the passive and rigid attitudes of North Korean workers stand in the way of facilitation of business activities. In addition, the non-existence of a consumer market, poor infrastructure in transportation and communications, and consequently, high logistics costs, are all factors that discourage investors. These negative factors need to be removed if the Kaesong Special Economic District is to be successful.

Background of the Kaesong Industrial Complex Project and the Reality

A. Basic plans

On August 10, 2000, Hyundai announced an agreement with

8) Yonhap News Agency, *North Korea Yearbook 2001*, October 2000, pp. 676-677.

North Korea selecting Kaesong for development as an industrial complex and designated it a special economic district.⁹⁾ Hyundai plans to develop the city of Kaesong, 70 km from Seoul and 160 km from Pyongyang, as an industrial complex spanning about 20 million pyong (6.05 million square meter) to house companies mainly engaged in light industry. The company expects that its development of Kaesong may have spillover effects: restoration of severed South-North railways and roads, and contribution to the development of neighboring communities, job creation, and promotion of exchanges of technology and foreign currency earnings through export. As part of its long-term strategy, the South Korean conglomerate is planning to build a multi-functional city, catering to international trade, tourism, manufacturing, commerce, and housing. It will function as a center for the market economy and as a free economic zone as well. (See Table 1)

For this purpose, Hyundai plans to lease land rights for more than 50 years in order to develop the Kaesong area into an industrial complex, and then to sell it both Korean and foreign enterprises. The plan divides the 8 million pyong (2.42 million square meter) of land into three sections that will be developed gradually in three phases from the year 2001 to 2008.

The criteria by which the first 1 million-pyong industrial park

9) In June 1998, Hyundai agreed to develop an industrial park on the west coast area with North Korea's Association of National Economic Cooperation. In October 1999, Hyundai's honorary Chairman Chung Ju-yong and Chairman Kim Yong-sun of North Korea's Asia Pacific Peace Committee signed an agreement comparable to a letter of intent to build an industrial complex. In November 1999, a 16-strong site survey team from Hyundai visited Shinuiju in accordance with Pyongyang's strong wish that the North Korean city would be chosen for the industrial complex. In June 2000, honorary Chairman Chung Ju-yong and Chairman Kim Jong-il met and agreed to get the project off the ground by commencing site survey of Haeju, Nampo, Kaesong, and Shinuiju at the earliest possible date. In August 2000, Hyundai signed an agreement on construction and operation of the industrial district with the Association and the Committee.

Table 1. Size of the Kaesong Industrial Complex and Its Benefits

Industrial complex						
	Area 10,000 Pyong	Km ²	Number of Companies	Number of Employees	Output Per Annum (million dollars)	Project Period
1 st Industrial Complex	100	3.3	150	20,000	2,000	2001
2 nd Industrial Complex	300	10	450	60,000	6,000	2002~2004
3 rd Industrial Complex	400	13.3	600	80,000	12,000	2005~2008
Total	800	26.6	1,200	160,000	20,000	
Surrounding new city						
	Area 10,000 Pyong	Km ²	Household	Reference		
1 st Housing Units	600	20	50,000	- Kaesong city to be utilized - Housing complex lying behind the industrial complex to be constructed		
2 nd Housing Units	200	6.7	43,000	- New city to be built - Housing complex lying behind the industrial complex to be constructed		
3 rd Housing Units	400	13.3	57,000	- Free trade zone to be developed		
Total	1200	40	15,000	- Entertainment park to be developed		

*The size of the first industrial park be expanded into 1.5 million pyong according to demand for space.

Source: Hyundai Asan Corporation, *Investment Environment in Kaesong Economic Free Zone*, November 2000, pp.4-5.

will be based on whether the companies will produce general light industry items, job-creating items, items which can be made using local materials, or export items. Specifically, such items include textiles, apparel, shoes, leather, bags, toys, socks, food (processed ginseng), beverages, electrical and electronic goods, metals and machinery, etc. According to Hyundai, the second and third industrial parks (7 million pyong) will be home to high-tech

industries dealing with industrial equipment, information and communications, computers, and software.

B. Justification for the Construction of Kaesong Industrial Park

North Korea adopted an open-door policy characterized by the “one center and two basic points” strategy. This strategy aims to open up to the world in only limited areas, while blocking any unwanted outside influence on the regime. For this type of opening, four requirements must be met. First, the areas to be opened must be far away from Pyongyang and must not be located close to any military bases. Second, it must be a coastal city with a port nearby which can serve as a gateway for international trade. Third, it must be equipped with industrial infrastructure. Lastly, it must have an easy access to a labor force.

Applying the four criteria, North Korea can be divided into five possible districts. (See Table 2) The Yalu River District centered around Shinuiju, Kusung, Kanggae, and Manpo; the Rajin-Sonbong District centered around Chungjin, Rajin, Sonbong, and Hoeryung; the Pyongyang-Nampo District centered around Pyongyang, Nampo, Anju, and Parkchun; the Wonsan-Hamheung District centered around Wonsan, Hamhung, Hungnam, Kimchaek; and the Haeju-Kaesong District centered around Haeju, Kaesong, and Sariwon.¹⁰ The division is based on the status of the respective cities’ social overhead capital (SOC), access to the outside and the possibility of the North Korean authorities’ support. The groupings of these cities might change if geographic proximity is factored in, but it is, nevertheless, helpful for at least a broad understanding of the investment environment in North Korea.

Foreigners favor the Pyongyang-Nampo District, since it is equipped with relatively good infrastructure, but the North Korean

10) The Center for Unification and Economy of Hyundai Research Institute, *A guidebook for Trade with and Investment in North Korea* (21 Century Books, July 2000), pp. 206-241.

Table 2. Feasibility Study of Areas For Possible Opening

District	Conditions	Possibility for Opening	Foreign Preference
Pyongyang-Nampo	High population concentration, Good SOC	Low	Excellent
Wonsan-Hamhung	High heavy industry presence, Poor port facilities	Medium	Poor
Haeju-Kaesong	Close to South Korea, Low logistics costs, Easy electricity provision, High military presence	High (conditional opening)	Good
Rajin-Sonbong	Possible economic compatibility with foreign countries, Poor SOC	Opening	Poor
Shinuiju	Possible economic compatibility with foreign countries	High	Poor

authorities do not favor its opening. The Rajin-Sonbong district lacks an industrial base, and is not popular among foreigners. The Wonsan-Hamheung district has low economic compatibility with foreign countries and also has poor infrastructure for light industry. The Shinuiju district, on the other hand, has a high economic compatibility with foreign countries, yet is still not favored by foreigners. On January 21, 2001, Chairman Kim Jong-il visited Shinuiju on his way home from his visit to China and conducted an on-site instruction, which sparked speculation that he would designate Shinuiju as a special economic district. Yet, it is not likely because if Shinuiju were to be developed, it would be for economic cooperation with China and for the development of Dandong, not for the sole development of Shinuiju itself. In fact, China has little interest in Shinuiju, favoring a plan to develop Dandong and turn it into an economic center, as well as a bridge linking China and North Korea. In fact, China even expressed its intention for provide electricity to the proposed project if North Korea would participate in the Dandong development.¹¹⁾

Rather than focusing on Shanghai and Guangdong provinces,

11) *Kyungghyang Shinmun*, January 26, 2001.

China intends to develop its northeastern areas in line with its plan to connect the Korean peninsula with its own economy by developing those underdeveloped regions where most ethnic Koreans reside. However, this strategy does not appeal to North Korea, since Pyongyang is probably more interested in developing Shinuiju than in establishing a special economic zone in Dandong. The Haeju-Kaesong district has no competitive edge over the other districts in terms of industrial base, SOC, access to the outside, and market size. In particular, a military base is located in the vicinity of Haeju, making it difficult to build an industrial complex near the city.

Meanwhile, Hyundai aims to develop the Kaesong area and wants it to be designated as a special economic region for international business, turning it into a North Korean version of the Chinese special economic district of Shenzhen. This would transform Kaesong into an international economic free zone with global competitiveness in manufacturing, finance, commerce, and tourism. Kaesong is well positioned to be an international economic zone in many ways. First, it is in the center of the Korean peninsula, and with the Kyongui railway passing through it, it would be a natural transportation hub. Kaesong is a large city, not far from the Seoul metropolitan area. When Kyongui railway (Seoul-Shinuiju) restored, it will be connected to Sariwon, Pyongyang and to Shinuiju, and even to the Trans-China Railways. If land transportation can be facilitated through the Kaesong district, it would considerably reduce the high logistics costs that have been a heavy burden on inter-Korean economic cooperation. Secondly, located nearby Seoul and other industrial areas, the Kaesong industrial complex will have easy access to raw materials, as well as semi-processed goods, components and information. Thirdly, Kaesong is an ideal city, in terms of location, where the South and the North can link their electricity, railways, roads, and water for use by an industrial park. Fourth, the population of Kaesong and neighboring areas is around 350,000—a large workforce.¹²⁾ Finally, vast plains lie to the west and

the south of Kaesong, providing ample sites for establishing an industrial complex.

As of late November 2000, 450 South Korean companies expressed their interest in establishing themselves at the Kaesong Industrial Complex. More specifically, 300 textile, clothing and footwear manufacturers, 100 electricity, electronics and metal assembly industries, and 50 other businesses, including accessory and kitchen utensil manufactures, have applied to secure 2 million pyong of factory sites in the industrial park. The labor-intensive light industries mentioned above are on the decline in the South due to high labor costs. The only way to operate the light-industry plants in the South would be to utilize low-wage laborers such as foreign migrant workers and ethnic Koreans from China. Moreover, it is forecast that plant construction would cost much less if industrial facilities in the South were relocated to Kaesong rather than to foreign countries.

CONDITIONS FOR SUCCESSFUL OPERATION OF THE KAESONG INDUSTRIAL COMPLEX

North Korea's Designation of Kaesong as a Special Economic Zone

In order to ensure the successful operation of the Kaesong complex, top priority should be placed on North Korea's designation of the Kaesong park as a special economic zone as was the case with the Rajin-Sonbong free trade and economic area. At the time, Pyongyang offered incentives to foreign investors in the Rajin-Sonbong area through the enactment of the "Foreign Investment Law" (October 1992) and "Free Economic and Trade Area Law"

12) Lim Kang-taek, "Possible Linkage of the Kaesong Industrial Complex and the Kyongin Industrial Zone," *Unified Korea*, Institute for Peace Affairs (September 2000), pp. 46-48.

(January 1993). Investors are especially interested in clauses in the special regulations that stipulate labor conditions and various tax breaks. North Korea's designation of a special economic zone is inevitable, given the fact that there are vast differences in the level of minimum wages and obligatory recruitment of workers in the North.

Experts in the North are known to be reviewing details for the possible enactment of a "Special Act on Free Economic Area" and the establishment of a body to take charge of the zone. Kaesong's final designation would take time since it depends on Kim Jong-il's final decision. However, there is a possibility that the designation would be made earlier than anticipated, in the wake of Chairman Kim's visit to China's Pudong special economic zone.

Affecting the decision-making process are conservatives in the North, who conclude that the opening of the Rajin-Sonbong area brought to the country more losses than gains. It remains to be seen how such views will affect the designation of Kaesong complex as a special economic zone. In addition, the North was distressed that South Koreans were engaged in missionary activities in the Rajin-Sonbong area, taking advantage of their legal status that guarantees relative freedom of activities.¹³⁾ What foreign observers will be watching for under these circumstances is how Chairman Kim manages to persuade conservatives, including the military, before making a final decision. Unlike the Rajin-Sonbong area, South Korean companies, on the whole, are positively reviewing the prospect of doing active business in the Kaesong complex. If the North shows that it is hesitant about the development and opening of the complex, by restricting business activities after the construction of Kaesong park is completed, it will lead to serious discord between the South and the North. Therefore, the North needs to conduct close consultation with the South, starting from the

13) Lim Ul-chul, "North Korea, Transition to Market Economy and Its Outlook: Focus on the Rajin-Sonbong Economic Zone," *The Reunified Korea Economy*, Hyundai Research Institute (March 1999), pp.82-89.

very first phase, including the designation of an economic zone. Through these consultations, South Korean businesses need to make informed decisions about the degree of opening in the North, thereby preventing possible future misunderstanding. What South Korean companies investing in the North fear most is that the North Korean authorities will block their access to the industrial complex without prior notice, citing political reasons.

Financing

It is forecast that the Kaesong Industrial Complex would cost approximately 300 billion won for first-phase construction, which encompasses 1 million pyong. The figure is likely to increase to some degree if the costs for electricity, industrial water and communication facilities are included. The construction costs for the second phase, which encompasses 3 million pyong, is expected to sharply exceed the one for the first phase. Some of the transportation requirements will be met when the Kyungui railway linking Seoul to Shinuiju is reconnected and the adjacent road is restored. As for industrial water, the South plans to secure water rights after consultations with the North on the first phase, while a review on construction of a dam across the Imjin River and use of water from the Yesung River is needed for the second phase. Concerning electricity, possible options include connection of 25km-power grid, originating in Munsan, South Korea. With respect to communication facilities, research is required to explore ways to establish a communications network between the truce village of Panmunjom and Kaesong. Currently, the cost for the second phase of construction (3 million pyong) is estimated at 1 trillion won. (Table 3)

Financing the construction of the infrastructure could include three choices: builders finance the cost; investors finance the cost on a commercial basis; and investors finance with governmental support. It is desirable to maintain a relatively low cost level for the first phase and increase expenditures for the second phase when

most of infrastructure is constructed. More specifically, for the first phase, it would be reasonable for state-funded companies in South Korea to finance the construction initially from their budget and be reimbursed by resident companies on the basis of the benefit principle. For the second phase of construction, foreign funding is essential. Furthermore, the development costs, including that of surrounding cities, would total approximately \$5 billion. In such circumstances, it is necessary to present a success model of domestic and foreign investment projects in North Korea through the diligent implementation of the first phase development project. International capital tends to flow into wherever profits are generated, and this was clearly exemplified by the Shanghai special economic zone.

In order to ensure the success of establishing the Kaesong complex, foreign participation is essential. First of all, foreign capital should be channeled into the project, starting from the second phase of construction. China's Pudong special economic zone proved to be a success thanks to foreign investment worth \$30 billion. The investment consisted of capital invested by the U.S., Hong Kong and Chinese living abroad, as well as 70 of the world's largest companies, such as Japan's NEC and Toshiba. This indicates that the world's leading companies have realized the necessity of advancing into China to utilize it as a springboard to the Asian market. Successful

Table 3. Estimated Cost For Construction of The Kaesong

Industrial Complex					
					(Unit: 100 million won)
	Railway/ Road	Water	Electricity	Communication Facilities	Construction of Kaesong
First Phase	Under Construction	350	250	170	2,000
Second Phase	–	1,150	450	330	10,000
Total Cost	–	1,500	700	500	12,000

Source : The Ministry of Construction and transportation, "Plan for Development of Kaesong Industrial Complex," September 2000.

operation of the Kaesong complex requires much more than mere participation of South Korean businesses and it is clear that the industrial park would not succeed without participation of foreign companies. To this end, it is important that U.S. economic sanctions against North Korea be lifted at an early stage. In addition, after Japan and North Korea establish diplomatic relations, Japanese capital must be attracted.

CONCLUSION

The development of the Kaesong Industrial Complex could serve as a hidden card, which will provide an ideal framework for inter-Korean economic cooperation. Current obstacles facing South-North economic cooperation include excessive logistics costs and restraints on free exchanges of goods and people. Moreover, for more than two months the North has prohibited unloading of goods at Nampo port by ships which run between Inchon and Nampo on a regular basis, hampering the transport of goods produced in the North on a trade-on-commission basis. It is difficult to believe that the North banned the unloading in retaliation, because the ships did not use North Korean containers—which are seven times more expensive than South Korean ones. Without rules and principles, economic cooperation cannot be maintained on a long-term basis. Both parties should abide by principles and rules that engender mutual trust. However, transcending past practices, the Kaesong complex is emerging as a new model for inter-Korean economic cooperation that is based on a better climate of understanding between the South and the North. It goes without saying that the South must fully explain every necessary detail of the plan to the North, which has no experience in operating a free-enterprise industrial complex or managing a capitalist economic system.

In the meantime, there are several problems in the development of the Kaesong complex. First, some argue that the entry of South

Korean companies into the North will lead to de-industrialization of the South, undermining its domestic industrial base. Others contend that, from a long-term perspective, the creation of a large-scale industrial park, coupled with the concentration of population in the metropolitan area, will exacerbate the imbalance of national land development, while undermining balanced regional development in the North. It is true that an industrial complex can serve as an effective means of increasing efficiency of SOC investment and facilitate the investment of South Korean and foreign businesses in the North.¹⁴⁾ Yet, if the industrial complex is concentrated in a specific area, it will lead to a regional imbalance of industrial facilities. Nevertheless, the Kaesong complex would be symbolic, and an ideal venue for inter-Korean economic exchanges on the Korean peninsula, where free exchanges of people and goods are still not permitted. Furthermore, the Kaesong complex as an international free economic zone will serve as a testing ground, not only for the economic resurgence of both the South and the North, but for the promotion of peace on the Korean peninsula. Chairman Kim's visit to Shanghai and Pudong on January 15, 2001 confirmed the truth of the old adage that "seeing is believing." If Pyongyang pushes ahead with reform and opening-up in its true sense, the best candidate for the reform efforts would be the Kaesong complex. In sum, once the North Korean leadership's commitment is guaranteed, there is a likelihood that the Kaesong international free zone will succeed.

14) Lee Tae-jung, "Feasibility and Problems of Development of the Kaesong Special Economic Zone," *Unification and Land*, Korea Land Corporation (Fall 2000), p.4.