

The Gaeseong Industrial Park and the Future of Inter-Korean Relations

*Youn-Suk Kim, Ph.D.
Kean University*

Introduction

Battered by a nearly bankrupted economy and continuous food shortages, North Korea has been cautiously opening its doors to strike economic deals with South Korea in recent years. The closed nature of the North's economy has resulted in low industrial productivity and efficiency, technological backwardness, and, in the end, economic stagnation. The North is also concerned that with the disparity in economic levels, unification with the South might result in the virtual absorption of the North into the South. Thus, the South's policy in this regard has been to reassure the North that unity through absorption is neither feasible nor desirable under the current state of military confrontation.

In this context, both sides appear to prefer a gradual narrowing of the economic gap between the two nations prior to unification, and a practical, business-like approach represents the simplest and most efficient way to accomplish this goal. While economic negotiations have been erratic and stymied at times by political difficulties, the South's business community has engaged in serious efforts toward developing trade and investment. Hence the mutual economic benefits perceived by both the South and the North constitute the permanent and crucial ingredients of possible unification.

Recent signs indicate that the North not only responds positively toward the South but also takes specific measures to accommodate itself with the South. The North specifically designated the Gaeseong special economic zone as an industrial complex site aimed primarily at accommodating the South's investments under commissioned processing, joint ventures and direct investment. In November 2002, the North Korean government announced plans to develop Gaeseong into an

industrial complex making a significant impact on the current level of inter-Korean economic cooperation.

Understanding the past track records of the two Koreas' respective business paths would help both the South and the North in the momentous task of accelerating and securing inter-Korean business transactions. Such increased economic cooperation leads to market extension with the concomitants of economies of scale, learning curve effects, competition, and trade creation.

This study contends that, in the wake of the historic July 2005 agreement, the South should aggressively promote and engage in business transactions with the North with the goal of achieving economic integration through trade promotion and dynamic international division of inputs. To this end, the Gaeseong Industrial Park complements and promotes the formation of South's Northeast Asian economic hub, and the South must take the lead and do all in its power to insure that the North takes the path toward mutual prosperity and Korean unification.

This article examines the issues regarding the North's special economic zone, the Gaeseong Industrial Park, and discusses recent progress and institutional arrangements of the Gaeseong Industrial Park. The study also analyzes how the Gaeseong Industrial Park affects overall inter-Korean relations, and looks into recent economic reforms in the North and the profound implications that the future of the Gaeseong Industrial Park will have on economic landscape in Korean peninsula.

The Gaeseong Industrial Park

The Gaeseong Industrial Park is an administrative zone with special economic legal status, and it is physically and legally separated from the rest of the North. Strong economic autonomy is provided under the guidance of market economy principles, and special economic considerations are given to the South's firms investing in the Gaeseong industrial complex. Thereby the Gaeseong Industrial Park is expected to create a favorable environment enabling the largest-ever combination of factors of production from both the South and the North. The Kaesong

Industrial Park, when it begins full-scale operation, should produce positive effects, practically influencing over all economic sectors of both sides.

The South's successful economic development has greatly increased the wage level of its domestic labor force, and many of the South's companies have been forced to either hire foreign labor from China and Southeast Asia or to transfer their manufacturing bases to those countries. However, due in part to North Korea's compulsory education system, the common Korean language, lower transportation costs and the exemption of tariffs on the transfer of goods between the North and the South, the North's workforce is generally considered to be more valuable to the South than their Chinese and Southeast Asian counterparts.

Furthermore, the productivity of the North's workforce would be enhanced by the technology transfer and management know-how from the South. Thus, the North's inexpensive labor offers a cost effective option for the South's companies operating in the Gaeseong Industrial Park.¹ The Gaeseong Industrial Park would also facilitate the industrial transformation of the South, as it would be able to transform its industrial structure at a lower cost toward high-value-added industries. The South and the North are benefited by this project since the South accesses low cost labor, and the North earns hard currency from the operation of the Gaeseong Industrial Park.

Small companies have pursued investment opportunities in the North as part of their survival business strategy, and under the current managerial difficulties such investment has grown all the more important for small companies. The wage differential between the two Koreas is substantial, pushing the South's small companies to shift their production facilities to the North in search of lower labor costs. Inter-Korean trade and investment are closely linked to each other. The North's lower labor cost with the South's investments has produced not only favorable commercial transactions between the two countries but international competitiveness along with factor equalization between them.²

Having participated in the Gaeseong Industrial Park, the South can assist the North's structural reforms and infrastructure buildup in order to make it easier for the North to adopt a market economy. The South has a major stake in how the North's economy will accommodate the inflow of foreign capital in the Gaeseong Industrial Park. The development and networking of industrial and business clusters on the Korean peninsula and expansion of the transportation and logistic infrastructures also constitute the core part of South's plan to establish itself as a regional hub, as the Gaeseong Industrial Park tries to induce investment, technology, and management know-how initially from the South, and then from Japan, the US and European Union by injecting a number of incentives.³

As the construction of the Gaeseong Industrial Park nears completion, more investment is forthcoming, not only for labor-intensive industries such as clothing, shoes, appliances, parts and components of communications and information technology from the South and other countries, but these developments will lead to further expansion of foreign investment in the service sector, including transportation, energy and tourism.

The Gaeseong Industrial Park could reap substantial economic benefits by creating a mechanism of sub-regional economic cooperation with its bordering regions. And if the Gaeseong Industrial Park is geared toward actively utilizing the infrastructure and economic resources of the Seoul metropolitan area, there is great potential for the Gaeseong Industrial Park to spread into a second park and third one as well. Thereby, resources would be used more efficiently as a result of eliminating unnecessary competition, and a sizeable economy would be created, thus increasing economic specialization and economies of scale, and further inducing investment.

Recent developments between the South and the North after the South-North summit of 2000 have accelerated the volume of inter-Korean trade, which increased from \$13 million in 1990 to \$ 724 million in 2003. In order to promote business relations by nurturing goodwill and reassuring the North, the South should endorse the North's membership in the World Trade Organization and Asia-Pacific Economic Cooperation, along

with demanding a special status for the two Koreas.

Hyundai Asan and the Korea Land Development Corporation, in conjunction with the North, made comprehensive and detailed plans for improving Gaeseong Industrial Park's infrastructure, an endeavor that will entail site preparation, an energy supply, communalizations and transportation. The Hyundai Asan projects that the Gaeseong industrial complex presents optimistic views in terms of Gaeseong's overall effect on GDP and employment for both Koreas as shown in Table 1.

Hyundai Asan projected that the Gaeseong Industrial complex would create jobs for 360,000 South Koreans and 250,000 North Koreans, with value additions of \$6 billion for the South and \$6.2 billion for the North, plus spin-off effects.⁴ The Federation of Korean Industries has also estimated that the Gaeseong Industrial Park will generate \$18.9 billion in production and \$7.8 billion in additional value creation for the South.

Table 1: Size of the Gaeseong Industrial Complex and Its Benefits

Industrial Complex	Area		Number of Companies	Number of Employees	Output per Annum (\$ in million)
	10,000	Km2			
1 st Stage	100	3.3	159	20,000	2,000
2 nd Stage	300	10.0	450	60,000	6,000
3 rd Stage	400	13.3	600	80,000	12,000
Total	800	26.6	1,200	160,000	20,000

Note: *Pyung = 3.954 square yards; **US \$1.00 = 1,200 won.

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

If the North makes a concerted effort to resolve the present nuclear problem,⁵ the international community will need to provide a concrete blueprint for moving beyond the current diplomatic stalemate. With the current Six-Party Talks (North Korea, South Korea, the U.S., China, Japan and Russia)

concluded, inter-Korean economic transactions along with the Gaeseong Industrial Park should increase rapidly. Moreover, as the infrastructure of the industrial complex is incomplete, manufacturing products of the South's investment are increasingly exported, and the Gaeseong Industrial Park will soon attract Japanese, American and other foreign investment in the industrial complex.

Several suggested methods for financing include combining funding sources from the South's developers and the international financial markets through the project financing method, incorporating public and commercial loans and/or issuing investment bonds for international investors. The South has the inter-Korean Economic Cooperation Fund designed to reimburse companies for losses incurred in doing business with the North, and this program requires more funds as the volume increases. The Fund should mandate the South's trading companies to become members since the entity serves as a kind of insurance. And the South should consider issuing internal bonds for sales abroad so as to increase financial resources.

Since many American companies are eager to be involved in the North's economy and in Northeast Asia at large, the U.S. government will look to expand contacts with the North. The North's assets in the U.S. may be unfrozen, and the U.S. government may allow the export of wheat and rice to North Korea, as American businesses lead the improvement of relations between Japan and the North. Japanese companies have already made basic preparations for expanding into the North, and once the legal apparatus is in place, Japanese companies expect to rapidly increase consigned production with the North and more joint ventures in the Gaeseong Industrial Park.

The Gaeseong Industrial Park can take advantage of the economic resources of the Seoul Metropolitan area. The majority of foreign enterprises entering the Gaeseong Industrial Park during the initial stages of its development have been focused on export activities, and the South's market. As development of the industrial complex progresses, and investment from the South flourishes, the Gaeseong Industrial Park will also spur increased interest from Japanese, American

and other foreign direct investments. Thus, such investment can be directed to labor-intensive manufacturing, and these developments in turn can lead to expansion of foreign investment in the service sectors, in such areas as transportation, energy and tourism.

Inter-Korean economic cooperation has recently been evidenced by talks between the two Koreas on the reconnection of the trans-Korea railway through the demilitarized zone (DMZ), which would dramatically reduce the cost of transporting to and from the South, and would transform the Gaeseong Industrial Park into a critical transportation center. The reconnection of the Gyungui railway through the DMZ greatly reduces the cost of transporting parts and goods and thus makes the Gaeseong Industrial Park much more attractive and competitive than Chinese counterpart cities.

Moreover, the Gaeseong Industrial Park not only represents a symbol of the two Koreas' increasing economic cooperation but also an opportunity to contribute to the South's plan to develop the Incheon Free Economic Zone (FEZ) as a business hub in Northeast Asia with the Gaeseong Industrial complex serving as a key part of the broader plan to link business clusters on the peninsula. The Gaeseong Industrial Park would thus become a production base for a key network of business clusters, including the Incheon FEZ and the city of Seoul. Gaeseong is only an 80-minute drive from the center of Seoul, and can be linked to inter-Korean railroads, which the South also plans to connect with the Trans-Siberia, Trans-Mongolia and Trans-China railways.

Economic Reform

Since the North's companies are often not able to pay regularly due to frequent suspensions of operations as a result of power shortages and a lack of basic raw materials, their workers have found it increasingly difficult to make ends meet on their wages. Because a growing number of workers have abandoned their worksites, the North has had to reform its policy to encourage workers to return to their workplaces by providing them with increased wages as well as material incentives. Of particular concern has been the massive exodus of workers who

abandoned their assigned worksites in search of other work opportunities, such as peddling and private businesses, in order to improve their economic situation.

Thus, the North's leadership has known that reform had to be introduced in response to this aggravating situation to jumpstart an economic recovery. The leadership was also aware that introducing reform creates the so-called "reform dilemma" and endangers their regime unless improvements are adopted at an accelerating rate. Thereby, the North launched efforts to reform and open up its economic system. Since the adoption of its "Economic Improvement Measures" on July 1, 2002, Pyongyang has implemented a series of surprisingly tangible measures aimed at promoting economic reform, which has included the recent authorization for individuals to engage in activities related to marketing. Based on these economic reform measures, the Gaeseong Industrial Park has tried to induce direct investment from the South.⁶

In November 2002, the Basic Law (five articles and forty-six sections) articulated specific provisions for the South's investors. This reform received much attention due to the extraordinary content of the Basic Law since it reflected elements of market economies, such as allowing individuals to own private property and have rights of inheritance, and also delineated the development implications for the 'one country, two systems' strategy. It is composed of investor's rights, development methods, and duration of land leases, labor utilization and commercial dispute-settlement procedures.

Furthermore, the Basic Law articulated special immigration procedures, residential status, personal safety, and the unrestricted usage of inter-Korean postal/communications services. Free movements within designated routes between the South and the Gaeseong Industrial Park have been facilitated and expedited with entry certificates, instead of visas, issued by the Gaeseong Industrial Park management authority. These measures have also simplified immigration processes and customs clearance procedures for the South's investors.⁷

The Economic reforms have specified the adjustment of

state-controlled prices to realistic levels, the partial abolition of the public rationing system, the rationalization of a foreign exchange rate and partial decentralization of the state planning system. With respect to the partial decentralization of the state planning system, the role of the national Planning Committee has been reduced to only announce provincial targets for industrial production and major infrastructure construction, while provincial and city administrations increased their roles in managing the economic activities of relevant regions. Individual production units, including state-owned enterprises and local-level factories, were authorized to implement their own production plans and decide the prices of their products.

The North's centralized industrial management system was restructured between mid-1999 and early 2000 to improve the productivity of state-owned enterprises. New economy/political ideologies including the "New Way of Thinking Movement" and "Practical Socialism" emerged as slogans for facilitating economic recovery. Hence, the recent expansion of the special economic zones could be interpreted as part of the North's attempts to tackle the economic decline through economic policy adjustments and partial economic openness.⁸

The North was also under pressure from the dilemma caused by the eventual breakdown of a civil society that could not sustain law and order due to the illegal mobility of its population, unless a market system were introduced. Thus, under the name of market pragmatism, the North granted its workers the right to move to pursue higher wages, and that has in turn led to higher productivity.

Since the economic reforms were instituted in July 2002, prices of most goods and the wages of workers rose significantly in the North due to the initial effects of the market mechanisms. Accordingly, price and wage levels seemed to be measured and guided by the market in terms of production costs and buyers' utility, namely supply and demand, under the initial stages of competition and resource allocation. Through interactions of supply and demand, pricing appeared to prevail along with reflecting market signals.

Prices of consumer goods, agricultural products and services rose ten-fold or higher, while the decade-long system of state subsidies for price differentials between the actual production cost and retail price was almost abolished. As noted earlier, the North implemented a series of surprisingly tangible measures aimed at promoting economic reforms, which included recent authorization for individuals to engage in activities related to the marketing and even distribution of intellectual property rights.⁹

Socialist economies would now be too complex to plan from the center and would require more information on technology, prices, quantities, and assortments than a central planning board could digest. Moreover, the task of planning and management could not be effectively decentralized, because in the absence of private property, even the best-intentioned managers of state enterprises could not make economically feasible decisions.

By allowing individual participants to respond to market incentives, the new market socialism offers greater inducements to combine resources efficiently at the local level. The North's current status could be compared to that of the regulated markets that existed during the early stages of economic reform in China. Indeed, the North is now in the initial phase of a partial transition toward a market economy.

As a reference point, the Chinese stance has been backed by policies designed to boost the domestic economy by expanding the market price system. In general, Chinese economic reform policies, including the agricultural contract system and industrial sector autonomy, have been developed gradually in a form that supports external liberalization policies. Having had foreign capital and technology, China's economic growth has been phenomenal by mobilizing its dormant labor and site resources, and the North saw opportunities in China's model in which China's abundant supply of labor and land resources and huge influx of foreign capital and technology have realized China's speedy economic development.

In the late 1970s, the reforms of Deng Xiaoping fundamentally altered the Chinese economy while at the same time maintaining state and party control. The post-1978 reform

era fundamentally changed the landscape of the Chinese economy as it has moved toward market socialism. Major changes were introduced in industry, services, and foreign trade in particular. Privatization of the small-scale industry proceeded earlier than that of large- and medium-scale industries, and the service sector expanded and the rigidities of the foreign trade arrangements were altered, along with the introduction of special economic zones.

The Chinese special economic zone¹⁰ was viewed as: (1) a special economic zone to function as a window linking China's domestic economy with the outside world; (2) a special economic zone to be able to function as a base for experimental economic reform associated with market-oriented policies; and, (3) a special economic zone to function as a developmental core that could induce spillover effects to neighboring areas.

An examination of the Gaeseong special economic zone proved that the North has incorporated a large part of China's experiences in terms of both special economic zones and the legal infrastructure in its special economic zone formulation under the name of economic pragmatism. The institutional arrangements and incentive packages to induce foreign capital showed the North's setup was similar to China's coastal special economic zones.

Inter-Korea Economic Relation in the Pre-Gaeseong Industrial Park

The North and South have pursued contrasting industrial policies for economic development, with distinctively different institutional arrangements. The North's industrial policy has been characterized by a central command economy: heavy industry-led development, 'Juche' (self-reliance) orientation, and science/technology policy. The North also adopted state ownership of the means of production as a major principle of its industrial policy. Its pricing mechanism was based on the value of socially needed labor, and the prices of goods and services were derived from labor costs, not through the pricing mechanism of supply and demand interaction.

Until the mid-1970s, North Korea's economic development,

bolstered by the benefits of foreign assistance, outperformed that of the South. But the North's central economy ran into trouble as it grew more complex, eventually slipping behind the South at an accelerating rate. The North experienced difficulties in handling the increasing complexity of its economy in the absence of market mechanisms, as its commercial management system was made up of wholesale commerce, which was controlled by the central government, and retail commerce, which was controlled by regional governments. That provided the North with only one channel for the entire distribution of goods and resources.

By contrast, the development of South Korea's economic system has relied on the market mechanism, though the national government assumed a vital developmental role in deciding major projects, allocating financial resources, and offering tax incentives to those who undertook production and export in strategic industries. The South adopted a policy of export-oriented industrialization. This policy extended preferences to exporters regarding import licenses, duty-free imports of intermediate products for exports, and generous capital depreciation allowances. Domestic savings were promoted through higher interest rates on deposits. Such measures eventually resulted in reduced inflation rates and lower rates of real interest, which in turn further promoted export-led industrial growth.

In order to import scarce resources, the export-led strategy, based on comparative advantage, expanded industries that used the South's abundant labor supply. Labor-intensive manufactured goods were exported, and, to facilitate an open economy, the South gradually reduced its protectionist policy by encouraging domestic industries to compete at home and abroad.

When the U.S. announced troop reductions in the 1970s, the South perceived this action as foreshadowing the necessity for a greater industrial base for its own military purposes and began to promote the development of chemical and heavy industries. The South also saw Japan's pattern of industrialization as one that its own export industries should pursue. The government considered conglomerates, or "chaebol," as suitable institutions to implement industrialization in chemical and heavy industries,

shipbuilding, steel, non-ferrous metals, machinery, petrochemicals, and automobiles.

In response to the South's rapid industrialization, a distinct change in the North's development policy occurred, adopting a turnaround policy from the centrally planned, self-reliant economy towards more cooperation and partnership with Western countries so as to acquire the necessary capital and technology. In this process, the North's foreign trade and external debt increased rapidly from the 1970's, accompanied by substantial growth. The North's trade with foreign nations increased from \$390 million in 1965 to \$1.91 billion in 1975.

A major turning point in inter-Korean relations took place in 1984 as North Korea's proposal to provide aid for flood victims in the South was accepted. Shortly thereafter, the North for the first time proposed tripartite talks with the U.S. and the South, a change from its previous insistence on bilateral talks with the U.S. only. Talks between the North and the South continued on several different levels. While inter-parliamentary discussions failed to get off the ground, due to a lack of an agreed agenda, and economic talks were aborted due to procedural differences, Red Cross negotiations bore fruit in September 1985 when family reunion exchange visits between the North and the South took place. Efforts also commenced, although eventually unsuccessful, to organize a joint Korean team for the 1988 Seoul Olympics.

With the rapidly changing international environment, the South unveiled a new initiative towards the North on July 7, 1988. Subsequently, the South called for a summit meeting between the two Koreas. The South was certainly aware of and sensitive to such new developments as a detente between the East and the West as well as the South's application for admission to the UN in autumn 1990, countered by proposing the prime ministers' talks¹¹ again in the 1990 New Year address.

The first inter-Korean exchange of goods occurred in 1988; this development had the potential to alter significantly

both the North's future economic development and its foreign economic relations. Trade began modestly with the 21 November 1988 arrival of forty kilograms of Northern clams at the South's port of Pusan. A second transaction, in January 1989, involved the South's imports of the North's art such as paintings, pottery, woodwork, and industrial artworks.

Nevertheless, the North tried to avoid direct trade with the South. Thereby small-scale trade was carried on through third countries with country of origin labels removed. The South imported raw materials from the North via foreign intermediaries in Hong Kong, Singapore, China and Japan after 1988. While rejecting direct trade, the North increasingly engaged in indirect trade while the North's trade officials busily contacted the South's businessmen in China to explore possible investment projects in the North.

Up to 1994 inter-Korean trade totaled \$930.8 million. Trade was transacted through counter-product arrangements by clearing third countries' cash accounts, evolving gradually toward counter-trade. The South's chaebol played a dominant role in the inter-Korean trade, while its small-and medium-sized firms participated only marginally. The North exported to the South zinc ingots, gold ore, thermal coal, steel billets, anthracite coal and copper, and imported capital goods, sock-weaving and vacuum packaging machinery, and consumer goods such as rice, televisions and clothes as well as semi raw materials, plasticizer, petrochemical products and polyester textiles.¹²

Trade between the South and the North has been intermittently expanding as shown in Table 2. Inter-Korean trade in 1997 increased a sizeable 22.7% over 1996.¹³ Steel and metal items accounted for more than 50% of the South's imports from the North. Gold and zinc ingots comprised the lion's share of these imports, with gold ingots representing fully 25% of all the North's exports to the South.

Table 2: Trade between North Korea and South Korea (on a custom clearance basis)

Year	North to South		South to North	
	Number of items	Value (U.S. \$1,000)	Number of Items	Value (U.S. \$1,000)
1988	4	1,037	-	-
1989	24	18,655	1	69
1990	21	12,278	3	1,187
1991	50	105,722	17	5,547
1992	81	162,863	24	10,563
1993	77	178,166	21	8,425
1994	83	176,298	42	18,248
1995	99	222,855	90	64,435
1996	125	193,069	102	69,638
1997	145	204,826	129	115,269
Total		1,275,769		293,381

Note: South's exports to the North in 1995 excluded \$237 million of rice assistance.

Source: S. Korea National Unification Board, *Monthly Report on North-South Trade & Cooperation*

Because of the IMF crisis, however, imports of gold ingots from the North declined sharply. In the first 10 months of 1997, an average of \$4.36 million worth of gold ingots were imported every month from the North. This figure plunged to \$2.64 million in November 1997. Zinc ingots suffered a corresponding drop: in the following January-October period, imports averaged \$3.07 million each month, falling to \$1.41 million in November. Imports of the North's steel and metal items declined as well in 1998-1999 because of the ongoing gold-collection campaign and sluggish production activity in the South.¹⁴

Moving to direct trade enabled both Koreas to save transaction costs such as transshipment, warehousing, and insurance costs. If inter-Korean direct trade were fully realized, the mineral resources of the North would be shared with the South, and the South's labor shortage would be relieved by employing workers from the North. Both domestic markets would be expanded, and the competitiveness of both Koreas in

the global market would be greatly enhanced.

In the 1980s the North's external policy began to change, following the introduction of the Joint Venture Law of 1984. The North set up the economic and free trade zone of Rajin-Sonbong with introduction of laws and special provisions for foreign companies and investment.

To relieve the heavy burden of its foreign debts and to induce foreign investment and technology, the North introduced a first-time joint venture law in September 1984. The North had high hopes for this law: 1) joint venture could bring about economic modernization programs using foreign capital and technology; 2) this was integrated into the economic plan, solving bottlenecks in necessary inputs; 3) joint ventures would blend the North's management and production with foreign inputs so as to upgrade the North's products and international marketing.

To the disappointment of the North Korean government, however, this law resulted in only 35 joint ventures to May 1989. In the economic and trade zone, security and political considerations were given greater priority over economic goals such as attracting foreign investment. The North even failed to provide adequate follow-up measures to promote the zone. It turned out to be a miserable failure caused by poor logistics and by a rigid policy within the system.

On December 30, 1991, the North announced the creation of economic and free trade zones in Sonbong, Rajin and Chongjin, south of the Tumen River. The zones offered foreign investors customs reductions, tax incentives, and capital protection. Specifically, the North established the free trade zone in the Rajin-Sonbong area as an alternative to China's Tumen River Development Plan. The North aimed to capitalize on the Tumen project in advertising its free trade zones worldwide to induce foreign investment.¹⁵

It was Rajin-Sonbong, a web of obsolete port facilities proclaimed a free-trade zone in 1991, where the North hoped to incubate its economic turnaround. The North agreed to develop this region, leasing out Chongjin harbor to China and solidifying

its position in shaping Northeast Asian economic cooperation centered on the Tumen River. The zone occupied a strategic transportation point for cargo between Japan and China, and it was remote enough to keep foreign ideas from infiltrating North Korean cities. The North was developing Shinuiju and Nampo regions, since these were closer to China's economic mainstream and had better social overhead capital.

As the Tumen River Project developed, it was expected to facilitate inter-Korean business transactions. Once the North carried out economic reform and attempted economic development, the South's business community was expected to share management skills, information and experience with the North. Through these efforts, a new economic system was likely to take root in the North. Its significance laid in a blending of the North's labor and the South's capital and technology.

The North adopted a consignment production law and a foreign investment law in October 1992. Unlike the 1984 joint venture law, these laws had a special provision implicitly designed for the South's investment. This was because the North realized that foreign companies were less willing to invest due to risk as well as foreign debt, while the South's companies were more willing to venture, as demonstrated by how overseas Chinese businessmen undertook investment ventures in China's economic free trade zones.

The emerging environment of the North was toward an initial stage of market economy, as shown by the Tumen River Project and Rajin-Sonbong zone in particular. Since then, the North's economy has gone through a slow transformation, starting with agriculture and trade. The operation of trading companies and the relaxation of agricultural collectives were considered to be signs of reforms toward a market economy. The reforms involved the increasing use of markets and profit incentives to achieve larger foreign exchange earnings and more output. Thereby, the economy became more responsive to outside market signals after 1993.

Increasing competition occurring as a result of market reforms put a tremendous pressure on many production units.

Increasing competition required the state enterprise sector to achieve the flexibility that existed in market economies. Especially, firms should be able to determine the size of their labor forces strictly on the basis of their needs of production, and dismiss redundant workers.

If the North's major policy emphasis was to raise the people's living standard and to establish a self-reliant economy with market principles, then the North should promote leading sectors of the people's economy, such as the coal, energy, and railroad industries, and also implement reforms in the ownership system, moving from the past cooperative union ownership to private ownership. In short, impending economic openings with attendant political risks would force the North to adopt gradual reforms in its domestic economic system. To achieve gains from adopting a market system and reap the benefits of opening its economy with minimum political risks, the North needed to establish more free trade zones.

Consigned production was an arrangement in which investors in the South provided intermediate materials and equipment and the North exclusively managed all the production processes. In other words, under a consigned production agreement, the South's investors sent processed materials, product designs, equipment, and technical personnel to the North. In return, the South's investors received finished products, compensating for the risk and costs incurred in supplying those inputs. This contractual joint venture let production and management be assumed by the North, and the South's partners were redeemed under the provisions of the joint venture contract. It was reported in 1994 that the North's average wage was \$40 a month, while a worker for a joint venture firm under consigned production agreement received an average of \$150 a month.

As economic contacts evolved, a commercial relationship based on mutual gains and trust was expected to develop, accompanied by laws and regulations and transfer payments. The South's investment largely took the form of consigned production, although there were yet limited direct investments by the South. The joint development of Mount Gungang into an international tourist attraction had been planned between the

North and Hyundai Asan Corporation.

South Korean companies invested very heavily in China, Mongolia, and Southeast Asia. However, these companies considered North Korea a better investment opportunity than these countries, because there exists no language barriers and cultural differences and transportation cost advantages.

The North signed processing contracts not only with the South, but also with Japan, China, and Germany (see Table 3). This implied that the arrangements were favorable for the North, reaping benefits from competition among investors. The consigned production provided the North with productivity enhancement derived from the inflow of capital, management know-how, marketing apparatus and technology.

Table 3: Processing-on-Commission Trade (1992) with Foreign Countries (Unit: U.S. \$ thousand)

Country	Imports of Fabrics & Semi-Raw Textiles	Exports of Clothing
Japan	52,236	63,855
Hong Kong	9,392	15,596
Germany	1,784	69,488
Italy	800	100
France	-	6,700
Ireland	-	1,000
Swiss	-	500
China	58,157	-
Singapore	9,500	-
India	1,000	-
Total	132,869	157,239

Source: Korea Trade Association, *Investment in North Korea* (in Korean), June 1993, p. 115

The North's government-sanctioned trading companies implemented the foreign-trade portion of the economic plan,

negotiated with foreign counterparts, executed contracts, and held final responsibility for actual transactions. As long as implementation was within the economic plan, the trading companies set their own terms of export and import as independent units. In other words, the North's trading companies exercised an exclusive right as agents representing powerful authorities such as the party's central committee and army headquarters to earn foreign exchange for financing import much needed merchandise.

It is noteworthy that the North's trading companies played an important role in the inter-Korean trade. The trading companies used to deal only in such specialized commodities as mineral and marine products. However, the North had adopted an independent accounting unit practice for each trading company. The trading companies handled exports and imports like general trading companies in the South and Japan. Therefore, they played the same role as the general trading companies in these countries, i.e., they sought strategic marketing arrangements for Northern manufacturing units and acted as channels of information about the outside world to the North Korean people. In short, they played a very important role as a catalyst in transforming the North Korean economy.

As for the overall assessment of the North's economy, there were three factors contributing to the dramatic changes in the North's policies. First, the rapid demise of the Soviet Union and other communist governments caused the most traumatic political difficulty which the North had ever experienced. Second, the agreement between the former Soviet Union and the North, signed in November 1990, establishing the payment settlements of trade in hard currency at world prices, was a crushing blow to the North's economy. The North had to settle its bilateral account with convertible hard currencies instead of acting on the traditional long-term barter basis. The gravity of this change could be understood when it was recalled that the North imported from the Soviet Union about a third of its crude oil and petroleum products, coking coal, and parts for machinery and equipment. Third, the North had no other choice than turning to China for crude oil, raw materials, and food items, and

obtained capital goods and consumer products from Japan and the South.

Future of Inter-Korean Relations

At a time when the North is cautiously adopting policy changes to overcome its international isolation, it is important that the neighboring countries create a favorable environment in which the North will be able to direct its efforts toward economic openness so as to adopt market principles nationwide. The Gaeseong Industrial Park is rationalized having economic development along with maintaining the North regime by earning hard currencies to relieve the North's severe balance of payments problem.

The Gaeseong Industrial Park develops into thriving special economic zone through sub-regional economic cooperation with bordering area, and technology and management skills are also transferred to the Gaeseong industrial park, enhancing Northern workers through Inter-Korean economic cooperation. What is important is that investments from the South and other countries are essential for establishing and implementing a special economic zone that enables the North to overcome the country's unfavorable economic conditions.

While many obstacles still remain in the path of achieving the success of the Gaeseong Industrial Park, North Korea does offer incentives to perspective foreign investors, but overall, it fails 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 facilitating 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 Gaeseong industrial complex is to be successful. Its success would result in a major boost to the North's economic rehabilitation and create a spillover effect for the rest of the North.

The inter-Korean joint ventures and industrial relocations have to be arranged based on regional comparative advantages

associated with factor endowments, market access, and other attributes since international capital flow is determined by a thorough comparison and examination of many special economic zones and free trade areas all over the world. Therefore, it is about time to establish the Committee for Inter-Korean Economic Adjustment to prepare for economic integration.

North-related issues cannot be resolved though the efforts of the South alone, since the Korean peninsula has long been a place where the interests of major powers –the U.S., Japan, China, Russia – collide. Therefore, along with the tasks faced by the South for the recovery of the North economy, there are political/economic problems that have to be resolved with neighboring countries under the framework of multilateral cooperation. Thus, consistent support from major powers is required for the North to make a smooth transition.

The South promised to send 500,000 tons of food to the North in the form of a loan.¹⁶ It is South's biggest pledge of food to impoverished North since 2000. Due to the possibility of confusion in moral values among its populace and subsequent political instability, cautions in the North's opening its doors and introducing the price mechanism should be in place. As the North intends to immerse itself in the world economy, the foremost requirement is to adopt market-oriented policies derived from reforming its centralized economy.

Under the current favorable premise that the Six-Party Talks on the nuclear crisis will be peacefully resolved, various economic projects that promote the full-scale development of the Gaeseong Industrial Park could be undertaken. These projects could be conducted with international assistance. The Gaeseong Industrial complex has easy access to raw materials, as well as semi-processed goods, components and information, and in terms of location, where the South and the North can link their electricity, railways, roads, and water for use by the Gaeseong Industrial Park.

At this juncture, the South should play the leading role in helping advance the North's economic openness and in encouraging neighboring countries to provide technical and

financial support for the North's special economic zones. Currently, the construction of the Gaeseong Industrial Park is in progress, despite the unstable political and military conditions that surround it.

The South's proposal has been rather simple: to supply two million kilowatts of electricity annually to the energy-starved North, if it completely scraps its nuclear weapons program. Unification Minister Chung Dong-Young announced that if the North accepts the offer, the South would begin to build power transmission facilities immediately for the cross-border power supply scheduled to start in 2008. Until then, the South intends to ask other participating nations of the Six-Party Talks collectively to provide fuel oil to the North. This offer must be attractive for the North, given its dire energy shortage and the serious food and foreign currency shortages. Among them the various problems, the energy shortage is most acute; without securing energy, the North cannot make any serious attempt to jumpstart its moribund economy.¹⁷

As the inter-Korea railway restoration project is completed, the Gaeseong Industrial Park is ideally located to develop into a major hub of transportation and trade between North and South Korea. The Gaeseong Industrial Park is connected to Russia and China through the Trans-Siberian Railway and the Trans-China Railway. The Gaeseong Industrial complex is in the center of the Korean peninsula, and with the Kyoungui railway passing through it, it would be a natural transportation hub not far from the Seoul metropolitan area. If land transportation can be facilitated through the Gaeseong Industrial Park, it will considerably reduce the high logistics costs that have been a heavy burden on inter-Korean economic cooperation.

When the Trans-Korea Railways are eventually reconnected with the Trans-Siberian Railway and the Trans-China Railway, the Gaeseong Industrial Park will become a major transit point for transporting Japanese and the South's products inland to China and Russia and for transporting Chinese products to the South and Japan. The Gaeseong Industrial Park is also located only 89 kilometers from the Incheon economic hub and its International Airport. As the South has undertaken to building

Korea into a hub of Northeast Asia, the Gaeseong Industrial complex would complement this project.

The potential gain from such cooperation is virtually incalculable, but continued engagement in positive inter-Korean relations is critical to achieving stability and economic growth over a long period. For instance, under the recent agreement of July 2005, the North will guarantee the South the rights to mine mineral deposits in the North, including coal, zinc and magnesite. In return, the South will provide raw materials allowing the North to produce basic necessities such as soap, clothing and footwear.

The two Koreas must coordinate the legal mechanisms and economic framework so as to improve inter-Korean business relations. South Korea's government has until now intervened and regulated all interactions, but this policy should evolve to allow business decisions to take over government-level economic activities. The North should be recognized as a developing country, and the South should undertake a revitalization program considering the North as a part of the entire Korean economic plan involving integration, trade promotion and dynamic international divisions of inputs.

The ultimate objective of the two Koreas has been political union through economic cooperation. Political gestures and diplomatic compromises between the democratizing, capitalist South and the rigidly communist North by themselves cannot go very far. As preparation for unification, the North's living standard must be improved in order to avoid massive population movement. Combined with the substantial benefits of expanding trade and investment, such efforts should lead to enhanced relations between the two Koreas.

Economic cooperation will have many positive effects on growth and welfare: market extension, economies of scale, learning curve effect, competition, and trade creation. It would, as well, have positive spill-over effects on political negotiations, eventually leading unification. The two Koreas must undertake serious studies on structural reforms, monetary integration, industrial relocation, privatization of state assets, foreign trade

and investment, and other related problems.

Conclusion

The aim of inter-Korean economic cooperation is to create a new form of value added, which will bring about tangible benefits to both sides. This is possible through the combination of the South's capital and technology and the North's labor and land. If successful, it will result in reducing unification expenses as well.

Economic cooperation between the two Koreas has increased substantially since the 2002 summit conference, and the Gaeseong Industrial Park has set an example for overcoming the major barriers that the South's businesses have previously experienced in the North. It now appears that inter-Korean cooperation is moving to a higher level, encompassing more comprehensive investment activities in the North, including trade, commissioned processing and either joint-ventures or exclusive investments. These economic engagements have spread to a broader range of inter-Korean relations over the past few months, including talks on key cultural, financial, military and political issues.

As the inter-Korea railway restoration project is completed, the Gaeseong Industrial Park is ideally located to develop into a major hub of transportation and trade between South and North Korea. The Gaeseong Industrial Park will be connected to Russia and China through the Trans-Siberian Railway and the Trans-China Railway. When the Trans-Korea Railways are eventually reconnected with the Trans-Siberian Railway and the Trans-China Railway, the Gaeseong Industrial Park will become a major transit point for transporting Japanese and South Korean products inland to China and Russia and for transporting Chinese products to South Korea and Japan. The Gaeseong and Incheon complexes together could become the Northeast Asian hub of business, industries and finance.

Having achieved economic cooperation, the two Koreas should then look to shave production costs by combining the North's relatively inexpensive labor and mineral resources with the South's capital and technological assets. These economic

transactions at the Gaeseong Industrial Park should create a synergy effect derived from production efficiency, economies of scale, low transaction costs of trade, and effective resource allocation. The two Koreas should continuously work for gradual transformation together with expanding and diversifying the Gaeseong Industrial Park.

The world is changing at a dazzling rate. The two Koreas are at a historical crossroads of inter-Korean cooperation towards economic integration. Economic gains would be increasingly realized from the growing economic engagement, and inter-Korean trade and investment hold enormous potential expediting the unification of the two Koreas.

Endnotes

- ¹ The savings in labor costs in the Gaseong Industrial Park are even greater with a faster transfer of technology. In addition, the South's companies did not have to pay payroll taxes or make other social welfare contributions. See Noland Marcus, *Avoiding the apocalypse: the future of the two Koreas* (Washington, DC: Institute for International Economics, 2000) p. 130.
- ² Jong-Woon Lee, "Economic Opening of the Hermit Kingdom: Current Status and Future Tasks of the New SEZs in North Korea," *Journal of International Economic Studies*, Vol. 8, No. 2, December 2004, pp. 123-129.
- ³ Sung Wook Nam, "Theory and Practice: Kaesong and Inter-Korean Economic Cooperation," *East Asian Review*, Vol. 13, No. 1, spring 2001, pp. 67-88.
- ⁴ Suhk-sam Park, "An Analysis of Economic Effects of the Kaesong Industrial Park," Vantage Point, August 2004, pp. 67-88; The Federation of Korean Industries, Center of Northeast Asian Economy, *The Economic Effectiveness of the Development of the Gaseong Industrial Complex*, 2002. (in Korean)
- ⁵ Positive signs have been forthcoming. For example, US Secretary of State Condoleezza Rice threw her support behind the South's proposal for massive energy aid to the North if it dismantles its nuclear weapons program, calling it a creative idea to tackle the North's needs without proliferation risks. See *The Korea Herald*, July 14, 2005.
- ⁶ See *North Korea's Economic Reforms* (Seoul: The Korean Institute for National Unification, May 2005), pp. 7-55.
- ⁷ The Korean Institute for National Unification, *North Korea's Economic Reforms*, May 2005; The Korean Ministry of Justice, *Analysis of North Korea's Gaseong Industrial Complex Development Laws*, 2003. (in Korean).
- ⁸ JoongAng Ilbo. The Heat of 'New Thinking,' *English JoongAng Ilbo*, August 6, 2001.
- ⁹ Hyun-Chin Lim and Yoiun Chul Chung, "Is North Korea Moving toward a Market Economy?" *North Korean Studies Reviews*, Vol. 7, No. 1, May 2004.
- ¹⁰ See Ge, Wei "Special Economic Zones and the Opening of the Chinese Economy: Some Lessons for Economic Liberalization," *World*

Development, Vol. 27, No. 7, 1999, pp. 1267-85.

- ¹¹ This proposal was accommodated in due course by the South, and the historical four-day inter-Korean prime ministers' talks began on 4 September in Seoul, with a 90-member delegation from Pyongyang visiting via the truce village of Pamunjom.
- ¹² Kim, Youn-Suk, "Economic Cooperation between the Two Koreas: An Historical Analysis," *Perspectives on Korean Unification and Economic Integration*, edited by Choi, Y. B. et al (Cheltenham United Kingdom: Edward Elga Publishing Ltd., 2001), pp. 57-71.
- ¹³ The South's exports in 1997 included \$2.9 million in fuel oil and \$1.7 million in materials for building light-water nuclear reactors, both provided under the 1994 Geneva Accord.
- ¹⁴ Park, Jin, "Inter-Korea Trade Was Analyzed in the IMF Era," *Korea Focus*, 6 (2), March-April 1998, 69-71.
- ¹⁵ The UN-sponsored Tumen project seems destined to have a hard time luring capital and multilateral cooperation since financing is the most crucial ingredient. Lending from the World Bank or Asian Development Bank was complicated by the fact that they lent not to international projects but to individual countries.
- ¹⁶ *The Korea Times*, July 12, 2005.
- ¹⁷ *The Korea Herald*, July 14, 2005.

