

# **Inter-Korean Economic Exchange and Cooperation: Current Situation and Tasks**

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The ongoing North Korean nuclear crisis that was sparked after meetings between U.S. and Democratic People's Republic of Korea (DPRK) officials in October of 2002 has had a definite impact on inter-Korean economic exchange and cooperation. The nuclear issue has weakened the aims and position of the Republic of Korea (ROK), which brought about active inter-Korean economic exchange/cooperation based on a policy of reconciliation and cooperation with the DPRK. The tedious debate over the Korean government's magnanimity toward Pyongyang flaring up again in the midst of the deepening and heated south-south conflict as the trust built up between the two Koreas over the last few years is now showing signs of instability. The international community has tried a variety of approaches in an effort to resolve the nuclear issue, yet there does not seem to be any short-term resolution in sight.

However, there is one consolation. Despite the nuclear crisis, there has not been a rapid freeze in relations between the two Koreas. Not only has the ROK government continued its efforts of engagement there has been an obvious effort as well by DPRK officials to ensure that inter-Korean dialogue continues. Linked to this effort were the groundbreaking ceremonies for reconnecting the Kyongui and Donghae railway lines as well as the groundbreaking ceremony for the construction of the Kaesong Industrial Complex. However, as in the past, progress on these projects has been slow. In addition, the Mount Keumgang tourism project, which has been in operation for five years now, has still failed to secure any profit and is only being kept alive through financial support from the South Korean government.

The overall situation appears to be in a state of disorder. In many respects the activities surrounding inter-Korean economic exchange/cooperation are not commonplace. It is

important to look back at how far we have come in inter-Korean economic exchange/cooperation and examine the current situation in order to better understand and evaluate what lies ahead in the future.

## **The Current Situation and Assessment of Inter-Korean Economic Exchange and Cooperation**

### *Current Situation*

Inter-Korean economic exchange began from 1989. Although there were several years when the size of trade showed a reduction (1996, 1998, and 2001), generally the amount of trade has shown an upward trend. However, this upward trend in the 1990s was due in large part to noncommercial transactions such as support to the DPRK with food and goods, the light-water nuclear reactor project, goods related to the Mount Keumgang tourist project, and the supply of heavy fuel oil from the Korean Peninsula Energy Development Organization (KEDO). Therefore, the overall size of business trade, that is the sum of commercial trade and processing -on- commission trade, has been in a relative state of stagnation.

From 2002, some different patterns in trade could be identified. The size of business trade and the size of total trade had both shown an increase. The sum of trade in 2002 was 640 million dollars, which was an increase of 59.3 percent compared to 2001. Out of this total trade, business trade was 340 million dollars, which was a record-breaking increase of 45.1 percent compared to 2001. The total amount of trade in 2003 was 724 million dollars, which was an increase of 12.9 percent compared to 2002. Out of this total trade, the business trade was 409 million dollars, which was an increase of 19.2 percent compared to 2002.(1) This increase can be explained by partial improvements(2) in the North Korean economy and the active attitude of the North Korean government toward economic cooperation with South Korea.

On the other hand, there has not been active investment in North Korea by South Korean businesses. There were fifty investment projects that received entrepreneurial approval from the Ministry of Unification by the end of August 2003 (with the exception of the light-water reactor project) and among these fifty, only twenty-three were able to get full approval to commence their projects. Even out of these twenty-three, quite a few projects had to be suspended because of the South Korean businesses' own circumstances or differing opinions in consultation with North Korea.

Therefore, since the first investment in North Korea by a South Korean private business in 1996 the total amount of private business investment reached 196 million dollars (excluding the light-water reactors) by August 2003(3). In addition, when we exclude investment in the Mount Keumgang tourism project by the Hyundai Corp. the total sum is only 51 million dollars.

However, since the historical inter-Korean summit in June 2000, economic exchange and cooperation, which had only occurred sporadically at the private level, expanded to the inter-governmental level. After the summit, both Korean governments agreed to restore disconnected railway lines and highways and the groundbreaking ceremonies for these projects were held on June 14, 2003. Furthermore, the two Koreas signed an agreement on four major areas of economic cooperation; guaranteeing investment properties, preventing double taxation, setting procedures for settling disputes, and payments for goods and services traded between the two countries. The agreement became effective on August 20, 2003.

In addition to this agreement, the designation of the Kaesong Industrial Complex as a special economic zone was a significant event. The Kaesong Industrial Complex is the first industrial complex in North Korea aimed at South Korean businesses. The complex has active human and material resources exchange and can significantly reduce related cost because of its close proximity to South Korea. Moreover, it can create an opportunity to upgrade inter-Korean economic exchange/cooperation from a focus on

simple trade and processing-on-commission to full-scale investment. However, further development of the Kaesong Industrial Complex has been idle since the emergence of the North Korean nuclear issue. After a series of ups and downs, the groundbreaking ceremony for the complex was held on June 30, 2003 but full commencement of the project is still plagued by delays.(4)

On the other hand, ROK humanitarian support to North Korea has actively continued. Both governmental and private humanitarian support, which began due to a severe food crisis in North Korea since the mid-90s, are well established as an important axis of inter-Korean economic exchange/cooperation. The total amount of governmental and private humanitarian support to North Korea has been recorded at more than 100 million dollars since 2000.

#### *Assessment*

How then can we assess inter-Korean economic exchange/cooperation thus far? First, let us summarize the achievements. We can get a better picture of the positive effects of exchange/cooperation by looking at three areas: the North Korean economy, inter-Korean relations, and the South Korean economy.

Above all, inter-Korean economic exchange/cooperation has opened an airway for the North Korean economy to breath, as it had been suffering from a severe goods and foreign currency crisis. This has helped contribute to the stabilization of North Korean society. In trade alone, South Korea has become an indispensable partner to North Korea. Inter-Korean commercial trade in 2002 reached 340 million dollars as South Korea became North Korea's third largest trading partner only behind China (780 million dollars) and Japan (370 million dollars). South Korea's role is even more significant when we factor in noncommercial trade such as humanitarian support.

The increasing economic dependence of North Korea on South Korea has naturally resulted in a positive influence on inter-Korean relations. Inter-Korean exchange and cooperation has carried out its role as a safety mechanism helping to regulate potential inter-Korean political and military conflicts. It has also helped to ease tension between the two Koreas and promote an atmosphere of reconciliation and cooperation.

Exchange and cooperation have also had a positive influence on the South Korean economy. Decreasing the so-called “North Korean risk” after the foreign currency crisis helped to enhance the credibility of the ROK government in the international community. Credibility has been further enhanced because inter-Korean economic cooperation has relieved tension on the Korean peninsula thus making South Korea more appealing to foreign investors.

Yet, despite these achievements, problems still exist. Although inter-Korean economic exchange and cooperation has largely increased quantitatively for the past fifteen years, one cannot deny its overall inactivity. Although the simple trading of goods and processing-on-commission have shown a tendency of gradual expansion, the fact that investment in North Korea has yet to break out of stagnation reveals a fundamental weakness in inter-Korean economic exchange/cooperation.

Another serious problem is the uncertainty with regard to stability and profitability in exchange/cooperation. Even after fifteen years, not many businesses have been actively participating on a long-term and sustained basis. Reports show that a considerable number of companies are having difficulties in guaranteeing profitability.

Despite some signs of recent growth mentioned already, where shall we look for the cause and reason for the overall inactivity in inter-Korean economic exchange/cooperation? With regard to North Korea, there is a lack of a willingness on Pyongyang’s part to open up to the international community resulting in the DPRK taking a passive approach toward inter-Korean economic cooperation. Regarding more

frequent contact between North and South Korean citizens as a factor that could lead to system instability, North Korea has strictly limited residence or stays by South Korean businessmen and did not allow businesses autonomous administrative rights. In addition, a lack of social overhead capital (SOC) including electricity, materials, and obsolete machinery, etc., make production in North Korea difficult. Furthermore, factors related to the DPRK's foreign relations have had a significant impact. U.S.-DPRK and Japan-DPRK relations have yet to emerge from hostility. As a result, there has been no inflow of strategic goods and technology intensive facilities into North Korea and the marketability of goods produced there is significantly limited by tariff barriers.

Problems also exist in South Korea. In a transitional situation where it is difficult to clearly identify the responsibilities of the government and business there has been confusion in South Korean society regarding the degree of intervention by the government in enterprise in the DPRK. From the conservative camps in South Korea, voices critical of support for North Korea can still be heard and act as a barrier blocking progress in inter-Korean economic cooperation/exchange.

### **Recent Changes and the Necessity of Reestablishing Awareness of Inter-Korean Economic Cooperation/Exchange**

#### *DPRK Economic Reform and Inter-Korean Economic Cooperation/Exchange*

One of the most crucial issues related to North Korean economic recovery is full-scale reform and opening. Authorities in Pyongyang have created expectations for full-scale economic reform by carrying out the July 1st Program (economic management improvement methods) in 2002 (5) and integrated market establishment measures in 2003.

It appears that the main intention behind these measures is to introduce market economy mechanisms into production and distribution. In other words, North Korea has established a socialist goods exchange market which trades materials between businesses and allows for production beyond quotas with the purpose of selling products on the market. In addition, North Korea has established an integrated market system and has allowed for the distribution of food and factory products. Within North Korea, there is awareness of the change in market functions which suggests that the policy of market function expansion will continue. Moreover, the North Korean government, through the Korean Central News Agency (KCNA) on June 10 2003, attracted attention with the unprecedented use of the expression “economic reform” when it made the first official announcement on the expansion and rearrangement of the farmer's market to create an integrated market. Yet, patience is needed as economic reform in North Korea is still at an early stage and is unlikely to reach levels similar to other socialist countries like China. Nevertheless, recent changes in policy are on a different level than those of the past and are indications of meaningful change.

The changing situation also demands a new understanding of the position and role of the ROK government. South Korea must expand the scope of its activity. North Korea knows very well that in order for reform and opening to produce benefits it is necessary to introduce outside resources and improve foreign relations. Therefore North Korea will likely find it difficult to display the same rigid attitude that it has shown in the past. Although its relations with other countries have worsened due to the nuclear issue, the inter-Korean relationship has maintained a level of considerable appeasement. In addition, inter-Korean economic exchange/cooperation has been somewhat more active than before with some stability. This is quite different from the situation that occurred during the first nuclear crisis from 1993-1994.

Although some results were seen early on in North Korea's efforts at economic reform, the potential for side effects is high in which case South Korea will have to increase its role. The simple notions of “reform” and “opening” are not sufficient conditions for

rebuilding an economy. It is important to have growth power and potential along with reform and openness. However, initial conditions for reform and openness in North Korea are poor. Economic reform may lead to a temporary increase in productivity but is also likely to lead to inflation and macroeconomic instability. In addition, the basic thrust of the economic reform policy increases the possibility of a transformational recession. As results from economic reform are obtained it is important to support the so-called “reformists” in North Korea as they try to counter the constraints and criticisms of more conservative groups in the DPRK government. Especially, if the expected results from the reform are not obtained and North Korea reverts back to its past policies, a rising of tensions on the Korean peninsula could occur. Thus, it is crucial that Seoul assist Pyongyang in successfully carrying out its reform policy.

#### *The Reorganization of Northeast Asian Economic Order and Inter-Korean Economic Relations*

The recent reorganization of the Northeast Asian economy is characterized by changes in the division of labor and specializations in the region. The so-called “wild-geese-flying pattern” has been referred to as a framework for describing Asia’s intra-regional division of labor and specialization. This can be understood in the dynamics of the Asian economy where Japan is leading in charge of high value added products, the newly industrialized economies (NIE’s), the Association of Southeast Asian Nations (ASEAN) and China respectively are pursuing technology transfers and industrialization resulting in a formation that can be understood in the image of geese flying in a straight line. However, this division of labor is breaking down because of Japan’s long-term economic recession and China’s rapid economic rise. With the reduction of differences in the quality of development in Japan, Korea, and China, the level of competition amongst the three nations is intensifying. Especially with China becoming a “world factory” its products are beginning to encroach upon those produced by Japan and Korea.



These changing dynamics in inter-Korean economic cooperation and the notion of an inter-Korean economic community require new perspectives of understanding. The South Korean economy, the real national economy, is afflicted by the division of the Korean peninsula which leads to a continuing rise in opportunity cost. South Korea does not have a stable domestic market because its size is small. Therefore, in the process of forming an inter-Korean economic community, the South Korean government should try to achieve results by eliminating the political instability on the peninsula or expanding the size of its domestic market. Guaranteeing the survival of the South Korean economy depends heavily on inter-Korean economic exchange/cooperation and an inter-Korean economic community.

### **Tasks for Inter-Korean Economic Cooperation: The Role of the ROK Government**

#### *The ROK Government and Developmental Assistance to North Korea*

The future of the Korean peninsula will require that the South Korean government support North Korea in its process of economic recovery. In this case more focus will need to be given to developmental support over mere consumption and developmental assistance instead simple aid. More so than in the past, North Korea is taking an active approach to economic reform and last year began an economic plan centered on energy. Therefore, the South Korean government needs to show more interest in preparing some kind of blueprint or outline for the rebuilding of North Korea's economy. Based on this blueprint, Seoul needs to pursue a concrete plan for developmental support through making agreements with authorities in Pyongyang.

Developmental support for North Korea should give priority to establishing social infrastructure such as agricultural systems, electric power, railways, highways, harbors, communications, etc. Of particular importance are the areas of agriculture and energy. Yet, the nuclear issue still stands in the way as a stumbling block to this kind of support

by the South Korean government. Therefore, such support needs to be promoted step-by-step at a pace commensurate with the resolution of the nuclear issue. Before the nuclear issue is resolved, simple expansion of SOC is not needed to reconstruct the North Korean economy as South Korean businesses investing in North Korea and the resulting SOC from the investment projects will be more appropriate in terms of feasibility and effectiveness.

### *The Link Between Inter-Korean Economic Cooperation and Northeast Asian Economic Cooperation*

It is necessary to link inter-Korean economic cooperation with Northeast Asian economic cooperation. First, it is unreasonable to expect South Korea to be the sole bearer of the immense financial burden needed to rebuild the North Korean economy. Although it is difficult to estimate the exact size of the financial resources needed there is general agreement on the enormity of the cost. In addition, no one believes that South Korea alone can raise the capital that is needed. However, the South Korean government will have to concentrate on how other countries will participate in the process and how to induce their participation in an economic recovery scheme.

Another important factor to consider is North Korea's geopolitical location. China is located near or connected to three different countries in Northeast Asia, namely the Russian Far East, Japan, and Korea. In the formulation of a plan to build an inter-Korean economic community the importance of North Korea's geopolitical location must be considered over the long-term. As the foundations of North Korea's manufacturing industry are collapsing it is important to give consideration to the limitations that are likely to occur in this area. Thus, cooperation and assistance from those countries surrounding North Korea will be even more important.

Northeast Asian economic cooperation that includes China, Russia, Japan, and North Korea can be viewed from various dimensions. In Northeast Asia there is emphasis on

the construction of a gas pipeline for the development and activation of natural gas as an energy source. With respect to the Korean peninsula there are discussions about connecting the Trans-Korean Railway (TKR) and the Trans-Siberian Railway (TSR) lines as well as the Trans-China Railway (TCR) for an overall railway connection and cooperation in Northeast Asia. Through connecting the TKR and TCR railways between Korea and China, China's northeastern and northwestern areas can function together with South Korea as one economic bloc.

### *Short-Term Tasks*

An important short-term task is the successful development of the Kaesong Industrial Complex. However, it too is affected directly and indirectly by the nuclear issue and U.S.-DPRK relations. If there is no resolution to the nuclear issue in sight, significant developments will be difficult to achieve at this time. It is only possible at this time to take a step-by-step approach that keeps pace with efforts to resolve the nuclear issue.

Yet, there is still potential for small and medium-sized businesses to move into the Kaesong Industrial Complex. Especially, in the area of light industry, Korean domestic small and medium-sized businesses have suffered from losing wage competitiveness and the domestic market is being flooded with low-priced products from China. This has limited the growth potential for such businesses. There are an increasing number of cases where small and medium-sized businesses move into China but because of assimilation problems have to later withdraw. Therefore, the Kaesong Industrial Complex may be the last potential stronghold where Korean small and medium-sized businesses can achieve success. The government is expected to take the main role in developing an industrial policy. This will also require strict inspections to ensure the existence of the appropriate conditions and administrative and financial support for maintaining them.

The South Korean government needs to work more toward developing projects that are combined at the business and governmental levels like the Mount Keumgang project. The overall importance and significance of the Mount Keumgang tourism project cannot be ignored with respect to inter-Korean economic exchange/cooperation and inter-Korean relations as a whole. It is also essential that the South Korean government provide more transparency regarding its proceedings and dealings in exchange and cooperation.

Lastly, effort is needed to improve the institutional environment of inter-Korean economic exchange/cooperation. In order to achieve this, concentration should be given to expanding funds for exchange and cooperation, effective means for managing the cooperation, and following through with the inter-Korean four-point economic agreement.

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(1) The Ministry of Unification, “Trends in Inter-Korean Trade in 2003” (Report).

[www.unikorea.go.kr](http://www.unikorea.go.kr)

(2) According to the Bank of Korea, for a period of nine consecutive years (1990-1998) the North Korean economy recorded negative growth but showed an increase in growth for four consecutive years from 1999 to 2002, “Estimation Results on North Korean Economic Growth in 2002” (Report) June, 2003.

(3) Materials submitted to the National Assembly by the Ministry of Unification. (Yonhap News) October 28, 2003.

(4) The nuclear issue is the pivotal key, but even if it is brought to a conclusion there are other tasks remaining. Arbitration will be needed in order to secure international competitiveness in the price for pre-selling locations for industrial complexes by North Korean authorities as well as approval for companies to self-manage labor. It will be important for the South Korean government to play an active role in obtaining cooperation for the establishment of infrastructure. In addition, the rapid completion of the Kyongui railway line should be a first consideration.

(5) The gist of the July 1<sup>st</sup> economic program involved the expansion of business administrative autonomy, the gradual abolishment of the ration system of food and daily necessities, changing exchange rates and duties, and a sharp increase in prices and wages.

(6) Businesses were able to produce beyond production quotas and sell their goods on the market when they obtained their own materials instead of receiving materials from the national government.