

Financing Methods for North Korean Development

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Defining the Issue

The inter-Korean summit held in June was a historic meeting. In South Korea, plans are being made for infrastructure creation and agricultural sector restructuring in the North. Participation by private companies is also expected to intensify. However, there is a sense that hopes may have risen too quickly with numerous South Korean firms jumping on the bandwagon of North Korean investment.

It is crucial for South Korea to have a cautious attitude and thoroughly prepare for relations with the North. North Korea currently has a severe shortage of funds needed to attract large scale investment, its investment conditions are very poor (for example, there is no investment guarantee system) and the country's external confidence is almost non-existent. Under these conditions, capital is the first factor for the South Korean government to consider when planning to supply financial aid to the North. If the capital invested into North Korea cannot be recovered, the effect on the South Korean economy, which is just emerging from the 1997 financial crisis, would be very negative.

This paper explores the financing methods that can be used in developing the North Korean economy, and estimates the approximate scale of funding. When companies plan a project, they usually estimate the money needed for its operation, and then look for

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ways to supply the required funds. For investment in North Korea however, since companies have little concrete knowledge about their future projects, it is very difficult to estimate how much money will be needed. Despite this uncertainty however, this paper will predict the methods and scale of financing for each stage of cooperation by considering factors such as Korea's credit rating or existing pool of funds. In addition, the paper examines some considerations to guarantee effective financing and support. The main topic is economic cooperation, and financing methods for education, training, or technological support are not covered.

Basic Financing Strategy

Economic cooperation is based on the assumption that in the long term, it will lay the basis for a unified Korea. Parties involved in financing North Korean ventures should create a basic strategy in light of the considerations below.

First, the South Korean government should lead the financing efforts. If foreign firms gain market occupancy in North Korea, the South and North will not be able to create economies that are fully complementary to each other. There is also a risk that the economy and industrial structure of the future unified Korea will be excessively dependent on foreign companies.

Second, rather than having South Korea shoulder the entire financial burden of economic cooperation, the two sides should find ways to allot some of the costs to North Korea, which will after all be the main beneficiary. For example, when raising funds for building North Korean infrastructure, the North should help finance the project by offering its mineral resources or revenues from tourism.

Third, financing should occur in several stages. In the short term, public funds and development finance institutions should be the main sources of capital. In the middle to long term, most financing should come from private companies, international financial organizations, and foreign direct investment. The South should support North Korea's efforts to join international financial organizations and act as the main source of funds until the North is

admitted. However, once North Korea's external credibility rises to a reasonable level and the country is able to raise funds from international financial organizations, the North should gradually raise its share of the financial burden.

Fourth, to lower costs, there should be a variety of domestic and foreign fund raising methods that are responsive to conditions such as the extent of North Korea's opening to the rest of the world, or trends in the domestic and international financial markets.

Fifth, while public funds should be used mainly as a catalyst for economic cooperation, the private sector should be the main source of large scale funding.

Raising Money Domestically

The scale of funds needed for the South Korean government to embark on South-North economic cooperation is enormous.¹ The government will need public consensus to supply funds on such a level. Considering this constraint, several financing methods are examined below.

One method is raising regular domestic capital. In this method, a small percentage of the money that South Korean firms raise for domestic facilities or operating costs will be sent to North Korea. Because of problems such as bond preservation or maintenance in North Korean investment, it is unlikely that a lot of money will be raised in this manner, and most of the regular investment in North Korea will probably come from companies directly involved in the North.

The government can also resort to a number of domestic funds. Currently, the most relevant fund is the South-North Cooperation Fund, which was created to promote inter-Korean exchange and cooperation. The fund could probably supply more than the 5 billion won that it has allotted to South-North economic cooperation.

¹ The LG Economic Research Institute estimated that it would take about 2 billion dollars yearly for ten years to relieve North Korea's food crisis and develop the country's power facilities, social overhead capital, and core industries (Kim, Sunjin, April 19, 2000. "Weekly Economy", LG Economic Research Institute, no. 567). According to Kim's estimate, it would cost about 150 trillion won to raise North Korea's industrial facilities - excluding infrastructure - to 30% of South Korea's level.

At the end of 1999, the fund totalled 829.1 billion won of which about 160 billion won is expected to be available for economic cooperation. Another fund is the Economic Development Cooperation Fund (EDCF). Created to support economic development and cooperation with developing countries, the fund amounts to 942.9 billion won. Because the EDCF is reserved for developing countries however, the existing law will have to be revised before the fund can be used for South-North economic cooperation. A third fund is the Small and Medium Industry Structural Improvement Fund, which is operated by the Small and Medium Industry Promotion Corporation. The fund totals 700 billion won, and is aimed at small and medium businesses investing in production facilities. While it is possible that the fund could finance South-North economic cooperation, most of the fund will probably be used to support domestic firms. Considering that last year's fund of 650 billion won was completely depleted by domestic companies, it is predicted that only a tiny portion of this year's fund will be available for economic cooperation. The Small and Medium Industry Promotion Corporation may allot a separate fund for economic cooperation, but again, the scale would be very small.

A third financing method is the establishment of a separate cooperation fund. Because economic cooperation will need a massive amount of funding, it will be difficult to fully support economic cooperation with existing funds, and a separate fund, possibly named the "South-North Economic Cooperation Fund" may have to be created. In the beginning, money could be collected in membership dues or from the money that firms investing in North Korea saved on taxes. Eventually however, the government will have to be the main contributor to the fund. Financial institutions, especially banks, could be another source for this fund by reserving a certain percentage of their money for South-North economic cooperation. Lotteries could also be used to build the fund. Since the fund raising percentage of lotteries is about 20% however, they will have to be used as an indirect means of fund contribution.

Public funds are a fourth method of financing economic cooperation. They can be raised through higher taxes, national bonds or

sale of public assets. Korea's tax level is low compared to developed countries,² so some money may be raised from an increase in taxes. However, with the domestic tax burden already high from light water reactor construction, the public will not be happy with a tax hike, and businesses may suffer financial crunches, leading to higher interest rates and contracted investment. Raising funds through government bonds brings the risk of a budget deficit if the bonds accumulate, and also has the effect of a quasi-tax. Finally, large sales of public assets such as land or stocks may have side effects in the private sector such as tightened liquidity, investment contraction, and concentration of capital. Sale of land in particular will have many unwanted effects. As for the sale of stocks, the government will need to examine ways to minimize the effects on the financial market.

Raising Money Overseas

Since domestic financing can only contribute a limited amount to economic cooperation, Korea will have to explore ways of raising money from overseas. The first source of funding that one can consider is North Korea's compensation claims for Japan's colonial occupation. Japan will probably want to pay the total estimated 5 to 10 billion dollars in reparation in real goods, so it is not expected that much of the reparation will be available in cash.

A second possible source of foreign funds is public loans from international financial organizations such as the IMF, IBRD and ADB. Public loans consist of money lent to the government by foreign governments or foreign financial institutions. This includes when the government borrows money and loans it to domestic financial institutions or when the government guarantees money that is borrowed by healthy domestic financial institutions from international financial organizations. In these cases, introducing public loans will take three to six months, and most are long term loans with maturities of ten years or longer. Since public loans are

² In 1996, Korea's tax and social security burden rate was 23.2%, while the figures for the US, Japan, and England were 27.9%, 28.4%, and 36.0% respectively (National Statistical Office 1999, International Statistical Yearbook).

usually made for specific purposes and are accompanied by conditions, the government will have to negotiate with the organizations for loan conditions that best allow effective aid to North Korea.

If North Korea wants to get loans from international financial organizations, it will first have to be admitted into one, for which US approval is essential.³ Since the United States considers North Korea as a supporter of terrorist activity however, the US is not likely to immediately approve of North Korea's admission. Considering this, it will probably take North Korea at least two years to join an international financial organization, and at least five to seven more years for it to receive loans. In the short term, loans to North Korea are not likely. For reference, it has been estimated that the loans available to North Korea amount to \$2.7 to \$4.5 billion.⁴

A third method of raising funds is issuing foreign currency bonds. Because this method requires a good external credit rating, the effort will have to be led by banks that fit this requirement. This method will allow the government to pursue relatively long term projects since the maturity of foreign currency bonds is five to ten years. The German Bank for Reconstruction (KfW), Germany's main development finance institution, used foreign currency bonds extensively to raise foreign capital in the US market to help finance development in East Germany.⁵

Commercial loans from foreign financial institutions could be a fourth method. These loans consist of domestic banks with high external credibility borrowing money from foreign financial institutions on their own credit. Usually, the loans are mid-term with a maturity of five years.

A fifth method is the creation of a multilateral fund like an international special trust fund, with contributions from the World

³ In February 1997, North Korea applied for membership at the Asian Development Bank, and the IMF and IBRD sent survey groups to the country in September 1997 and February 1998 respectively. For details, refer to Chang Hyungsoo, Lee Changjae, and Park Yonggon. 1998. "International Cooperation in Preparation for Reunification: Focus on International Financial Institutions", KIEP, pp. 68-73.

⁴ Park, Seoksam September 1999, "Estimated Scale of Possible Loans from International Financial Institutions to North Korea", Bank of Korea.

⁵ For details on the German Bank for Reconstruction's fund raising efforts abroad, refer to Kim, Myungshik, May 15, 1998. "The Role of Development Finance in German Unification", Industrial Economics, Korea Development Bank, pp. 20-24.

Bank and a number of countries. Quick creation of such a special trust is possible because countries interested in investing in North Korea would contribute to the fund.⁶ However, the fund's scale may be limited by conflict of interest among its members.

Stages of Domestic and Foreign Financing

In the table below, estimates of the money needed for economic cooperation as well as the sums that can be raised from domestic and foreign sources are listed by the stage of economic cooperation. Large scale fund raising will only be possible if South-North relations are positive, and the following table makes this assumption.

One of the likely effects of the June summit between South and North Korea is improved North Korean relations with the US and Japan. In response, the South Korean government needs to plan and prepare South Korean-led support projects to the North. At this stage, most of the required funds for economic cooperation will be used for preliminary work such as project selection and feasibility studies. The required funds are estimated at 5 to 10 billion won, which could be supplied by the existing South-North Cooperation Fund. Thus, the priority tasks for 2000 are to use the South-North Cooperation Fund and the Small and Medium Industry Structural Improvement Fund in economic cooperation and to set legal and institutional mechanisms for supporting further projects through the Economic Development Cooperation Fund or other funds.

In the mid term (2001 to 2004), an atmosphere of peace is expected to be established on the peninsula, with improved South-North relations and amicable North Korean ties with the US and Japan. This will bring large scale economic support to North Korea including infrastructure creation, support for structural reforms in agriculture, and the creation, expansion, and rebuilding of industrial facilities. The money needed for these activities is estimated at 2 to 5 billion dollars yearly. Domestic financing sources can include an annual 100 to 200 billion won from an expanded South-North Cooperation Fund, 100 to 200 billion won yearly from the Small

⁶ Chang, Hyungsoo, et al. 1998. pp.102-103.

and Medium Industry Structural Improvement Fund, 200 to 300 billion won yearly from other funds, and a yearly 100 to 200 billion won raised from taxes or sale of government assets. Money from abroad can include 0.5 to 1 billion dollars yearly from reparations for Japanese colonial rule, 2 to 3 billion dollars yearly from public loans or foreign currency bond issues, 0.5 to 1 billion dollars yearly in commercial loans, and if necessary, 0.1 to 0.2 billion dollars from a multilateral fund. From this stage, North Korea will have to lower its cost of raising money by attracting direct foreign investment, and measures should be taken to allow quick adoption of a free market management system.

In the long term, beginning in 2005, a South-North economic community is expected to gradually take shape, bringing heightened infrastructure creation in North Korea as well as a surge in industrial facility investment. This stage will see a significant improvement in North Korea's investment conditions, and the country will be able to raise money by gaining access to international financial institutions while trying to expand foreign investment and actively attracting reinvestment. In addition, domestic financing sources will be expanded further, with the South-North Cooperation Fund, Economic Development Cooperation Fund, and other funds each expanded to around 500 billion won yearly, the Small and Medium Industry Structural Improvement Fund will bring in 100 to 200 billion won yearly, while tax hikes and sale of public assets should account for about 100 to 200 billion won per year. Foreign capital sources will include an annual 0.5 to 1 billion dollars of colonial reparation funds from Japan (until a certain date), 3 to 5 billion dollars yearly from public loans and issue of foreign currency bonds, 1 to 2 billion dollars yearly from commercial loans, and 0.2 to 0.3 billion dollars yearly from a multilateral fund.

Conclusion

To activate economic cooperation, the first task is to improve North Korea's investment conditions, which includes establishing investment guarantees and preventing double taxation. After this

has been done, the first line of domestic financing will be the South North Cooperation Fund and the Small and Medium Industry Structural Improvement Fund, with the Economic Development Cooperation Fund and other funds to be considered gradually. Since there is a limit to the money that can be raised domestically however, foreign sources will also have to be considered. Reparations from Japan for its colonial rule will be the first source, followed by public loans, foreign currency bond issues, commercial loans, and multilateral funds.

South-North economic cooperation will need large scale financial support, and this will cause the debt ratios of domestic companies to rise. Therefore, excessive debt ratios should be permitted in supporting economic cooperation: preferential credit rate treatment should be given and companies shouldn't have to keep their debt ratios below 200%.

Financial institutions should examine supplementary bond measures, and since domestic and international funds may be insufficient, the use of private capital such as project finance or leases should be expanded. In addition, to lower the risk associated with economic cooperation, the North Korean government should take some of the financial burden by issuing mining permits or tourism development rights to certain locations, or rights to build power generation facilities.

When considering large scale industrial aid to North Korea, the South should also examine ways to approach the problem of North Korea's foreign debt. Without resolving this issue, it will be impossible to induce large loans or foreign investment.

Activating economic cooperation with scarce capital and laying the groundwork for unification will create a win-win situation for South and North Korea. While raising money for cooperation is important, financial support is an even more important issue. In giving financial support, the South will have to emphasize efficiency and participating financial institutions must have expertise in conducting feasibility studies and performing technological examinations of the projects in question. This will help maximize the effects of support to North Korea within the constraint of limited funds. ■

<Table> Domestic and Foreign Financing Methods for Economic Cooperation >

		2000	2001 to 2004	2005 and after	
South-North Diplomatic Situation		<ul style="list-style-type: none"> South-North Summit North Korea's thawing relations with the US and Japan 	<ul style="list-style-type: none"> Improving South-North relations North Korean amity with the US and Japan Establishment of peace on the peninsula 	<ul style="list-style-type: none"> Emergence of a South-North economic community 	
South-North Economic Cooperation		<ul style="list-style-type: none"> Planning and preparation for aid to North Korea 	<ul style="list-style-type: none"> Actual support to North Korea Infrastructure and industrial facility creation, agricultural reform 	<ul style="list-style-type: none"> Further infrastructure creation Expansion of industrial facility investment 	
Estimated funds needed		5 to 10 billion won	2 to 5 billion dollars yearly	5 to 10 billion dollars yearly	
Financing Strategies		<ul style="list-style-type: none"> Funds are only needed for feasibility studies, and can be supplied by the South-North Cooperation Fund 	<ul style="list-style-type: none"> Financing led by the South Korean government until North Korea's investment conditions improve and the country is able to receive loans from international financial institutions Attraction of foreign investment 	<ul style="list-style-type: none"> Financing will be possible with the improvement of North Korea's investment conditions and its entry into international financial institutions Expansion of foreign investment 	
Financing Methods	Domestic	South-North Cooperation Fund	5 to 10 billion won	about 100 to 200 billion won yearly	about 500 billion won yearly
		Economic Development Cooperation Fund	Legislation in progress to include North Korea as a possible recipient	about 100 to 200 billion won yearly	about 500 billion won yearly
		Small and Medium Industry Structural Improvement Fund	5 to 10 billion won	50 to 100 billion won yearly	100 to 200 billion won yearly
		Other Funds	Laws and regulations in creation	200 to 300 billion won yearly	more than 500 billion won yearly
		Miscellaneous	unnecessary	100 to 200 billion won yearly	100 to 200 billion won yearly
	Foreign	Japanese Reparations for colonial rule	Negotiations in progress	0.5 to 1 billion dollars yearly	0.5 to 1 billion dollars yearly (until a given date)
		Public loans	unnecessary	2 to 3 billion dollars yearly	3 to 5 billion dollars yearly
		Foreign currency bonds	unnecessary		
		Commercial loans	unnecessary	0.5 to 1 billion dollars yearly	1 to 2 billion dollars yearly
		Multilateral funds	Laying the groundwork for new funds	0.1 to 0.2 billion dollars yearly	0.2 to 0.3 billion dollars yearly
		Foreign direct investment	Improving the investment environment	Attraction of FDI	Expanded FDI