

# DEVELOPING THE KAESONG INDUSTRIAL AREA: ECONOMIC EFFECTS AND FUTURE TASKS

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Some observers think that North Korea will pursue economic development through promotion of technology and special economic zones. One reason to believe this was Kim Jong-Il's visit to Shanghai's Pudong Area, which is one of China's designated areas for reform and opening. North Korea's strategy is an experimental way of introducing the market system. Through the strategy, North Korea hopes to maintain its regime and rebuild its economy by attracting foreign investment and by enacting a socialist market economy. In this regard, both Koreas are eager for the Kaesong Area<sup>1)</sup> to succeed. In addition, the area will be a test of whether inter-Korean economic cooperation can move beyond the present stage of consignment manufacturing and tourism to investment cooperation in manufacturing.

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## Basic plan for development

The Hyundai Asan group plans to create a 26.6km<sup>2</sup> industrial area near Kaesong City and Pyunghwa-ri in Panmun-kun, in three stages. It is hoped that Kaesong will become an free and open industrial area at the level of China's Shenzhen and Pudong special economic zones. A modern residential area for 150 thousand persons covering 40.0km<sup>2</sup> is also planned. Hyundai plans to purchase a 70-year lease of the land, gain business permits to create the conditions for free and competitive investment, and then lease the land to domestic and international companies. To do this, Hyundai is negotiating development and operation conditions with several North Korean committees, including the Chosun Asia-Pacific Peace Committee, the National Economic Cooperation Committee, and the Samchully Assembly.

Development of the Kaesong Industrial Area is expected to take eight years. A win-win arrangement is planned for both Koreas: the South will provide the capital (including idle facilities) and technology as well as management know-how and export channels, while North Korea can contribute its low-cost skilled labor and the industrial site. In the first stage of development, companies are expected to focus on export goods such as textiles, clothing, footwear, leather, socks, and electrical and

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1) Located near Kaesong City and Panmun-kun, Pyunghwa-ri, the Kaesong Industrial Area covers 26.6km<sup>2</sup>, and is 140km from Pyongyang and 60km from Seoul.

Table 1. Kaesong Industrial Area: Stages of Development

Stage	Industrial Area				Residential Area	
	Area (km <sup>2</sup> )	Number of Firms	Employment (Thousand Persons)	Yearly Export (Billion Dollars)	Area (km <sup>2</sup> )	Households (Thousands)
First Stage (2001)	3.3	150	20	2	20.0	50
Second Stage (2002~2004)	10.0	450	60	6	6.7	43
Third Stage (2005~2008)	13.3	600	80	12	13.3	57
<b>Total</b>	26.6	1,200	160	20	40.0	150

Note: The area of the first stage may increase 5.0 to 6.6km<sup>2</sup> depending on demand.

Source: Hyundai Asan Corporation (February 2001)

electronic goods. These goods are relatively labor-intensive and quickly produced, and do not require heavy facilities or imported raw materials. Currently, about 460 companies hope to enter the area through groups such as the Korea Federation of Textile Industries and the Korea Electronic Industries Cooperative.

In the second and third stages, the main industries are expected to include electrical and electronics products, autos, precision chemical, IT, and heavy and chemical industries, as well as the first-stage industries. The second stage intends to set North Korea's foundation as an exporter and developing economy, and the third stage is expected to boost further growth and development.

### Economic effects of developing the Kaesong Area

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Non-economic effects include: better inter-Korean relations and increased mutual trust, diminished tensions and recovered national solidarity, creation of an inter-Korean legal and institutional framework, promotion of a national economic community, opening of North Korea and more chances for the country's globalization.

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Intangible benefits include: development of inter-Korean industrial structure, as well as balanced economic development on the peninsula. Other intangible benefits to the South include a stimulus effect to the sluggish economy, increased price competitiveness, efficient use of idle facilities, and possible expansion into Northeast Asian markets.

North Korea will also receive intangible benefits such as a higher quality of life (through employment and higher income), capital accumulation, and creation of new demand sources (through stimulation of related industries and local development). The following analysis focuses on tangible economic benefits.

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### Economic benefits to the North

If plans to develop the Kaesong Area are successfully pursued, North Korea will reap a total of 670 million dollars in economic benefits in the first stage of development. This would include direct benefits such as wages (16 million dollars a year for ten thousand workers) and the sale of materials (37 million dollars a year), as well as indirect benefits such as infrastructure creation and building construction. The

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**Table 2. Economic Effects for North Korea**

		(unit : million dollars)				
		Stage 1 (2001)	Stage 2 (2002~4)	Stage 3 (2005~8)	Total (8 years)	After Completion (yearly)
<b>Direct Financial Effects</b>	<b>Labor Costs</b>	16	84	255	355	96
	<b>Income from Material Sales</b>	37	259	939	1,235	494
	<b>Budgetary Income (from railway, etc)</b>	-	66	354	420	221
	<b>Total</b>	53	409	1,548	2,010	811
<b>Indirect Effects</b>	<b>Creation of Industrial Area and Infrastructure</b>	192	575	766	1,533	-
	<b>Building Construction</b>	425	1,275	1,700	3,400	-
	<b>Total</b>	617	1,850	2,466	4,933	-
<b>Grand Total</b>		<b>670</b>	<b>2,259</b>	<b>4,014</b>	<b>6,943</b>	<b>811</b>

second stage is expected to bring in 2.26 billion dollars, followed by 4.01 billion dollars in the third stage. Thus, by the end of the eight-year development project, North Korea is expected to earn 355 million dollars in wages, 1.23 billion in material sales, and 420 million in fees such as railway fees and water utilities, for a total direct cash income of 201 billion dollars.

After the development is completed, North Korea is expected to earn 96 million dollars in wages, 494 million in material sales, and 221 million in various fees, for a total cash income of 811 million dollars. Considering that North Korea's exports and gross national income for last year were around 560 million dollars and 16.5 billion dollars respectively, the 20 billion dollars of exports expected in the ninth year of the project is a considerable figure.

### Economic effects for the South

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Completion of the Kaesong Area would give South Korea a production base in the North, and would allow the South to save on labor costs by employing North Korean workers. In the first stage of construction South Korea is expected to reap economic benefits of 3.21 billion dollars, including 151 million dollars in labor cost savings and 306 billion dollars in stimulation of production and value-added. In the second and third stages, the South is expected to gain 12.4 billion and 30 billion dollars in economic benefits. Therefore, during the 8-year construction project, South Korea is expected to earn a total of 45.75 billion dollars in economic effects, including 7.3 billion in labor cost savings (which exceeds the 6.9 billion in total

Table 3. Economic Effects for South Korea

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		Stage 1	Stage 2	Stage 3	Total	After
		(2001)	(2002~4)	(2005~8)	(8 years)	Completion
		(yearly)				
<b>Direct</b>	<b>Lower Labor Costs</b>	151	1,418	5,750	7,319	2,573
<b>Effects</b>	<b>Sale of materials</b>	37	259	939	1,235	494
<b>Indirect</b>	<b>Production Stimulus</b>	2,132	6,396	10,394	18,922	-
<b>Effects</b>	<b>Promoting Value-added</b>	929	2,787	4,529	8,245	-
<b>Total</b>		<b>3,212</b>	<b>12,379</b>	<b>30,157</b>	<b>45,748</b>	<b>8,501</b>

economic effects gained by North Korea), 11.2 billion in material sales, and 27.1 billion from stimulus of production and value-added.

After construction is completed, South Korea is expected to earn a yearly 2.57 billion in labor-cost savings, and 8.5 billion in material sales. An additional 9 billion dollars of income is expected if North Korea requests the South to build a residential area for 150 thousand persons. Therefore, the Kaesong Area project is not simply an “aid” package for the North, but is a win-win deal that will actually bring more gains to South Korea than the North, while promoting North Korea’s economic recovery.

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### Tasks for successful development

In contrast with the Rajin-Sonbong Areas, which were failed attempts at creating special economic zones, the Kaesong Area has a good chance of success for several reasons. First, Kaesong is located near North Korea’s border and Seoul, allowing the possibility of a common industrial belt, as well as easy access to South Korea’s infrastructure. Secondly, development, operation, and investment for the Kaesong Area will be consigned to South Korean companies.

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The benefits of the Kaesong Area will only arise when the development plans are realized. However, there are a number of obstacles to the project’s success. While political reconciliation has made economic cooperation possible, its sustainability will depend on project stability, profitability of markets, and the fund-raising capacity of investing companies. The first issue requires cooperation from North Korea, while the last two issues are challenges for the South.

For the project to be stable, North Korea needs political stability, and legal and institutional guarantees for investment. This will require assurance of reform and opening from North Korea’s ruling party, the army, and political leaders, compromise on nonproliferation of weapons of mass destruction, and a review of the 4 section North-South Agreement on Economic Cooperation.

For investing firms to ensure profitability and markets for their products, North Korea should provide preferential tax or financial measures (such as a preferential law for Korean nationals). North Korea should also improve its relations with the US by trying to remove itself from the list of rogue states or violators of the Missile Technology Control Regime, and work to receive most-favored nation status as well as be included in the generalized system of preferences.

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The restructuring of Korean companies will decrease the fund raising ability of companies investing in the Kaesong Area. The government should not view the Kaesong project as merely a private sector affair, but should consider supplying policy funds if needed. **VIP**