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How South Korean Means Support North Korean Ends: Crossed Purposes in Inter-Korean Economic Cooperation

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Abstract

North and South Korea share the same political and strategic aim of integration and eventual unification of Korea, although they remain divided in their understanding of what should be the specific nature of the unified Korea. Both states, in their own ways, use the same instruments of unification policy; these are military deterrence, political diplomacy, economic cooperation, and humanitarian assistance. Economic cooperation and humanitarian assistance provide the main instruments of inter-Korean cooperation, albeit in an unequal manner as it is South Korea that provides the major funding for cooperation projects. The objective of this paper is to evaluate whether South Korea receives economic or political value for money in its expenditure on inter-Korean cooperation. This is not therefore an argument about the military and political instruments of the unification strategies of North and South but instead remains focused on the nature and modalities of economic cooperation. My thesis is that economic instruments are being used for cross-purposes and that this should matter to South Korea as it is unwittingly helping North Korea achieve aims which it does not share, and, as a logical consequence, weakening its ability to achieve its own unification goals. I argue that South Korean means need to be re-calibrated with South Korean ends. I also argue that the South Korean unilateral approach to economic cooperation, while beneficial in opening up relations with the North, has now run its course. A determined complementary strategy of economic and humanitarian multilateralism will enable it to pursue its own agenda at the same time as supporting the moral imperative, shared by the majority of South Korea's electorate of every political hue, of assisting the impoverished North Korean population in the short-, medium- and long-term.

Key Words: economic instruments, development, conditionality, unification goals, multilateralism

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The paper begins by articulating the different political unification objectives and strategies of North and South Korea. I then unpack North Korea's development goal whereby the ends of regime maintenance are underpinned by the means of 'military-led' politics and enclave capitalism economics. I demonstrate how North Korean promotes an enclave capitalism whose dominant rationality is political not economic and which tries to square the circle of opening to foreign capital as well as simultaneously closing to foreign contact. I show how the initial means of enclave capitalism have transmuted now into the ends of a new North Korean development strategy. In so doing I show how South Korean financed instruments of economic cooperation have the unintended effect of providing the means for

North Korea's ends. I further show how the North Korean strategy designed to achieve the goal of regime maintenance is underpinned by a two-level game that seeks long-term financial funding from Japan and in the short-term relies on economic assistance from South Korea. I outline the aims and philosophy of South Korean economic support to the North and summarize the unintended effects of the way in which South Korean funded economic cooperation instruments have been deployed. I demonstrate how current modalities of inter-Korean economic cooperation are therefore structurally biased against the achievement of South Korean objectives.

Different Political Objectives

The broad goal for North Korea and South Korea is unification of the peninsula. Both accept, however, that, in the short- and possibly medium-term, two ideologically opposite systems will continue to coexist within one country. Only at this rather high level of generality, however, do North and South Korean share political objectives. North Korea hopes for the eventual dominance of its own system over the whole peninsula.[1] South Korea's political objective appears to be for the North to ultimately and peacefully converge with the South around a liberal democratic polity. For fear of antagonising the North, South Korea is usually careful not to specify concrete political objectives. Instead policy goals remain coded as commitments to 'political reform, market economy, and prosperity on the Korean Peninsula.'[2]

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[1] Regular editorials in DPRK media make the goal explicit. See as a typical instance, 'The reality shows that…. [the DPRK can] bring the anti-imperialist, anti-US face-off to a successful conclusion, accomplish the building of a great prosperous powerful socialist country and national unification and accelerate the ultimate victory of the revolutionary cause of Juche.' See *The Pyongyang Times*, Saturday, August 2, 1999, p. 2.

[2] 'Presidents' Resolutions,' *Korea Now*, January 11, 2003, p. 5.

North Korean Objectives

Northern decision makers have not made any statements that display interest in allowing themselves to be incorporated within a pan-Korean democratic polity. There is no evidence whatsoever that the unification objective of the North remains anything other that the attainment of a political regime for the entire peninsula in which those currently holding power in North Korea would continue to play a large part in national policy making. The rest of the world, including South Korea, may not take these objectives seriously. The North Korean government does, however, consider its political objectives realistic. North Korean analyzes the contemporary politics in the South as being fruitful for a convergence of interest and values between North and South as one 'nation' – possessing joint interests in contra-distinction to the United States.[3] These shared values are 'anti-Americanism, independence, and national cooperation.'[4]

North Korea's policies designed to achieve the outcome of unification on its own terms are, in the short-term, the maintenance of military deterrence; the continuation of bilateral and multilateral diplomacy; the continued eliciting of bilateral humanitarian support from China and South Korea; and continued engagement with South Korea, again on its own terms. These policies are designed to contribute to achieving short-term goals of obtaining economic support to stem further socio-economic degradation; to build its preferred vision of market socialism as marketization without liberalization; and to stave off international isolation and possible military intervention from the United States.[5]

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[3] Editorial, 'Make this a year of brilliant victory,' in *Korea Today*, No. 3, Juche 93, 2004, pp. 6-7.

[4] *Ibid*., p. 7.

[5] I have developed this idea of marketization without liberalization as a way to understand the DPRK's economic policies in detail in Hazel Smith, *Hungry for Peace: International Security, Humanitarian Assistance and Social Change in North Korea* (Washington, DC: USIP Press, 2005).

South Korean Objectives

Underpinning South Korea's ideas of how unification will come about is the strong but often unstated premise that institutionalized inter-Korean political and economic integration will inevitably lead to the South Korean system peacefully prevailing over that of the North. This is because of what are seen as the natural, almost gravitational pull factors of the comparative advantages of the South Korean system, that is, freedom and prosperity. Thus peaceful unification through the provision of a 'good example' will take place.

The logic of South Korean engagement with the North seems to be that the very process of negotiations will engender confidence-building, information-sharing, and increased openness between the two sides and consequently between North Korea and the wider international community. The policy goal of dialogue as a short-term end in itself is predicated on the idea that the socialization of DPRK negotiators into global norms and the self-evident South Korean intention to prevent war or violent regime change in North Korea will eventually lead to increased trust of the South. Such trust will form the foundations of a Northern willingness to gradually dismantle economic, social, and political obstacles to institutionalized integration of the two states. Gradual openness to South Korean ideas should gradually lead, given the superiority of the South Korean system, to North Koreans freely choosing a unification project based on a liberal democracy polity.

The South Korean position seems to assume that once the South Korean system is recognized as a better system by sufficient numbers of people in the North, then a free choice could be made by key decision makers, if not the population as a whole, in favor of gradually abandoning the current North Korean system. This is a problematic premise given that many of North Korea's elite have a very realistic understanding that their privileges and power would be threatened

should North Korea be somehow incorporated into a democratic society. They are aware that in South Korea even previous presidents have not been immune from justice to the extent that they have been tried and imprisoned for wrong-doing. It is also difficult to identify any political trends within North Korea that might imply that in the future either the population or sectors of the elite could exercise the degree of choice in domestic or foreign policy that allow, effectively, for the political absorption of the North by the South. Indeed, as I demonstrate below, the unintended effects of the current modalities of South Korean economic cooperation contribute to achieving the rebuilding of the North Korean system in ways that are least compatible with South Korean objectives.

North Korea's Development Goals

Since the late 1990s North Korea's domestic development goal has been of regime maintenance and is therefore a political, not an economic, goal. The strategy is to prevent regime change – from inside or out. In pursuit of the strategic goal the government has decreed that the entire society should be reconstituted as a military force under the leadership of the army.[6] The armed forces, which have law and order functions as well as national defence capabilities, are the guarantor of regime maintenance. DPRK economic policies are designed to support the political reconstitution of the society around the military-led development project.

The economic objectives of building a modern industrial and technological capacity and developing an economic system of tightly

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[6] *Rodong Sinmun/Kulloja*, 'Invincible is the Workers' Party of Korea's high priority army politics,' reprinted in English in *Korea Today*, No. 10, Juche 88, 1999, pp. 11-18; For representative statement see 'Ever-Victorious Sword-High Priority Army Politics,' *Korea Today*, No. 12, Juche 88, 2004, p. 4.

controlled market socialism should be understood as functional in respect of the primary goal of regime maintenance. The medium-term strategy designed to achieve the goal of regime maintenance has political and economic strands. It is to consolidate the regime such that it can sustain itself without the constant necessity for crisis management – for instance by having to rely on the 'imperialists' of Japan and the United States for food aid to compensate for North Korea's continued substantial and now chronic food deficits.[7]

To a large extent the North Korean government has for the short- to medium-term adopted the development strategy of Latin American authoritarian regimes of the 1970s and 1980s – also adopted to prevent regime change from below or from outside. Entrepreneurs are allowed to flourish provided they keep their distance from the political realm. Political controls are retained over the population to control dissidence and the army acts as the guarantor of regime stability. The new North Korean development project is also similar to that of Cold War Latin American authoritarian capitalist regimes in two other ways; the embedding of poverty for large swathes of the population and the structural support for corruption as a necessary way of doing business. There are no plans to revive the extensive social welfare system that underpinned the Kim Il Sungist period and at the same time we see in North Korea the continued creation of a large class of marginalized poor people.[8] Also similarly to Latin America in the 1970s and 1980s, because of the relative freedom allowed to economic entrepreneurs and the necessity for those entrepreneurs to find their ways around the restrictive political controls that inhibit opportunities to maximize profit, the inevitable results have been growth in the

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[7] FAO, 'North Korea has bigger harvest but millions still need food aid,' November 23, 2004, http://www.fao.org/newsroom/en/news/2004/51607/.

[8] Hazel Smith, *Hungry for Peace: International Security, Humanitarian Assistance and Social Change in North Korea* (Washington, DC: USIP Press, 2005).

bribery and corruption as a necessary feature of doing business in the new DPRK.[9]

The Political Means: A Military-led Society

In the mid-1990s, following domestic economic collapse and the cut-off of external financial support, up to a million North Koreans died of famine.[10] North Korea has never published numbers of famine deaths although it openly recognizes the disaster that befell the county in its continued references to the period of the 'arduous march' after the famine in which all North Koreans struggled for survival.[11] In the wake of the economic collapse of the 1990s, North Korean reconstituted its political objectives around what it terms a 'military-led' or 'Songun' system.[12] In this system the entire society is instructed to operate as if it were part of a military organization. In this reconstituted North Korea 'all members of the society should model [*sic*] after the traits of soldiers.'[13] For North Korea the highly valued traits are obedience, discipline, and subordination to the leadership. These are neither implicit to North Korea's understanding of what constitutes

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[9] Hazel Smith, Crime and economic instability: The real security threat from North Korea and what to do about it, *International Relations of the Asia Pacific*, Volume 5, 2005, pp. 235-249; Hazel Smith, The disintegration and reconstitution of the state in the DPRK in Simon Chesterman, Michael Ignatieff, and Ramesh Thakur (eds.), *Making States Work* (Tokyo: United Nations University Press, 2005), pp. 167-192.

[10] For an exhaustive and rigorous analysis of famine deaths in the DPRK in the 1990s see Suk Lee, *Food Shortages and Economic Institutions in The Democratic People's Republic of Korea,* unpublished doctoral thesis, Department of Economics, University of Warwick, January 2003.

[11] For example, "Local industry in Kowon county," *Korea Today*, No. 10, Juche 88, 1999, p. 10.

[12] Editorial, 'Make this a year of brilliant victory,' in *Korea Today*, No. 3, Juche 93, 2004, pp. 4-7.

[13] *Ibid.*, p. 5.

necessary features of the reconstituted political system nor marginal features.

In the new era of the 'military-led' society 'working people… should put the interests of society and the collective above their own.' The society is rigidly hierarchical and its individual members have no rights to individual choice or dissent. This anti-democratic political system by definition provides structural restraints to political change – for to change to democracy it would have to overturn its own principles, norms, and institutions. It is also a system that is by definition controlled through the exercise of force and the threat of punishment. As in the military, those who do not obey orders are punished.

The Economic Means: The Pursuit of Enclave Capitalism

The North Korean government has had a clear policy of encouraging foreign investment since the creation of the state in 1948. It had imported technology, inputs, and know-how from the former communist states and when it could afford it, technology from the West.[14] In the 1980s however, the DPRK could not generate sufficient export earnings to service its debts and stopped paying its international creditors. International lack of creditworthiness combined with the end of concessionary support from former communist countries and China in the early 1990s resulted in a dramatic downturn in foreign investment, precipitating the famine conditions of the early and mid-1990s.[15] In 1995, lacking alternative sources of investment other

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[14] For summary of DPRK foreign and economic policy prior to the 1990s see Hazel Smith, 'North Korean Foreign Policy in the 1990s: The Realist Approach,' in Hazel Smith *et al*. (eds.), *North Korea in the New World Order* (London and New York: Macmillan and St. Martin's Press, 1996).

[15] For detail on pre-famine economic strategies, post-famine economic strategies, and the socio-economic change that too place in the DPRK from the 1990s

than from the major capitalist countries and requiring emergency inputs to put a halt to deaths from starvation and malnutrition, the government turned to the West for economic assistance and humanitarian aid.[16] It did so in such a way as to try to minimize the potential political impact of large numbers of foreigners doing business in the North.

One problem for the North Korean government was that its educational system and media had drawn a picture of foreign countries, especially South Korea, as having an inferior level of social, cultural, and economic achievement to that of North Korea. An unmediated exposure to large numbers of foreigners, even those who did not speak Korean, would have exposed this picture of the outside world as false. Large-scale access to alternative sources of information, combined with visible long-term immiseration for most of the population, could have provided grounds for political unrest. Another objective was for the government to gain maximum credit for any economic success story such as to help re-build the domestic legitimacy of the regime.

A priority therefore was to prevent large numbers of foreigners having unimpeded access to the population and perhaps fomenting dissent. The North Korean government thus searched for a framework for DPRK-capitalist cooperation that could encourage foreign investment but at the same time prevent anything other than superficial interaction of foreigners with the North Korean population.

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onwards see Hazel Smith, *Hungry for Peace: International Security, Humanitarian Assistance and Social Change in North Korea* (Washington, DC: USIP Press, 2005).

[16] For details of these negotiations see Hazel Smith, *Overcoming Humanitarian Dilemmas in the DPRK* Special Report No. 90 (Washington, DC: United States Institute of Peace, July 2002).

Developing the Enclave Model

In 1991 the DPRK designated the remote north-eastern region of Rajin-Sonbong as a special economic zone in an attempt to encourage foreign investment in the region and to promote international trade. In the mid-1990s, in the wake of the 1994 Geneva agreement and the creation of the multilateral Korean Peninsula Energy Development Organization (KEDO), the government designated a fenced-off site in the east of the country at Kumho for the building of two light-water nuclear reactors. The Kumho light water reactor site was designed to provide a hermetically sealed site for state-controlled receipt of foreign capital investment and advanced technology, mainly from South Korea and Japan.

Rajin-Sonbong was part of the UNDP Tumen River Area Development Programme: A regional cooperation zone that also included bordering remote areas of China, Russia, and eastern Mongolia. Rajin-Sonbong did not attract major foreign investment – less than one hundred million dollars between 1991 and 2000.[17] It did, however, provide a forum in which North Korean senior government officials could interact with South Koreans, thus providing one of the few arenas of direct dialogue before the great thaw between North and South that started in 2000 with the meeting of South Korean President Kim Dae Jung and North Korean leader Kim Jong Il.

Reasons for lack of economic success included the lack of infrastructure including decent roads and reliable rail transport into North Korea and out through China and Russia; poor telecommunications; and irregular and inadequate electricity and water supplies. Another reason was that possibilities were not available for market expansion back into North Korea. The North Korean

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[17] For investment data see Tumen Secretariat, *Tumen Update*, No. 3, Beijing, October 2000, p. 13.

government deliberately discouraged interlinkage backwards into the DPRK society and economy. The inhospitable mountains separating Rajin-Sonbong from the rest of the country were seen by the North Korean government as a plus not a negative factor in the promotion of Rajin-Sonbong as an enclave for capitalist enterprise. Foreigners would thus be geographically prevented from contact with the North Korean population. The foreigners who visited Rajin-Sonbong, of which there were 90,000 in 1999, were kept under close scrutiny with South Koreans particularly subject to suspicion.[18]

At Kumho, the North Korean government physically cleared the site of the local North Korean population. Only North Korean technicians and service workers were permitted to stay on site. Visiting foreign technicians and officials were not permitted to leave the site. Uzbeki workers brought in by the management organization, the Korean Peninsula Development Organization (KEDO) endured conditions verging on penal servitude. They were contracted for one year for less than $200 a month and were not allowed to leave the Kumho construction site, which lacked all but the most basic facilities, during the entire year long contract.[19]

Both the Rajin-Sonbong and the Kumho KEDO project provided testing grounds for the enclave strategy. The DPRK learned from the experiences of Rajin-Sonbong and Kumho that its interlocutors in the West would be prepared to accept severe restrictions of freedom of movement of foreign staff and visitors; that conditions of labor were

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[18] South Korean academic staff at Yanbian University of Science and Technology, in the Yanbian area of China that is also part of the Tumen River special economic zone, informed me in 2002 that two of their number had been arrested and imprisoned in Rajin-Sonbong after their deliveries if food and goods to children's nurseries had brought them under suspicion of spying.

[19] Uzbeki sources report that Uzbeki workers were paid just $110 a month. See http://uzland.freenet.uz/2001/march/19.htm. North Korean workers had been paid $110 a month, and when they demanded more money, KEDO refused to pay and imported Uzbeki workers who were also paid low wages. The sum of $200 is from my interviews with KEDO officials.

not a priority negotiating objective for foreign investors; and that an acceptable modus operandi was to physically segregate foreigners from the North Korean population. The North Korean government thus adopted this model as the template for inter-Korean economic cooperation, which began in the late 1990s with the Hyundai sponsored Mount Kumgang tourism project, and was followed by the Kaesong joint industrial zone in the early 2000. The North Korean government saw the Mount Kumgang project as a way to generate millions of dollars of hard currency while the Kaesong project was viewed as providing a vehicle through which large-scale capital and high-end technology could be transferred.

North Korea further demonstrated its commitment to the enclave strategy in its attempt to push through an international free trade zone in Sinuiju on its north-western border with China. The plan failed as it did not have the cooperation of the Chinese government.[20] Intrinsic to the plan was the non-voluntary relocation of the entire population of Sinuiju, some 340,000 people, from their homes to what would have been a newly created residential area. What was also planned was the building of a wall to prevent anything other than minimal contact of the displaced population with foreigners.

The Modalities of SEZ Cooperation

The DPRK considers it has a unilateral political and sovereign right to insist on specific modalities of economic cooperation. These included the 'macro-modalities' of the principles of economic cooperation as well as the 'micro-modalities' of the procedures of

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[20] See Hazel Smith, Asymmetric nuisance value: The border in China-Democratic People's Republic of Korea relations, in Timothy Hildebrandt (ed.), *Uneasy Allies: Fifty Years of China-North Korea Relations* (Washington, DC: Woodrow Wilson Center Asia Program Special Report, September 2003), pp. 18-25.

inter-Korean economic cooperation. In the South Korean-funded economic zones these macro-modalities adhered closely to those principles understood by the North Korean government as necessary for regime protection. The local North Korean population was excluded from both sites except as they were needed as workers. South Korean businesses were not given control over the labor they employed; and foreigners, whether as tourists to Mount Kumgang or employees in Kaesong and Mount Kumgang, faced strict controls in terms of their interaction with local counterparts and North Korean workers.[21]

Politically driven macro modalities were mirrored by politically driven 'micro-modalities' that sought to maintain a one-sided control over business dealings with the South. These included insisting on cash transfers, inadequate accounting procedures, refusal to permit productivity-linked wages, one-sided arbitrary decision-making, and sideline payments. Such non-transparent methods had been inherited from the way in which North Korean business and the government had learned to engage in economic cooperation with foreigners in the past: North Korean economic strategies have now internalized and institutionalized these modalities within SEZ practice. Macro- and micro-modalities of inter-Korean cooperation are intrinsically non-liberal and, in a liberal capitalist sense, non-economic.

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[21] Lim and Lim argue that South Korean businesses have greater autonomy in labor management in Kaesong than in the past. This may be true in relative terms. In practical terms, as Lim and Lim acknowledge, all decisions regarding labor polices must be negotiated with the 'representatives of Kaesong SEZ workers' which in the context of North Korea means the North Korean government. See Kang-Taeg Lim and Sung-Hoon Lim, *Strategies for Development of a North Korean Special Economic Zone through Attracting Foreign Investment*, Studies Series 05-01 (Seoul: Korea Institute for National Unification, 2005), pp. 47-48. Lim and Lim's generally rather optimistic analysis of the potential for SEZs in North Korea also notes that one of the problems in Kumgangsan is that 'more free activity to individual tourists' needs to be permitted, *ibid*., p. 38.

Experimenting with Exceptions

North Korea did not confine its attempts to secure funding from abroad to promoting special economic zones. The government experimented with different modes of economic interaction with the outside world from the 1990s onwards; most importantly with the international humanitarian organizations and with foreign business. These diverse interactions were, except for the experience with the humanitarian agencies, politically controllable. Economically, however, they proved not to be substantial or viable enough to provide a foundation for North Korea's economic reconstruction.

The Humanitarian Organizations

The government received significant funding from the multilateral humanitarian and development organizations, and NGOs, particularly the United Nations World Food Programme (WFP).[22] The WFP contributed around $300 million dollars of aid a year through the late 1990s at a time when the DPRK's export earnings were hardly double that amount. This funding came at a political cost to North Korea. The World Food Programme, as did all the major agencies, insisted on accountability of monies spent in terms of transparent reports back to donor governments and of using the principles of efficiency and fairness when allocating relief aid. The DPRK government found the transparency required of them intrusive and sometime threatening. As relations with the United States deteriorated through the 2000s, the government increasingly took the view that national security was jeopardized by allowing foreigners, even those employed by the

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[22] Hazel Smith, *Hungry for Peace: International Security, Humanitarian Assistance and Social Change in North Korea* (Washington, DC: USIP Press, 2005).

humanitarian organizations, to travel, observe, and analyze North Korean society.[23]

North Korea had managed to find ways to gradually accommodate the demands for transparency of the humanitarian organizations up until the early 2000s. It had done so reluctantly but because it continued to require very large amounts of food, agriculture and medical assistance that it could not afford to buy and that could only be obtained from multilateral agencies. From the early 2000s, however, North Korea became less reliant on multilateral humanitarian aid as bilateral aid from China and South Korea flowed into the country.[24] Bilateral aid did not require the detailed reporting and monitoring that had been a condition of multilateral aid and was therefore more attractive to the North Korean government.

In 2004 the North Korean government announced that it wanted the humanitarian agencies to cease operating in the DPRK. The rationale was that harvests were improving and the government no longer needed humanitarian food assistance but instead wished to attract development funding. In fact, DPRK agricultural production continued to be so inadequate that without South Korea's annual assistance of substantial amounts of fertilizer and food aid the population would again face the starvation of the 1990s.[25] In addition, development funding in the sense that 'development' is conventionally understood would have required much more intrusive socio-economic data collection and analysis than anything that had been hitherto undertaken by the humanitarian agencies.

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[23] For detailed discussion on the changing nature of DPRK interaction with humanitarian organizations see *ibid., idem*.

[24] Mark E. Manyin, 'Foreign Assistance to North Korea,' *CRS report* (Washington, DC: Congressional Research Service, 2005), pp. 24-28, reproduced on http://www.fas.org/sgp/crs/row/RL31785.pdf.

[25] For 2004/2005 cereal deficit predictions see FAO, 'North Korea has bigger harvest but millions still need food aid,' November 23, 2004, http://www.fao.org/newsroom/en/news/2004/51607/.

Non-South Korean Foreign Business Investment

North Korea encouraged foreign business to invest in the DPRK through offering very favorable tax incentives. The various handicaps to investment including poor infrastructure and absence of business-oriented socio-economy, however, combined with the intense competition from business-friendly China, meant that these ventures were not successful in bringing substantial amounts of foreign capital or significant technological transfers. The experience of foreign business in dealing with North Korean business and government was that a political rationality always trumped economic imperatives. This resulted among other things with contracts being unilaterally and abruptly changed, terminated, or not honored.[26]

Chinese businesses may have had a comparative advantage in having experience of working around politicized decision-making in economic affairs.[27] They were, to a large extent, border traders from Korean speaking areas in China with the additional comparative advantage of knowing the Korean language. They also managed to find their way around the new North Korean system by relying on cash transactions, petty or major corruption and were able to cope with the degree of opacity required by North Korean interlocutors. These businesses operated at a relatively low level of economic activity, however, and by their nature could not bring the quantity of foreign capital and advanced technology that the DPRK needed to support its

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[26] There is a favorable report on the success of South Korean business in non-enclave North Korean business initiatives in Pyongyang, Nampo, and Sinuiju, in '80 percent post profits in Inter-Korea Trade,' *Korea Now*, August 24, 2002. This should be contrasted with the more sober assessment of Young-Yoon Kim in 2005 who reports that 65 percent of South Koran businesses operating in the DPRK 'considered that their business... was not going well.' Young-Yoon Kim, *Evaluation of South-North Economic Cooperation and Task for Success*, Studies Series 05-03 (Seoul: Korea Institute for National Unification, 2005), p. 31.

[27] Information in this paragraph from author's interviews with Chinese traders based in Dandong, China, and Pyongyang, DPRK, 2000-2001.

re-development model.

Miscellaneous Sources of Capital

The government also received financial transfers from other diverse foreign sources. These included over twenty million dollars from the United States Department of Defence in the 1990s and 2000s in return for access to military teams searching for the remains of those missing in action in the Korean War.[28] Other sources of income included arms sales. Annual transfers of substantial but undocumented sums of hard currency from the London insurance markets with which it held policies in respect of natural disasters and harvest failure also took place.[29] North Korea has been accused of engaging in criminal activities such as currency counterfeiting and drugs production and shipments, although there has been little hard evidence to support claims that such activities are directly organized by the government.[30]

The Enclave Model as Development Ends

By the mid-2000s the North Korean government believed it had found solutions to its food and economic problems – mainly through the channelling of South Korean resources into meeting its development objectives. Firstly, the North Korean government no longer needed to submit to the politically uncomfortable processes of openness to the

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[28] Mark E. Manyin, 'Foreign Assistance to North Korea,' *CRS report* (Washington, DC: Congressional Research Service, 2005), p. 33, reproduced on http://www.fas.org/sgp/crs/row/RL31785.pdf.

[29] Interviews with insurance company assessors in Pyongyang 2001.

[30] The most well-documented incident was the Australian seizure of a North Korean ship carrying 50 kilos of heroin that ran aground on a beach I Victoria, Australia in 2003. See Alan Boyd, 'North Korea: Hand in the cookie jar,' *Asia Times*, April 29, 2003, reproduced on http://www.atimes.com/atimes/Korea/ED29Dg01.html.

humanitarian organizations, as it was more or less assured that the basic food needs of the population would be taken care of through bilateral and hence unconditional aid from South Korea and China. Second, foreign business investment remained welcome but only insomuch as it kept to the terms of trade established by the North Korean government. Thirdly, North Korea's decade and a half of experience of Special Economic Zones had convinced the government that it could attract foreign capitalist investment and expand international trade without opening up the rest of the country to physically free access to foreigners. Special Economic Zones (SEZ) 'North Korean style' thus evolved as a way to square the circle of opening to foreign capital at the same time as closure to foreign contact.

The SEZ strategy did not solve all the governments' economic problems. The government for instance periodically tried to regain control over markets, particularly the buying and selling of grains, and had not been successful in doing so. The government was less concerned about the petty trading mechanisms that had ensured survival for most North Koreans since the mid-1990s since the government had not been able to provide even basic food rations. It was, however, concerned that if private grain traders or more productive cooperative farms became rich through their own independent participation in the market, this could herald the formation of a powerful social group with potential political interests separate, even contrary, to that of the government. The government's determination to channel large-scale transfers of capital into the controlled and supervised geographically fenced off SEZ sites might, however, prevent the growth of political alliances between those potentially enfranchised as interlocutors for foreign capital (senior military and party officials), the *nouveau riche* (those that grew wealthy from domestic trading), and the better-off farmers.

Short-term Economic Results

The largest of the private South Korean investors, Hyundai, has not yet made a profit from the Mount Kumgang project. Despite the North trumpeting its advantageous labor costs and favorable tax policies, nearly two thirds of South Korean investors made a loss in their North Korean projects.[31] South Korean business also found that overall production costs are cheaper if goods are made in China.[32] Projects were abandoned for reasons that included unilateral suspension by the North, disputes during the project and lack of profitability.[33]

Bradley Babson and Yoon Deok Ryong, in their realistic and not unsympathetic treatment of DPRK development strategies, note that special economic zones are successful to the extent that they are situated in commercially attractive areas; increasing policy liberalization and experimentation takes place; and there is increased private involvement in the management of such zones.[34] This is perhaps to miss the point. North Korea's purpose in establishing special economic zones is not the same as that of conventional liberal economic planners. For North Korea, the purpose of SEZ policy is to avoid policy liberalization and to reinforce government, not private,

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[31] Young-Yoon Kim, *Evaluation of South-North Economic Cooperation and Task for Success*, Studies Series 05-03 (Seoul: Korea Institute for National Unification, 2005), p. 32.

[32] In one survey three out of four South Korean businesses found it was cheaper to produce in China than North Korea. See Jong-geun Lee, 'Research on the structure of processing trade between two Koreas,' M.A. dissertation (Kyungnam University, December 2002), used as the basis for a table on 'Comparison of the Production Cost of Processing Trade with North Korea and China' in Young-Yoon Kim, *Evaluation of South-North Economic Cooperation and Task for Success*, Studies Series 05-03 (Seoul: Korea Institute for National Unification, 2005), p. 19.

[33] *Op. cit.*, p. 31.

[34] Bradley Babson and Yoon Deok Ryong, 'How to finance North Korea's capital requirements for economic recovery,' in *East Asian Review*, Vol. 16, No. 2, Summer 2004, p. 90, reproduced online at http://www.ieas.or.kr/vol16_2/16_2 _4.pdf.

control over investments. The lack of short-term economic success is therefore not surprising.

Medium- and Long-term Aims

The North Korean government had thus two aims for SEZ policy. The first was as part of the means to re-establish control over the broader national economy such that capital and technology transfers could take place to build the foundations for re-development without exposing the North Korean population to the impact of uncontrolled information from foreigners. Secondly, Special Economic Zones would serve as government-controlled sites for receipts of large-scale Japanese capital and technology subsequent to a political deal on the nuclear issues being agreed. The SEZ had become much more than a singular element of a broader foreign economic strategy but instead had become in many ways the economic strategy itself.

The Two-level Economic Game

The DPRK engaged in a number of diplomatic and commercial interactions in order to try to find funding for re-development. It was successful in gaining large-scale humanitarian assistance from a variety of states, international governmental organizations, and non-governmental organizations. It was, however, less successful in persuading foreign business to invest in any significant sense. It was also unable to persuade the major international financial institutions to lend substantial amounts and, because it is still a major international debt defaulter, it was not able to secure international investment loans from private or public sources.

By 2005, the DPRK had accumulated a reasonable knowledge of where economic support for its development project might come

from and where it might not. It had reluctantly ruled out the European countries and the European Commission as a source of inputs. It understood that the European concentration on improving human rights in the DPRK and preventing nuclear proliferation combined with the lack of a hospitable economic climate in the DPRK meant that significant sums from Europe were not going to be forthcoming. It also realized that despite its rhetoric to the contrary, it was not United States sanctions policies that prevented the growth of North Korea's trade and foreign investment inflow. China after all had a wide-open (for business) 1,000 mile border with the DPRK. Neither political nor human rights prevented the growth of commerce with China. More significant obstacles were the appalling transport and communications infrastructure; the lack of security for investors; poor quality North Korean products; and lack of capital to purchase technology and necessary inputs.

North Korea learned from some of the experiences of interaction with the outside world to the extent that by the mid-2000s, North Korea's economic strategy evolved as a two-level game. At the macro-level, the political negotiations designed to dismantle the North's nuclear weapons capabilities were understood as eventually providing a payoff in that a political deal on the nuclear issues would be followed by substantial foreign investment. Some funding might eventually come from the international financial institutions but North Korea was not counting on the World Bank or the IMF in the short-term. Instead the DPRK was confident that it would receive substantial sums from Japan in the wake of a security deal, probably in the region of between 50 to 100 billion dollars.[35] These payments would be analogous to those received by South Korea in 1965 and

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[35] Mitsuru Mizuno, 'Japan's Development Assistance: Implications on [*sic*] North Korean Development,' reproduced in The Export-Import Bank of Korea/ University of North Korean Studies, *International Symposium on North Korean Development and International Cooperation*, mimeo, Seoul, July 6-7, 2005, p. 18.

would be designed to settle outstanding claims for restitution and compensation for Japanese colonialism and wartime occupation. Japan announced that substantial payments will be forthcoming in the aftermath of normalization of diplomatic relations with the DPRK, including grants, long-term concessional loans, and humanitarian assistance.[36] They are unlikely to be conditional on domestic economic or political reform.

At the micro-level and in the short-term North Korea's strategy was to increasingly rely on economic assistance from the South Korean government and South Korean NGOs; as well as investment from South Korean large- and small-scale businesses. South Korean trade and investment was not large in South Korean terms, either in absolute amounts or in percentage terms of national wealth. By 2003 total inter-Korean trade amounted to only around three quarters of a million dollars, that is a mere 0.09 percent of South Korean GDP and nearly a half of this comprised humanitarian assistance to the North.[37] From the North Korean perspective however, these financial flows from South Korea were large enough to enable the DPRK to support a stabilization of the economy, albeit around a low level of economic activity. More importantly South Korean investment gave a breathing space to the government so it could reconstitute the economy around its development project of authoritarian marketization.

The importance of South Korean economic assistance can be demonstrated in trade and investment terms. North Korea had only achieved a slight recovery in its export capacity since the 1990s with total exports rising from around $650 million dollars in 1998 to around one billion dollars in 2003.[38] By 2003, however, South Korea was

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[36] *Ibid*, p. 17 of the reproduced paper. No page numbers given for the entire volume.

[37] Young-Yoon Kim, *Evaluation of South-North Economic Cooperation and Task for Success*, Studies Series 05-03 (Seoul: Korea Institute for National Unification, 2005), pp. 6-7.

[38] *Ibid.,* p. 6.

North Korea's second largest export destination, second only to China.[39] China's trade with South Korea continued to increase in 2004 while South Korea's slightly diminished and in absolute terms also provide a significant source of financial support for the North Korean economy.[40] South Korean economic relations with North Korea are significant, however, not just because they are also relatively large but because South Korea is a technologically developed, fully capitalist and democratic country with which North Korea has hopes of eventually uniting. South Korea is a member of the OECD, the club of the richest countries in the world, and its methods of economic operation are governed by economic regimes that also govern the major capitalist countries including the United States and Japan.

South Korean investment was, crucially for the North, not made conditional on economic or political reform, either in macro-institutional terms or in terms of micro-business interaction with the DPRK. In macro-terms, South Korea did not wait for instance for the implementation of judicial or regulatory reform that would have ensured more security for the South Korean investor, for instance in ensuring that might have ensured that contracts once signed could not be arbitrarily changed or cancelled. Neither was South Korean business and government investment made conditional on the application of international labor and business norms in South Korean-funded enterprises.

South Korean businesses remained unable to hire and fire labor – nor were they permitted to provide incentives for individual workers so as to encourage productivity or, conversely, impose penalties to

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[39] *Ibid*., p. 5.

[40] Dae-Kyu Yoon and Moon-Soo Yang, 'Inter-Korean economic cooperation for North Korean Development: Future Challenges and Prospects,' in The Export-Import Bank of Korea/University of North Korean Studies, *International Symposium on North Korean Development and International Cooperation*, mimeo, Seoul, July 6-7, 2005, no page numbers given.

sanction lack of productivity. North Korea also took as much care as it could to avoid the free movement of South Korean persons on its territory, refusing to allow systematic monitoring for instance of the substantial amounts of food and fertilizer aid by South Korean agronomists and technical personnel.[41] This means among other things that the modalities of multilateral humanitarian assistance that were so carefully developed through nearly a decade of tough negotiation with the North Korean government and which introduced principles of accountability, transparency, and efficiency to North Korea along with the aid itself were undermined.[42]

South Korean Aims and Philosophy

The successful visit of President Kim Dae Jung to Pyongyang in 2000 had opened up hitherto unimagined political, social, and economic communication between North and South. The South was for the first time able to engage in substantial bilateral relations with the North, visually epitomized by the joint entry into the Sidney Olympiad opening ceremony in 2000. As the DPRK's political relations became ever more tense with the two Bush Administrations in the United States the South found itself increasingly in the position of mediator and political conduit between the North and the outside world.

The national 'we' feeling engendered by the renewed hope that

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[41] Some of this is hinted at *ibid.*, no page numbers given. I interviewed agronomists that accompanied the fertilizer aid to North Korea's main port of Nampo in 2002 in Seoul. The South Korean agronomists were not permitted to leave the hotel in Nampo or the shipyard area in working hours. They could not visit Pyongyang or the farms to which the fertilizer was to be sent.

[42] For details of these negotiations see Hazel Smith, *Overcoming Humanitarian Dilemmas in the DPRK* Special Report No. 90 (Washington, DC: USIP, July 2002).

the Korean nation and the increasing disbelief that the North could be a military threat given its poverty and economic weakness further inclined South Korea to what were for the South paltry amounts of economic transfers to the struggling North. Given the relative small amount of funds, the consequences of the modalities of economic transfers were not either properly understood or, if considered, understood as temporary, conjunctural, and easily reversible difficulties.

South Korean policy was to encourage increasing numbers of inter-Korean cooperative economic projects while at the same time to negotiate for gradual and incremental improvements in the quality of those exchanges. South Korean economic and humanitarian support was not, however, conditional on improved quality of implementation of projects. The South Korean government did not demand for instance that South Korean businesses have hire and fire authority over local labor. The problems in the quality of cooperation are various and include 'transportation, the payment system, and communication system, causing problems in the quality of the product.'[43] Payment is often demanded before the South Korean investor even visits the DPRK for the first time and failure to meet due delivery dates continues to be a major issue. When goods are produced, it is 'almost impossible' for South Korean investors to control the quality of production as they are not permitted to send quality control inspectors into the factories.[44]

South Korean philosophy was that the process of negotiation would of itself lead to improvements and if it did not some incremental change in the right direction was better than none at all. The overall philosophy – of South Korean business and of South Korean govern-

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[43] Young-Yoon Kim, *Evaluation of South-North Economic Cooperation and Task for Success*, Studies Series 05-03 (Seoul: Korea Institute for National Unification, 2005), p. 39.

[44] *Ibid*., p. 43.

ments – was to accept economic irrationality and lack of profitability in inter-Korean cooperation for the greater good of working for national unity.

The issue of providing bilateral aid to North Korea was defended as less costly for the South Korean government and, because bilateral food aid was delivered on concessional loan terms, as encouraging the North Koreans to understand that they would have to engage in reciprocity and pay back the loans at some point.[45] The last point is somewhat disingenuous as nobody seriously expects that the North will pay back the food loans. The costliness of the WFP operation is no doubt a factor and these costs include payments for the extensive monitoring and evaluation exercises that will be foregone if WFP no longer works in the DPRK. Another reason for South Korean preference for bilateral aid is that the government favors monetization of food aid and may hope that the substantial amounts of food aid it sends is sold in markets as a way to reinforce the marketization processes that it wishes to see grow in the North.[46] One obvious problem with this approach is that food aid goes to those that can afford it not to those who most need it.

The Unintended Effects of South Korean-funded Economic Cooperation

Kang-Taeg Lim and Sung-Hoon Lim note that North Korean SEZs were 'designed to be of benefit to business but also for

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[45] Chung-In Moon, 'Why Seoul helps the North,' *International Herald Tribune*, September 30, 2005, reproduced on http://www.iht.com/articles/2005/09/30/opinion/edmoon.php.

[46] The United States and South Korea monetize food aid as a matter of policy. For discussion of the problems see Sophia Murphy and Kathy McAfee, *US Food Aid: Time to Get it Right* (Minneapolis: Institute for Agriculture and Trade policy, 2005).

overcoming economic difficulties... as well as constructing a base for future economic growth... [the SEZ] is going to have a relationship with a capitalist system and play the role of being a test ground for the North Korean economy.'[47] Lim and Lim also argue that the North Korean approach to SEZ policy 'will have an important influence on the national economic system.'[48] These influences may not necessarily be as positive as South Korea seems to hope.

Two million dollars worth of South Korean investment has been channelled into geographical enclaves.[49] These sums, while negligible in relation to the South Korean economy, are significant for North Korea. South Korean investment thus allowed the North to implement experimental economic strategies designed to promote tightly controlled enclave capitalism. South Korean government policy of relatively unconditional investment fitted well with North Korea's approach to economic and political development. It did not disturb North Korea's preferred foreign economic strategy of promoting 'enclave capitalism' that it saw as underpinning the overriding development goal of reconstituting the DPRK as a 'military-led' hierarchically organized society, obedient to the leadership, whose primary purpose was regime maintenance. Insofar as the South Korean approach to economic cooperation gave credibility, legitimacy, and financial support to politically controlled economic projects intrinsic to which are the subordination of the individual to the state, it also had the inadvertent affect of giving support to the North's military-first policy.

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[47] Kang-Taeg Lim and Sung-Hoon Lim, *Strategies for Development of a North Korean Special Economic Zone through Attracting Foreign Investment*, Studies Series 05-01 (Seoul: Korea Institute for National Unification, 2005), p. 20.

[48] *Ibid*.

[49] Young-Yoon Kim, *Evaluation of South-North Economic Cooperation and Task for Success*, Studies Series 05-03 (Seoul: Korea Institute for National Unification, 2005), p. 25.

Contrary to South Korean hopes, the North Korean government did not commit itself to using the inter-Korean economic zones as a means to introduce liberal economic principles and practices into the DPRK economy – much less of using these as a means to allow trickle down into the rest of the economy of such principles. Perhaps even more worrying for South Korea, South Korean-funded economic cooperation within the special economic zones was encouraged because it supported the North's political rationality for the promotion of special economic zones as a means to re-establish the *ancien régime*. South Korean-funded economic instruments of inter-Korean cooperation have thus contributed to a North Korean development goal that is intended to establish the foundations for a unification outcome that is very different from that envisaged or desired by South Korea.

Understanding crossed Purposes: Re-calibrating Means with Ends

Young-Yoon Kim provides a salutary warning when he remarks that the 'North Korean government regards South-North economic cooperation as a means to obtain foreign currency and advanced technology without the reformation of internal economy system.'[50] This warning perhaps does not go far enough. The fact is that North Korea's internal economic system is being reconstituted but that this reconstitution is based on economic principles which are not likely to lead to either economic growth or what South Korean decision-makers had hoped for, that of political liberalization.

Non-economic modalities of economic exchange have become the standard operating procedures (SOPs) of inter-Korean exchange.

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[50] *Ibid.*, p. 27.

These SOPs have become institutionalized as the 'normal' pattern of economic interaction in the SEZs that North Korea expects to use as the major vehicle for the receipt of foreign capital and technology. This non-economic rationality will be very difficult to alter once it is established and underpinned by capital and technology transfers. Another difficulty arises because SEZ-based cooperation forms a major part of inter-Korean cooperation, which is itself the most substantial of North Korean economic links with the West. The patterns of cooperation established through the further expansion of SEZ-based inter-Korean cooperation will therefore be consequential for the way the North Korean government enters into all its foreign economic relations.

South Korean hopes to achieve unification through an incremental process of economic interaction and dialogue and uses the policy of support for SEZs as a way to encourage dialogue with the DPRK for the broad objective of 'promoting reconciliation.' North Korea's more concrete objective is to use fenced-off investment zones to consolidate government control over financial transfers into the DPRK. The North's aim is to re-constitute the ways of doing business that were formerly characteristic of the top-down governmental economic methods of the pre-1990s.

I do not argue that it is necessary for South Korea, in order to safeguard its own interests and strategic objectives, to abandon what has been a politically productive economic engagement strategy. It is after all possible that North Korea will not achieve its intended aims, however hard it seeks to channel South Korean cooperation in the direction it prefers, simply due to the law of unintended affects. North Korean society in other words may gradually transform itself in the direction preferred by South Korea through a sort of automatic process in the direction of liberal capitalism. I do argue, however, that simply hoping for transformation is a risky strategy for South Korea, given

the determined planning by its counterpart to try to prevent such an outcome.

Instead, I argue, South Korean means need to be re-calibrated with South Korean ends. The modalities of economic cooperation need to be modified in the light of the significantly large unintended and undesirable effects, at least from South Korea's perspective, of current modalities of inter-Korean cooperation. I also argue that the South Korean unilateral approach to economic cooperation, while beneficial in opening up relations with the North, has now run its course. A determined complementary strategy of economic and humanitarian multilateralism will enable it to pursue its own agenda at the same time as supporting the moral imperative, shared by the majority of South Korea's electorate of every political hue, of assisting the impoverished North Korean population in the short-, medium-, and long-term.