

Silent Partners



Chinese Joint Ventures in North Korea

Drew Thompson

February 2011

A U.S.-Korea Institute at SAIS Report

Silent Partners:

Chinese Joint Ventures in North Korea

Drew Thompson

February 2011

A U.S.-Korea Institute Report

About the Author

Drew Thompson is the Director of China Studies and Starr Senior Fellow at The Nixon Center. Prior to joining The Nixon Center, he was the National Director of the China-MSD HIV/AIDS Partnership, an Assistant Director to the Freeman Chair in China Studies at the Center for Strategic and International Studies (CSIS), and the President of a Washington, D.C. company that manufactured snack food in Qingdao, China. Thompson also founded the American Chamber of Commerce Transportation and Logistics Committee in Shanghai. Thompson studied Chinese language at Beijing University in 1990, and was a graduate student in 1992 at the Johns Hopkins University Center for Chinese and American Studies in Nanjing, China. He graduated cum laude with a B.A. in Asian Studies from Hobart College in 1992. In 2004, he received an M.A. in Government, with a concentration in Homeland Security, from Johns Hopkins University.

Copyright © 2011 by the U.S.-Korea Institute at SAIS
Printed in the United States of America.
All rights reserved.
www.uskoreainstitute.org

The U.S.-Korea Institute (USKI) at the Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, works to increase information and understanding of Korea and Korean affairs. USKI's efforts combine innovative research with a repertoire of outreach activities and events that encourage the broadest possible debate and dialogue among scholars, policymakers, students, NGO and business leaders, and all those with an interest in the Korean peninsula. USKI also sponsors the Korea Studies Program at SAIS, a growing policy studies program preparing the next generation of leaders in the area of Korean affairs. For more information, visit www.uskoreainstitute.org.

Cover design by Jenny Town.

Executive Summary

China is considered North Korea's economic lifeline. Chinese aid, trade, and investment are critical to North Korea's social stability and economic productivity and a key source of technology and hard currency. Presumably, without this trade and investment, Kim Jong-il would lack the means to secure the allegiance of elites that support his rule, making trade and investment with China particularly important for ensuring the regime's survival. Joint ventures with China are an important aspect of the bilateral relationship, because in addition to propping up the regime in Pyongyang, they contribute to economic development in China's northeastern "rust belt." These Chinese financial investments in the DPRK are geopolitically significant not only in terms of Chinese strategic interests but also for South Korean aspirations to unify the peninsula. Efforts by the international community to isolate North Korea and to impose sanctions in response to its efforts to develop nuclear weapons and its other provocative behaviors are complicated by the economic relationship between China and North Korea.

Chinese investments in North Korea reflect China's strategic outlook on Northeast Asia and the role of North Korea in China's grand strategy for the region. China's relationship with North Korea is central to its effort to achieve "great power" status, and a key aspect of China's perception of its place in the region and the international system. While the relationship between China and North Korea is unique, Chinese investment in North Korea is consistent with China's wider "go abroad" effort. There is little or no evidence that Chinese investments in North Korea are politically driven, motivated by a shared communist ideology, or part of a grand strategy specific to the peninsula. Trade and investment with North Korea is consistent, however, with China's broad national interest in promoting stability in North Korea and supporting economic development in border regions and the northeastern provinces.

Chinese investment projects in North Korea, however, are smaller and less successful than projects in neighboring states. For example, from 2003 to 2009, Chinese outbound investments to North Korea totaled US\$98.3 million, compared to US\$1.2 billion to South Korea, US\$273 million to Thailand, US\$437 million to Vietnam, US\$729.8 million to Myanmar, and US\$890.7 million to Mongolia over the same period. North Korea is a particularly difficult environment for Chinese investors due to rent seeking, poor infrastructure, and the oppressive

political environment.

Only two of China's top 100 companies are investors in North Korea, both steel companies. The majority of Chinese investors in North Korea are small and medium-sized enterprises, though some smaller firms enjoy brand recognition, such as Nanjing Panda, China Minmetals, and Wanxiang. The majority of Chinese investors in North Korea are not State Owned Enterprises (SOEs) controlled by the central government, but privately owned companies and provincial, prefecture, and municipal-owned SOEs. As far as one can tell, only four out of the 138 investors identified as legitimate investors are central-government owned companies.

Of the 138 joint ventures established between 1997 and August 2010, 41 percent are in extractive industries, 38 percent light industrial, 13 percent services, and eight percent heavy industry.

Chinese investors in North Korea are geographically concentrated in the two northeastern provinces bordering North Korea. Twenty-eight percent of Chinese companies involved in joint ventures are from Jilin, 34 percent are from Liaoning, and the balance are from other provinces, including Beijing, Shandong, and Shanghai. Jilin and Liaoning share a 1,400 kilometer border with North Korea and are increasingly focused on foreign trade and on achieving competitive economic advantages through their proximity to North Korea. Approximately one million Korean-speaking Chinese is the only significant population of native Korean speakers abroad who can freely do business with North Korea, giving Korean-Chinese cultural advantages with limited competition.

While North Korea can hardly be said to have taken full advantage of the economic opportunity presented by China, the ultimate success of regional development plans in the Northeast is predicated on the successful launch of a reform and opening process in North Korea. Local analysts have determined that the massive infrastructure investment taking place in China's Northeast is justified because it will make the border provinces highly competitive in a reformed and opened North Korean market. Yanbian Prefecture in Jilin and Dandong City in Liaoning have invested heavily in their own infrastructure to facilitate cross-border trade and promote investments on the North Korean side of the border. The fulfillment of northeastern China's hopes for long-term revitalization may partly depend on North Korea's willingness to pursue more rational economic policies.

Chinese joint venture investments in North Korea have local as well as national political implications. These investors have rights that both the Chinese and North Korean governments are obligated to recognize. The Chinese government has reasonable expectations that the North Korean government will respect and protect these tangible Chinese interests, raising the possibility that predatory corruption in North Korea can become an issue in the bilateral relationship. It is unlikely, however, that these mostly small companies themselves enjoy significant influence on the formulation of Beijing's policies towards North Korea, though they likely have greater influence at provincial and local levels.

In the course of normal business operations, the small and medium-sized enterprises from Jilin and Liaoning that dominate the North Korean investment scene for the most part do not rely on contacts with the Chinese government for the success of their businesses. Essentially, they are silent partners in the relationship between China and North Korea. In the event of any dramatic change on the peninsula, however, these companies might abandon their low-profile approach. Like all companies, if faced with the loss of their business, they would likely respond vocally and press their case with the Chinese government. While their investments might be small on a national scale, any losses incurred would be substantial at the firm and possibly local levels. Some of the Chinese investors are owned by provincial or sub-provincial government departments and the loss of those investments would affect local government balance sheets. Chinese towns with key border crossings to North Korea would certainly face hardships were North Korean economic activities to collapse. Arguably, these border regions already suffer some hardship from the international stigma attached to North Korea. Despite their distance from the capital, a variety of bureaucratic mechanisms and personal connections could be utilized to remind Beijing of northeastern interests in the event of a threat.

Investment and trade with North Korea is consistent with China's geostrategic outlook toward the peninsula. China's broad national interests vis-à-vis North Korea are to maintain a stable regional security environment, ensure the survival of the North Korean regime, support economic development in the Northeast, and achieve a nuclear weapons-free peninsula. Beijing seeks to achieve these objectives through a comprehensive approach of economic engagement with trade, aid, and investment; bilateral interactions; and multilateral engagement such as the Six Party Talks process. Encouraging the development of a robust economic relationship between China and North Korea is an important component of China's strategy, not only for the benefits that it brings for Chinese businesses, but also because it is presumed that trade and investment

contributes to regime security and social stability, thereby preventing a North Korean collapse. Chinese officials and analysts also recognize that North Korea is unlikely to willingly negotiate away its nuclear weapons unless there is greater internal stability and the regime's security is assured. By this logic, Chinese investments in North Korea are potentially indirect contributors to the Pyongyang regime's security.

Mutual mistrust characterizes the relationship between China and North Korea, especially in the economic sphere. North Korea is dependent on China for trade, aid, and investment but is wary of being "hollowed out" by Chinese investments in its extractives industries, particularly in the mining sector. Without other security allies and with no larger trading partner or investor than China, North Korea has little choice but to engage with its northern neighbor. Despite China's abundant capital and immense experience building infrastructure around the world, North Korea has remained cautious about deepening its dependency on China. However, Pyongyang likely views China as less of a threat than the risks posed by improving ties with South Korea, which might result in ideological exports that would undermine the foundation of North Korea's system. Beijing offers a model that promises the pursuit of economic reform while maintaining strict political control. Chinese joint ventures have the potential to be an important vehicle for "interpreting" the Chinese experience of reform and opening for their North Korean counterparts, fostering an orderly reform process that would preserve the North Korean regime for the time being, but perhaps also enhance the possibilities for an agreeable North-South unification in the more distant future.

The presence of Chinese investment in North Korea likely hinders Beijing's freedom of policy action and creates liabilities that are not well understood. In general, Beijing is uncomfortable with sanctions, though they are America's preferred foreign policy tool of choice for pressuring North Korea to denuclearize. The existence of Chinese investments affects Beijing's ability to endorse sanctions, which would harm Chinese companies, undermine whatever trust exists between Beijing and Pyongyang, and contradict China's argument that reform and opening is necessary.

Few people if any are actively concerned about Chinese investors upsetting delicate security balances in the region. Chinese joint ventures could potentially play a significant role, however, in other ways that might be equally dramatic when viewed over time. It is more likely that investment from abroad will contribute to gradual change among North Korean elites and

workers, just as it changed China.

Investment in China's Northeast and the handful of small-scale Chinese investments in the DPRK reveal an array of Chinese actors with a common strategy of seeking to position themselves for a future opening of the DPRK. Should reform and opening take place, successive waves of investment could dramatically alter the political and economic landscape of North Korea and ultimately, the Peninsula itself. But for now, the biggest barrier to expanded Chinese investment as well as peace and stability on the Korean Peninsula in North Korea is the DPRK itself.

Table of Contents

| | |
|---|----|
| Preface | 11 |
| China's Global Interests and North Korea | 13 |
| <i>Methodology</i> | 13 |
| <i>China's Grand Strategy and North Korea</i> | 14 |
| China's Outbound Investment | 17 |
| <i>WTO Accession and Investment Abroad</i> | 17 |
| <i>Investment Priorities</i> | 18 |
| <i>Rising Raw Material Prices, Industrial Overcapacity</i> | 20 |
| <i>Attraction to North Korea's Mineral Resources</i> | 22 |
| <i>Go Abroad—Foreign Relations and Local Interests</i> | 23 |
| <i>From National Policy to Local Interests</i> | 24 |
| North Korea's Tortured Path to Attracting Foreign Investment | 27 |
| <i>Context for Today's Trade, Aid, and Investment</i> | 27 |
| <i>North Korea's Relationship with China</i> | 28 |
| <i>North Korea's Reform Dilemma</i> | 29 |
| <i>A Port of Our Own: Rajin and the Changjitu Pilot Zone</i> | 31 |
| <i>The Port of Rajin: The Gleam in Yanbian's Eye</i> | 37 |
| <i>North Korean Policies and Organizations to Attract Investment</i> | 41 |
| Chinese Joint Ventures in North Korea | 45 |
| <i>Who is Investing in North Korea?</i> | 49 |
| <i>Who Are the Chinese Investors?</i> | 51 |
| <i>Where Are They From?</i> | 52 |
| <i>Mining and Extractives Industry Joint Ventures</i> | 53 |
| <i>Beyond Hegemony: Rare Earths and the China-North Korea Molybdenum Axis</i> | 57 |
| Profiling Chinese Investors in North Korea | 63 |
| <i>Dalian-based Holding Company</i> | 64 |

| | |
|---|----|
| <i>China-North Korea Border Trade City</i> | 67 |
| <i>Sinosteel</i> | 69 |
| How Might Investments in North Korea Shape Chinese Policy? | 71 |
| Chinese Investment in North Korea and the Geostrategic Balance | 75 |
| <i>Survival of the North Korean Regime and Regional “Balance”</i> | 76 |
| <i>Stability in North Korea</i> | 76 |
| <i>Economic Prosperity in Northeast China and the Reform and Opening of North Korea</i> ... | 77 |
| <i>North Korea’s Reluctance</i> | 77 |
| <i>Sudden Change, Unification, and South Korean Interests</i> | 78 |
| Conclusion | 85 |

Preface

The relationship between the People's Republic of China and North Korea is an important factor in the strategic balance of Northeast Asia, particularly in light of North Korea's isolation from the open, vibrant economies surrounding it. The China-North Korea bilateral economic relationship is not only a critical element of China's strategy for the region, but a potentially important issue that should inform South Korean and U.S. strategy as well.

Renewed tension on the Korean peninsula, caused by the sinking of the South Korean naval corvette *Cheonan* and the shelling of Yeonpyeong Island, has underscored the complexity of the triangular relationship between China, North Korea, and South Korea. China's determination to support North Korea following the attacks, as well as Beijing's reaction to the joint naval exercises carried out by the United States and South Korea in the Yellow Sea, has raised concerns about China's rise and its increasingly assertive posture. Unease about China's long-term intentions are particularly acute in Seoul, which has had high expectations of China in light of growing economic ties and the elevation of their diplomatic status to a "strategic relationship." South Korean trade with China surpasses that of its trade with the United States and Japan combined, but the economic relationship has not translated into political leverage for Seoul. China remains committed to North Korea's long-term survival, putting its policy fundamentally at odds with South Korea's goal of reunifying the peninsula.

This report sheds light on an important aspect of China's support for North Korea: Chinese investments in North Korea. Ironically, despite considerable asymmetry in China's economic relationships with both North and South Korea, no country has been able to effectively leverage economic relations to achieve strategic objectives. China is North Korea's largest trading partner, investor, and provider of aid and energy, yet Pyongyang is hardly Beijing's puppet. However, Chinese investments in North Korea contribute to the regime's durability and are potentially influential agents in shaping Chinese policy towards the peninsula, which makes them important actors worthy of our attention.

This report, commissioned by the U.S.-Korea Institute at the Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, reveals important facts about the economic relationship between China and North Korea and the possible ramifications of Chinese

joint ventures on North Korea's future. These investments have significant implications for the role of the United States in the region, Chinese responses to sudden changes in North Korea, and Korean aspirations for unification.

A handwritten signature in black ink, appearing to read 'Jae Ku', with a stylized flourish at the end.

Jae Ku
Director, U.S.-Korea Institute
School of Advanced International Studies
Johns Hopkins University

China's Global Interests and North Korea

Few geopolitical pairings are as unique as the long and complicated relationship between China and North Korea. North Korea is a pariah state, antagonistic with virtually everyone in the world except China and Russia. It is often assumed that North Korea is China's client state and therefore Beijing has exceptional leverage over Pyongyang. While the two states enjoy what they have referred to in the past as a "special relationship," strains and mutual mistrust are often evident, particularly as China tries to maintain balance in its relations with North and South Korea. China's relationship with North Korea is particularly unusual in that China embraces globalization and trades both with developed and developing countries, while North Korea's erratic foreign policy leaves it largely dependent on China for its commerce and security.

China is considered North Korea's economic lifeline. Chinese aid—including energy, food and fertilizer—is critical to North Korea's social stability and economic productivity. It also is a key source of capital for investment and hard currency garnered from exports. Presumably, without this trade and investment, Kim Jong-il would lack the means to secure the allegiance of elites that support his rule, making trade and investment with China particularly important for ensuring the regime's survival. Joint ventures with China are an important aspect of this economic relationship. In addition to propping up the regime in Pyongyang, they contribute to economic development in China's northeastern "rust belt." These financial investments, as well as the trade and aid that enable North Korea to continue its existence, are geopolitically significant not only in terms of Chinese strategic interests but also for South Korean aspirations to unify the peninsula. Efforts by the international community to isolate North Korea and to impose sanctions in response to its efforts to develop nuclear weapons and its other provocative behaviors are complicated by the economic relationship between China and North Korea. When examining Chinese outbound investment to North Korea, it is important to ask whether these Chinese investments are fundamental to regime survival, a barrier to unification, or minor apolitical actions in a much larger context.

Methodology

This report reviews and analyzes the extent, types, and scope of Chinese investments in

North Korea, specifically investments by Chinese companies that have established joint ventures in North Korea and have North Korean financial partners. The focus is on companies that have tied up capital and thus have a significant interest in the continued existence of the North Korean regime. This report does not consider trading companies, exporters, or other entities which, despite their financial interests in commerce with North Korea, do not have the amount of investment and degree of dependency on North Korea that characterize companies that have invested capital in the North.

Based on interviews conducted in Beijing and Northeast China and on analysis of a database of Chinese investors in North Korea compiled using open sources, this report provides new insights into these key Chinese stakeholders in North Korea, the policy environment in which they operate, and the commercial dynamic that drives their economic behavior. Because Chinese investors in North Korea are important stakeholders in both countries, it is valuable to know their identities and the scope and scale of their businesses. Their existence helps define China's interests in North Korea, and their presence is critical to understanding how they might shape the future of the peninsula.

China's Grand Strategy and North Korea

Chinese investments in North Korea reflect China's strategic outlook on Northeast Asia and the role of North Korea in China's grand strategy for the region. China's relationship with North Korea is central in many ways to its effort to achieve "great power" status, and a key aspect of China's perception of its place in the region and the international system. Beijing's primary objectives are to continue its economic and military modernization and to manage its relations with major global powers (particularly the United States) and its neighbors, including both Koreas. China's broad diplomatic strategy has long been to maintain the international conditions that permit Beijing to focus on its domestic development and to ensure its international security.¹

One component of China's grand strategy is to maintain stability on its borders. This imperative for border security influences Beijing's calculations regarding its policy towards

¹ Avery Goldstein, "The Diplomatic Face of China's Grand Strategy: A Rising Power's Emerging Choice," *The China Quarterly* 168 (2001), 835–864.

economic development of China's northeastern provinces are a more pressing concern in Chinese calculations about North Korea. China prefers the continued existence of North Korea to other alternatives and is particularly appreciative of North Korea's role as a buffer state.

Due largely to Pyongyang's international isolation, China is North Korea's most important trading partner. This is a function of the two nations' Cold War alliance and common political heritage, and is often manifested in "friendship" projects and arcane rhetoric. Trade and investment is an important component of the political relationship, just as aid is. Beijing's assertion that this trade is "normal" and not tied to North Korea's nuclear program is reflected in its efforts to shield North Korea from international sanctions. While statistics from different sources vary, North Korea's foreign trade with China was estimated to reach US\$2.79 billion in 2008 and roughly the same amount in 2009; this trade is expected to increase in the wake of Seoul's decision to halt North-South trade in response to the *Cheonan* incident in March 2010.² In the first five months of 2010, total trade between China and North Korea grew by 18 percent. During this period, North Korea imported US\$727 million of goods from China while exporting US\$256 million to China.³ This figure does not include small-scale, duty-free border trade or undeclared commerce including military transactions and smuggling. An undetermined portion of China's trade with North Korea is conducted by approximately 138 companies that have officially invested in joint ventures and opened offices in North Korea.

² Jayshree Bajoria, "The China-North Korea Relationship," *Council on Foreign Relations Backgrounder*, 21 July 2009.

³ Chris Green, "Sino-North Korean Trade Grows Again," *Daily NK*, 6 July 2010.

China's Outbound Investment

While the relationship between China and North Korea is in many ways unique, Chinese investment in North Korea is consistent with China's wider "go abroad" effort. There is little or no evidence that Chinese investments in North Korea are politically driven or motivated by a shared communist ideology. Chinese outbound investment in North Korea is driven by the same four factors that have driven China's investment globally since the year 2000: a favorable global economic environment; domestic economic pressures; Chinese government policies facilitating outbound investment; and factors in the destination country. The steady increase in the number of Chinese investments in North Korea since 2000 parallels the growth of Chinese investment in other countries around the world.

The year 2000 was a turning point for Chinese outbound investment and is generally considered to be the start of an important global trend.⁴ Recognizing that joining the World Trade Organization (WTO) would increase competition not just within China, but globally, the Chinese government and Chinese companies began contemplating new strategies.

WTO Accession and Investment Abroad

Since 2000, changes in the global economic environment have obliged Chinese companies to look abroad in order to remain competitive. When China joined the WTO, the opening of domestic markets forced Chinese companies to begin competing in global markets. Both the Chinese government and Chinese companies developed strategies to respond to these changes on the global economic playing field. The Chinese government formulated the *zouchuqu* or "go abroad" policy to support the globalization of Chinese companies. The policy was first conceptualized in 2000 and began initial implementation in 2002 following its incorporation into the Tenth Five-Year Plan in 2001. By legitimizing Chinese investments and providing a framework for banks to allocate loans to investors for their projects, the *zouchuqu* policy represented a watershed event for Chinese outbound foreign direct investment (OFDI). Prior to

⁴ Hinrich Voss, Peter J. Buckley, and Adam R. Cross, "Thirty Years of Chinese Outward Foreign Direct Investment," (paper presented at CEA (UK) conference, Three Decades of Economic Reform 1978–2008, Cambridge University, United Kingdom, 1–2 April 2008), 8.

the launch of this policy, companies that wanted to invest overseas faced political and regulatory hurdles, largely because guidelines and regulations had not been formulated. The rapid growth of China's economy in the mid-1990s was accompanied by a surge of overseas investments by private companies and by enterprises owned by local and provincial governments. With little oversight, expertise, or international experience, many of these investments failed, prompting Beijing to implement more rigorous screening and develop a regulatory framework.

New rules decentralized the investment approval process to sub-national authorities and eliminated hurdles such as the requirement for a feasibility study.⁵ Beginning in October 2002, Chinese authorities tested new policies whereby investors in six coastal provinces could purchase foreign exchange for their international investments from their local State Administration of Foreign Exchange branches. By 2005, these policies were expanded nationwide.⁶ To improve implementation, responsibilities were more clearly divided between different parts of the Chinese government. For example, the Ministry of Commerce issues regulations and implements policies approving and overseeing international investments in the non-financial sector.

Investment Priorities

Distribution of China's outward foreign investment largely reflects the priorities of the Chinese government, which include gaining access to raw materials and advanced technology, increasing foreign exchange earnings, and promoting Chinese exports.⁷ The Chinese government's strategy for OFDI encourages manufacturing enterprises to utilize the "two resources and two markets principle."⁸ This translates as targeting both domestic and international markets and using strategic resources of capital, knowledge, raw materials, and information. After 2000, stronger government monitoring and clearer regulations encouraged Chinese enterprises to invest in priority regions, specifically in developing countries. As its economy expanded further in the late 1990s, China's need for cheap sources of raw materials increased rapidly though it had limited experience acquiring them on open markets. In 1998, the State Council restructured pilot trading programs that had been established in the late 1980s,

⁵ Voss, Buckley, and Cross, "Thirty Years of Chinese Outward Foreign Direct Investment," 17.

⁶ Voss, Buckley, and Cross, "Thirty Years of Chinese Outward Foreign Direct Investment," 18.

⁷ Mark Wang Yaolin, "The Motivations Behind China's Government-initiated Industrial Investment Overseas," *Pacific Affairs* 75, no. 2 (Summer 2002).

⁸ Yaolin, "The Motivations Behind China's Government-Initiated Industrial Investments Overseas," 194.

though China's commodity exchanges are still relatively immature. Today, futures contracts are available for only three metals—copper, aluminum, and zinc—and only to domestic traders.⁹ Without established futures markets for raw materials and currency, Chinese dealers lack the ability to hedge against fluctuations in international markets, prompting many companies to seek to mitigate their risks by investing in the producers themselves. Importantly, Chinese outbound investments globally have placed a high priority on gaining access to natural resources which can then be sold on international markets or shipped to China. However, it should be recognized that although large-scale resource and infrastructure investments are highly visible and sometimes controversial, Chinese investments abroad also include infrastructure, manufacturing, and services.

China's outbound investments globally totaled US\$55.91 billion in 2008 and US\$56.53 billion in 2009. These two years alone account for almost half of China's cumulative outbound investment since 2002, indicating how recent and rapid the increase has been.¹⁰ This recent emergence is disruptive to some degree, partly because of the relative lack of Chinese investment abroad prior to 2004, when Chinese companies invested only US\$5.5 billion abroad. China's outward FDI accounted for only 0.6 percent of the world's total in 2005, described by some authors as a "disproportionately small sum" even among countries at similar stages of development.¹¹ In addition to investments in Asia, Latin America, and Africa, tax havens in Hong Kong and the Caribbean are top destinations for Chinese investors.¹²

According to Derek Scissors of the Heritage Foundation, Chinese firms, like their multinational counterparts, prefer to invest in transparent, well-regulated economies; this largely explains why the two largest destinations for Chinese non-bond investments are Australia and the United States. However, Chinese companies have been very active investors in countries with closed political systems, particularly those rich in natural resources. Chinese firms are particularly competitive in countries where political risk is high or where sanctions or other liabilities keep other multinationals from committing significant capital. Chinese firms are

⁹ Chris Wright, "Chinese Futures Report: Commodity Exchanges," *Euromoney*, June 2010.

¹⁰ People's Republic of China Ministry of Commerce, National Bureau of Statistics and State Administration of Foreign Exchange, "2008 Statistical Bulletin of China's Outward Foreign Direct Investment," 2; "2009 Statistical Bulletin of China's Outward Foreign Direct Investment," 2.

¹¹ Randall Morck, Bernard Yeung, and Minyuan Zhao, "Perspectives on China's Outward Foreign Direct Investment," *Journal of International Business Studies* 39 (2008), 338.

¹² Morck, Yeung, and Zhao, "Perspectives on China's Outward Foreign Direct Investment," 339–340.

not hindered at home by legal challenges from non-governmental organizations, nor are they concerned about corporate image when investing in high-risk markets led by unsavory regimes or where severe human rights abuses take place. In fact, Chinese companies are attracted to the potential for large profits in markets with less competition from multinational firms. China is a significant investor in Sudan, the Democratic Republic of Congo, Myanmar, Zimbabwe, Iran, and of course, North Korea. A consistent theme in China's investment in many of these "pariah" states is the availability of natural resources and need for investment in infrastructure. China has major investments in other countries that are less politically sensitive, but resource-focused investments are more visible in these pariah states. Derek Scissors has compiled a dataset of Chinese non-bond investments that includes all confirmed transactions of \$100 million or more. This dataset includes infrastructure investments, not just joint ventures.¹³ Scissors' research reveals that, among these large, non-bond investments, the energy and power sector accounts for over 40 percent of investment while natural resources extraction constitutes another 35 percent. Additionally, he points out that many of China's large scale investments have not come easily; in fact, failed investments are "frequent and sizable."¹⁴ However, by only focusing on large scale projects, this dataset trends towards resource investment; because of their smaller size, investments in services and light industry are not captured.

Rising Raw Material Prices, Industrial Overcapacity

Accessing raw materials and ensuring energy security are important strategic concerns for China and are assumed to be driving considerations for much of China's outbound investment. China's combined share of world consumption of aluminum, copper, nickel, and iron ore doubled in 10 years, from seven percent in 1990 to 15 percent in 2000, reaching 20 percent in 2004. Housing and infrastructure construction, consumption of automobiles and appliances, and investment in transportation networks are key drivers of this demand for commodities.¹⁵ For example, in the forecast of global consumption of primary aluminum in 2010, China is expected

¹³ Derek Scissors, "China Global Investment Tracker: 2010," The Heritage Foundation, 7 July 2010.

¹⁴ Derek Scissors, "Chinese Outward Investment: Better Information Required," (testimony before the U.S.-China Economic and Security Review Commission, *Hearing on U.S. Debt to China: Implications and Repercussions*, 25 February 2009).

¹⁵ David Zweig, "China and the World Economy: The Rise of a New Trading Nation," (paper presented at the World International Studies Association, Ljubljana, Slovenia, 24 July 2008), 5.

to consume 16.5 million tons out of a predicted total world consumption of 39.2 million tons.¹⁶ In 2009, China accounted for nearly 50 percent of total world steel production while consuming 48.4 percent of world steel output.¹⁷ Rising demand for these strategic materials requires Chinese enterprises to source them globally, and North Korea is one component of its supply. The U.S. Geological Survey describes North Korea's reserves of coal, iron ore, limestone, and magnesite as "large by world standards."¹⁸

Competition and rising domestic prices, including energy and labor costs are key motivators for Chinese companies to invest abroad and seek to expand market share overseas. China's accession to the WTO in 2001 spurred manufacturers in electronics, automotive, mobile phones, and textile industries to expand beyond their overcrowded domestic market to overseas production facilities.¹⁹ In addition, Chinese industrial overcapacity motivates companies to pursue overseas investment in order to assure an adequate supply of raw materials. The steel, cement, and flat glass industries were singled out for their overcapacity problems by an official from the Ministry of Industry and Information Technology (MIIT) in December 2009. At the end of 2008, China's crude steel manufacturing capacity reached 660 million tons, exceeding the expected output of 500 million tons, according to officials from the China Iron and Steel Association.²⁰

This overcapacity is driving down costs for some and profit margins for others, driving Chinese companies to seek cheaper raw materials closer to home, making North Korea an attractive source for ores and coal. China's huge industrial processing capabilities require significant energy supplies. Coal accounts for 70 percent of China's total primary energy consumption and more than half is used by the industrial sector. China's coal imports began increasing after 2002 because the price of imported coal, including transportation, became competitive with Chinese domestic production due to rising costs in China.²¹ Though China was previously a net exporter, it imported 126 million tons of coal in 2009. Mine closures, high

¹⁶ Carole Vaporean, "Alcoa raises demand outlook; China to be major consumer," *International Business Times*, 13 July 2010.

¹⁷ Zacks Investment Research, "Analyst Interviews: Steel Industry Review and Outlook," *DailyMarkets.com*, 29 June 2010.

¹⁸ John C. Wu, "The Mineral Industry of North Korea," *2005 Minerals Yearbook: North Korea*, U.S. Geological Survey (June 2007), 15.1.

¹⁹ Kim Icksoo, "Inward and Outward Internationalization of Chinese Firms," *SERI Quarterly* (July 2009), 25.

²⁰ Lucy Hornby, "China's severe steel over-capacity to persist," *Reuters*, 23 February 2009.

²¹ United States Energy Information Administration, "China: Coal," *Country Analysis Briefs* (July 2009).

local freight rates, and an increase in domestic prices are attributed to this increased reliance on imports.^{22,23} With an estimated production capacity in 2007 of 25 million metric tons per year, North Korea is a significant producer of coal. The Korea Resources Corporation estimated coal reserves in North Korea at 20.5 billion metric tons (Gt), of which 4.5 Gt were anthracite and 16 Gt were lower quality brown coal.²⁴ North Korea's coal production is often constrained by a lack of electricity and shortage of spare parts, raising the attractiveness of Chinese investment to alleviate these problems.

Chinese investors are consistently driven to invest abroad by rising costs and industrial overcapacity which invites hyper competition. According to one Chinese investor with investments in several countries, rising costs in China for inputs such as water, electricity, natural gas, and salaries are a key factor in their decision invest overseas including in North Korea. Rising wages can be partly attributed to inflation and labor shortages in key manufacturing regions and industrial sectors. In 2006, shortages of qualified workers were reported in Guangdong, Jiangsu, Zhejiang, and Shandong Provinces, forcing companies to attract workers by raising wages. In addition to rising costs, one Chinese investor also identified excess industrial capacity driving down profits as another reason to invest abroad.²⁵

China's plentiful capital, seemingly insatiable demand for raw materials, and proximity to North Korea would appear to perfectly complement North Korea's international isolation, abundant natural resources, and limited capital with which to exploit them. However, there are strains in the commercial relationship stemming from both countries' mercantilist tendencies and North Korea's distrust of dependence on foreigners, which conflicts with *juche* ideology.

Attraction to North Korea's Mineral Resources

With increasing hunger for raw materials, rising prices and stiff domestic competition, North Korea's mineral resources are attractive Chinese industries, despite the challenges of

²² "China's May Coal Imports Rise 17%; Prices Climb on Demand Gain," *Bloomberg News*, 21 June 2010.

²³ Harsh winter conditions in 2009 increased demand for coal, resulting in bottlenecks that forced power plants to cut output in provinces across China. See Joe McDonald, "Reports: Chinese power plants running out of coal," *Associated Press* via *Taiwan News*, 12 January 2010.

²⁴ John C. Wu, "The Mineral Industry of North Korea," *2007 Minerals Yearbook: North Korea*, U.S. Geological Survey (September 2008), 14.3.

²⁵ Anonymous Chinese investor, interview by the author, Beijing, China, November 2009.

operating there. China's expanding heavy industry sector, particularly steel production and manufacturing of steel-consuming products such as automobiles and ships drives demand for a number of commodities that North Korea possesses. North Korea has relatively large deposits of coal, iron ore, and other minerals and their proximity to Chinese power plants, foundries, and factories gives them a competitive advantage over products from more distant sources. A Goldman Sachs report estimated the value of North Korea's potential deposits of minerals at about 140 times the country's 2008 GDP at current market prices.²⁶ The sector is vital to the North Korean economy as well. Mining and manufacturing accounted for 34.6 percent of North Korea's GDP in 2008. The country's main mineral production includes coal, copper, graphite, iron ore, lead, limestone, magnesite, salt, tungsten, and zinc.²⁷

In North Korea, large-scale enterprises are owned and operated by the central government with provincial and local governments owning the small to medium-scale mines and mineral processing facilities. Joint ventures develop and operate cement, coal, copper, gold, graphite, iron ore, lead, zinc, magnesite, and molybdenum facilities. Coal, iron ore, and crude magnesite are exported mainly to China. North Korea exported 64,000 tons of iron ore, to Yanji, China in 2008, an increase of 2.3 percent from 2007. North Korea's magnesite reserves in Ryong Yang and Tancheon, together with China's adjacent deposits, are among the world's largest.²⁸

Go Abroad—Foreign Relations and Local Interests

It is important to note that many outbound Chinese investments are not made by corporations owned by the central government, but by privately held concerns or by companies owned by local governments. Many of these smaller companies began investing abroad in the late 1990s, often with mixed results. While these enterprises sometimes had resources to invest abroad before the implementation of the *zouchuqu* policy, they often lacked the expertise or capital reserves to be successful. A number of disastrous investments prompted the government to improve the policy framework and regulatory system for outbound investments. However, despite this framework, Chinese outbound investment still faces many challenges. Some of

²⁶ Goohoon Kwon, "A United Korea? Reassessing North Korea Risks," Goldman Sachs Global Economics Paper 188 (21 September 2009), 10.

²⁷ Lin Shi, "The Mineral Industry of North Korea," *2008 Minerals Yearbook: North Korea*, U.S. Geological Survey (February 2010), 14.1.

²⁸ Lin Shi, "The Mineral Industry of North Korea," 14.3.

China's highest profile investment failures have been in Africa, though North Korea is also a graveyard for a number of Chinese joint ventures. The challenges of managing investments abroad in Africa have been reported widely. During a visit to Zambia, Chinese President Hu Jintao was forced to skip a visit to the Chinese-owned Chambishi Copper Mine because miners were actively clashing with owners and protesting low pay and poor working conditions.²⁹ An executive vice president of the government's sovereign wealth fund, China Investment Corporation, acknowledged the challenges facing Chinese companies, saying, "We lack experience. Without experience, but with a lot of money—that becomes trouble. We have to learn from our mistakes."³⁰

The Chinese senior leadership is well aware of the negative consequences of the *zouchuqu* policy. High-level meetings were held in 2006 and 2009 to study the linkages between China's domestic interests and international affairs.³¹ Concern about the negative consequences of the *zouchuqu* policy was a major topic of the Central Work Conference on Foreign Affairs in 2006. As more Chinese enterprises go abroad, their visibility increases and their shortcomings become apparent. Chinese investors often have been criticized for a lack of cultural understanding and private companies have been mistakenly accused of representing the Chinese government. New coordination and communication measures were announced in 2006 to increase the central government's knowledge of activities abroad initiated at the local level.³²

From National Policy to Local Interests

Perhaps the most difficult investment destination for Chinese companies is North Korea. The appalling conditions there have not deterred more than a hundred Chinese investors from trying. The majority of Chinese investors in North Korea are from the two provinces bordering North Korea: Liaoning and Jilin. During the planned-economy period, the economies of Jilin and Liaoning were dominated by heavy industry, inherited partly from Manchuria's history as a Japanese manufacturing base in the 1920s and 1930s. In the decade prior to China's accession

²⁹ Colin Freeman, "Africa Discovers Dark Side of Chinese Master," *Telegraph*, 4 February 2007.

³⁰ Heda Bayron, "No Let Up in China's Corporate Acquisitions, But Challenges Abound," *VOA News*, 24 April 2008.

³¹ Bonnie S. Glaser and Benjamin Dooley, "China's 11th Ambassadorial Conference Signals Continuity and Change in Foreign Policy," *China Brief* 9, no. 22 (4 November 2009), 8–12.

³² Bonnie S. Glaser, "Ensuring the 'Go Abroad' Policy Serves China's Domestic Interests," *China Brief* 7, no. 5 (8 March 2007).

to the WTO, aggressive restructuring of China's State-Owned Enterprises (SOEs) led to massive layoffs and the shuttering of many uncompetitive factories in the two provinces. As China's economy evolved, Jilin and Liaoning were increasingly left behind by the prosperous coastal provinces. The two provinces share a 1,400 kilometer border with North Korea and are increasingly focused on foreign trade and on achieving competitive advantages through their proximity to North Korea, accessing financial incentives provided by the "Revitalize the Northeast" campaign. The presence of a large population of Korean-speaking Chinese in these two areas gives them a unique competitive advantage for investing in North Korea. Notably, due to international sanctions, this is the only significant population of native Korean speakers abroad who can freely do business with North Korea. Liaoning and Jilin also have a geographic competitive advantage over rivals from other Chinese provinces, giving them access to the North Korean market not only at the border, but throughout the country.

Both Jilin and Liaoning are relatively poor provinces that view North Korea as a potentially important partner in overseas trade. Landlocked Jilin in particular is interested in North Korea's potential to connect the province with new markets and advance its economic development. In terms of GDP, Jilin ranks twenty-second out of China's 31 provinces. Tellingly, Jilin's share of GDP from foreign trade is 19 percent, compared to around 70 percent for China as a whole (though rebalancing and rising domestic consumption is reducing that figure). Jilin's proximity to North Korea's east coast has stirred local aspirations to access a "port of its own" in North Korea, giving enterprises access to overseas trade without relying on links to Liaoning or other coastal provinces. In addition, more than 500 kilometers of the China-North Korea border runs through Jilin's Yanbian Korean Autonomous Prefecture. Yanbian has a relatively low level of economic development, although it possesses an important competitive advantage for its dealings with both North and South Korea with its own ethnic Korean population of close to 900,000, many of whom have personal ties to the Korean peninsula. To capitalize on these advantages following China's accession to the WTO, in 2001 the Yanbian prefectural government initiated new efforts to strengthen border trade with North Korea in order to develop a "foreign-oriented economy." Border trade was encouraged through duty free allowances for residents living within 20 kilometers of the border and an export processing zone was approved in Yanbian.

Liaoning dominates China's trade with North Korea. Despite efforts to encourage cross-border trade in Yanbian prefecture, approximately 75 percent of the legitimate, traceable trade

passes through Dandong in Liaoning.³³ Like their counterparts in Yanbian, the government and the business community in Dandong actively promote border trade while provincial authorities likewise encourage and finance trade and investments that stimulate cooperation with North Korea.³⁴

Despite the disparity between Jilin and Liaoning in volume of trade with North Korea, the two provinces share several important similarities. Transportation costs are a key component of raw material costs, giving these two provinces a geographic advantage over more distant provinces that might purchase North Korean raw materials, such as coal, scrap metal, or semi-processed products. Both provinces have invested heavily in infrastructure to link to North Korea and facilitate cross-border trade, including highways and facilities at border crossings such as expanded customs houses, truck parks, and inspection stations. Chinese businesspeople are also relatively comfortable operating in an opaque system where personal relationships are more important than institutional ones. North Korea's state-led system, characterized by the absence of institutional checks and balances and a government-led legal system, is very familiar to Chinese investors—though that does not make it “friendly” by any means. North Korea's international isolation can also be an advantage for Chinese traders and investors. North Koreans are not able to access international pricing regimes; instead, they are compelled to accept the best price they can get from Chinese buyers. Chinese buyers are likely to pay lower prices for North Korean resources than would be possible on the open market, though North Korean traders are adept at playing their Chinese counterparts against each other. While North Korean sellers can shop around for partners, the potential pool is quite limited both in terms of whom North Koreans can access in their networks and in the need to find partners who are not limited by sanctions or risks to their reputations.

³³ Lucy Hornby, “Currency Shift Hits North Korea Business, Spooks China Traders,” *Reuters*, 10 December 2009.

³⁴ Li Dunqiu, “Economic and Social Implications of China-DPRK Border Trade for China's Northeast” (paper presented at conference of the National Bureau of Asian Research on Regional Economic Implications of DPRK Security Behavior, Beijing, China, 18–19 January 2006). See also 辽宁边境地区与朝鲜的经贸合作探析, 21 July 2009; 丹东市对外贸易经济合作局工作职责 (Dandong Foreign Trade and Economic Cooperation Bureau Responsibilities), 26 July 2007; Dong Lisheng, “China's Drive to Revitalize the Northeast,” *China Perspectives* 58 (March–April 2005).

North Korea's Tortured Path to Attracting Foreign Investment

North Korea has followed a tortured path in its attempt to attract foreign direct investment since the end of the Cold War. Though the country is in dire need of trade and investment, North Korea's adherence to the *juche* ideology makes it resistant to outsiders and their presence in the country and economy. Foreign trade and investment have never played a large role in North Korea's economic system, but the end of the Cold War and of "friendship" relations with the Soviet Union (and the aid that came with it) have caused foreign economic relationships to play a new, more vital, role for the regime. However, North Korea faces a dilemma in attracting foreign investment. The *juche* ideology and the need to isolate its citizenry from the realities of the outside world make Pyongyang wary of contact with or dependence on outsiders. The legacy of its colonial past further increases the regime's ambivalence towards attracting foreign direct investment.

Context for Today's Trade, Aid, and Investment

North Korea's failure to adjust to the collapse of the Soviet Union resulted in economic catastrophe and famine in the 1990s. The Soviet Union and then Russia, ended friendship pricing and aid, instead demanding hard currency payments for exports. North Korea's industrial and agricultural sectors declined precipitously. According to noted North Korean economic experts Stephen Haggard and Marcus Noland, long-term distortions caused by socialist policies combined with the costs of the 1993–1994 nuclear crisis contributed to a collapse of the food distribution system in 1995 and stimulated an involuntary reform process. The North Korean economy experienced a "marketization from below" as the population searched for food and commenced new bartering and trade activities.³⁵ Some market activities were decriminalized in 2002, but 2005 saw the beginning of a process described by Haggard and Nolan as a "reform in reverse" as the regime became more wary of economic reform and began to crack down

³⁵ Stephan Haggard and Marcus Noland, "The Political Economy of North Korea: Implications for Denuclearization and Proliferation," East-West Center Working Papers, Economics Series no. 104 (June 2009), 4–5.

on markets and on the use of foreign currencies.³⁶ North Korea's leadership appears to lack confidence in their ability to maintain political control while pursuing economic reform. The regime appears to fear the emergence of a class of entrepreneurs outside the state sector, which is believed to be the justification for the disastrous currency revaluation in November 2009.

With the collapse of the Soviet Union, China was left as North Korea's only patron, though the establishment of diplomatic relations between Beijing and Seoul in 1992 complicated China's relationship with North Korea. Since then, Beijing has had to consider how its policies are received on both ends of the peninsula. After 1992, Beijing sought to adjust its economic relationship with Pyongyang and lessen the burden of providing aid to North Korea by promoting market-based trade, but Pyongyang appeared unprepared for this shift. The collapse of North Korea's economy saw bilateral trade between North Korea and China drop from US\$900 million in 1993 to US\$550 million in 1995.³⁷ However, North Korea remains largely dependent on China for its foreign trade, which reached US\$2.79 billion in 2008, an increase of 41.3 percent compared to 2007. China provides an estimated 80 percent of North Korea's imported consumer goods and 45 percent of its imported food.³⁸

North Korea's Relationship with China

The relationship between China and North Korea is largely isolated from the global economy, though clearly Chinese companies are influenced by world trends and geopolitical realities. In addition to promoting border trade and larger-scale commercial transactions, China continues to provide North Korea with significant aid, including food, fuel, fertilizer, and technology transfers. Though Chinese analysts and businesspeople alike would prefer that the economic relationship become more "normal," and that it be conducted on a market basis without subsidies, such a transition does not appear to be underway. Importantly, development assistance to North Korea is characterized as strategic and handled through high-level leadership channels, including through the Chinese Communist Party International Liaison Office rather than through the overseas development assistance channels of the Ministry of Commerce.³⁹

³⁶ Haggard and Noland, "The Political Economy of North Korea," 2.

³⁷ Scott Snyder, *China's Rise and the Two Koreas* (Boulder, CO: Lynne Rienner Publishers, 2009), 111.

³⁸ Bajoria, "The China-North Korea Relationship."

³⁹ Snyder, *China's Rise and the Two Koreas*, 112.

Furthermore, because North Korea cannot access international financing, Chinese aid and direct investment is an indirect trade subsidy that underwrites North Korea's global trade imbalance, which is currently more than two to one, the majority with China. According to surveys by the Korea Trade-Investment Promotion Agency (KOTRA), North Korea's external trade was US\$3.4 billion in 2009, a decrease of 10.5 percent from 2008. North Korea's exports totaled US\$1.1 billion while imports totaled US\$2.4 billion, for a trade deficit of US\$1.3 billion. North Korea's exports to China were valued at US\$790 million in 2009 while importing US\$1.9 billion of Chinese goods.⁴⁰ This trade and aid is a significant manifestation of China's preference to prop up North Korea and prevent its collapse.

North Korea's Reform Dilemma

In particular, North Korea needs foreign direct investment to develop its decrepit manufacturing and extractives sectors as well as to earn hard currency from exports. This situation is similar to the one faced by China in the 1980s; however, despite persistent coaching and encouragement from Beijing, Pyongyang remains reluctant to open its economy to investment and trade or to enact other necessary reforms for fear of the potential political and social consequences. As Scott Snyder points out in his book, *China's Rise and the Two Koreas*, "North Korea has traditionally borrowed many lessons from the Chinese experience and China's economic and social example has been at least partially accepted in Pyongyang, according to some Chinese reports. North Korea has sent officials to China to learn from its economic and technological development."⁴¹ Echoing the strategy it pursued during visits by Kim Il-sung in the 1980s and 1990s, Beijing has promoted its economic reform model to Kim Jong-il on most of his visits to China. During a 2001 trip to China, Kim Jong-il was taken to China's wealthiest city, Shanghai, including visits to the Pudong Development Zone and Shanghai Stock Exchange, and in 2006 he toured Shenzhen. Kim Jong-il's two trips to China in May and August 2010 brought him to all three of the northeastern Chinese provinces that are central to the China-North Korea economic relationship. On his May trip to China, the Chinese authorities required Kim to leave his armored train and drive on new highways so he could see the relative wealth of China's countryside and its comparatively better infrastructure. On his August visit, President Hu Jintao

⁴⁰ Kim Tae-gyu, "N. Korea suffers trade deficit for two decades," *Korea Times*, 24 May 2010.

⁴¹ Snyder, *China's Rise and the Two Koreas*, 148.

reportedly told Kim, “Economic development should be self-reliant and also cannot be separated from opening up and cooperation,” giving a nod to Kim’s penchant for *juche*, but also expressing Beijing’s frustration with the slow pace of reform, and in effect admonishing the North Korean leader that opening to the outside is unavoidable.⁴² Given that Chinese authorities had been respectful of North Korean sensitivities about the use of the word “open” prior to that visit, Hu Jintao’s statement can be seen as a clear signal of Beijing’s growing exasperation.

Pyongyang’s reluctance to open up and engage China reflects a strategic shortsightedness and provides an indication of the depth of North Korea’s mistrust of even its closest ally. Marcus Noland and Stephen Haggard have identified North Korea’s greatest economic opportunity as its proximity to more advanced economies.⁴³ North Korea could leverage the highly industrialized economies and large consumer markets of its neighbors China, Japan, and South Korea. Agricultural reforms, while they would ameliorate the North’s chronic food insecurity, present less of an opportunity than a strategy driven by trade and investment that exploits the country’s neighbors. Unlike the agricultural sectors of China and Vietnam, that of North Korea is small and constrained by the country’s environment: limited arable land, a short growing season, and vulnerability to floods and drought. Surrounded by the dynamic economies of Northeast Asia, North Korea’s best opportunity for future success lies in increased trade, investment in infrastructure, and, according to a 2009 report by Goldman Sachs, realizing the potential of the country’s human capital, achieving productivity gains, and exploiting its significant mineral resources.⁴⁴

While North Korea can hardly be said to have taken full advantage of the economic opportunity presented by China, the provinces of Jilin and Liaoning and the border region have wagered that North Korea will eventually reform and become more accessible to Chinese business interests. Both Yanbian and Dandong have invested heavily in their own infrastructure to facilitate trade and are increasingly promoting investments on the North Korean side of the border. The Yanbian-Tumen highway has cut travel time from Yanbian Prefecture’s capital of Yanji to the Quanhe border crossing, where China has built large customs and inspections stations that today, often sit idle. China has also provided resources to North Korea to build their

⁴² Chris Buckley, “North Korea’s ‘family firm’ sidles up to China,” *Reuters*, 31 August 2010.

⁴³ Haggard and Noland, “The Political Economy of North Korea,” 5–6.

⁴⁴ Goohoon Kwon, “A United Korea? Reassessing North Korea Risks,” Goldman Sachs Global Economics Paper 188 (21 September 2009), 10.

own customs facilities at the border. Furthermore, China has invested in the creation of a border market on the North Korean side of the border, though North Korean authorities closed it down after a few years. However, if bilateral trade were to expand, the border crossings and bridges that span the Tumen and Yalu rivers would quickly go from tourist attractions to bottlenecks unable to handle large volumes of commerce that the Chinese anticipate. These bridges are both symbolic and necessary to bilateral trade, and various plans to expand them have circulated since the early 1990s. On his visit to North Korea in 2009, Premier Wen Jiabao announced the intention to construct a new Yalu River Bridge to connect Dandong and Siniuju. China is providing the construction costs for the bridge, an estimated 1 billion yuan (US\$145 million).⁴⁵



Tourists on the Tumen Bridge

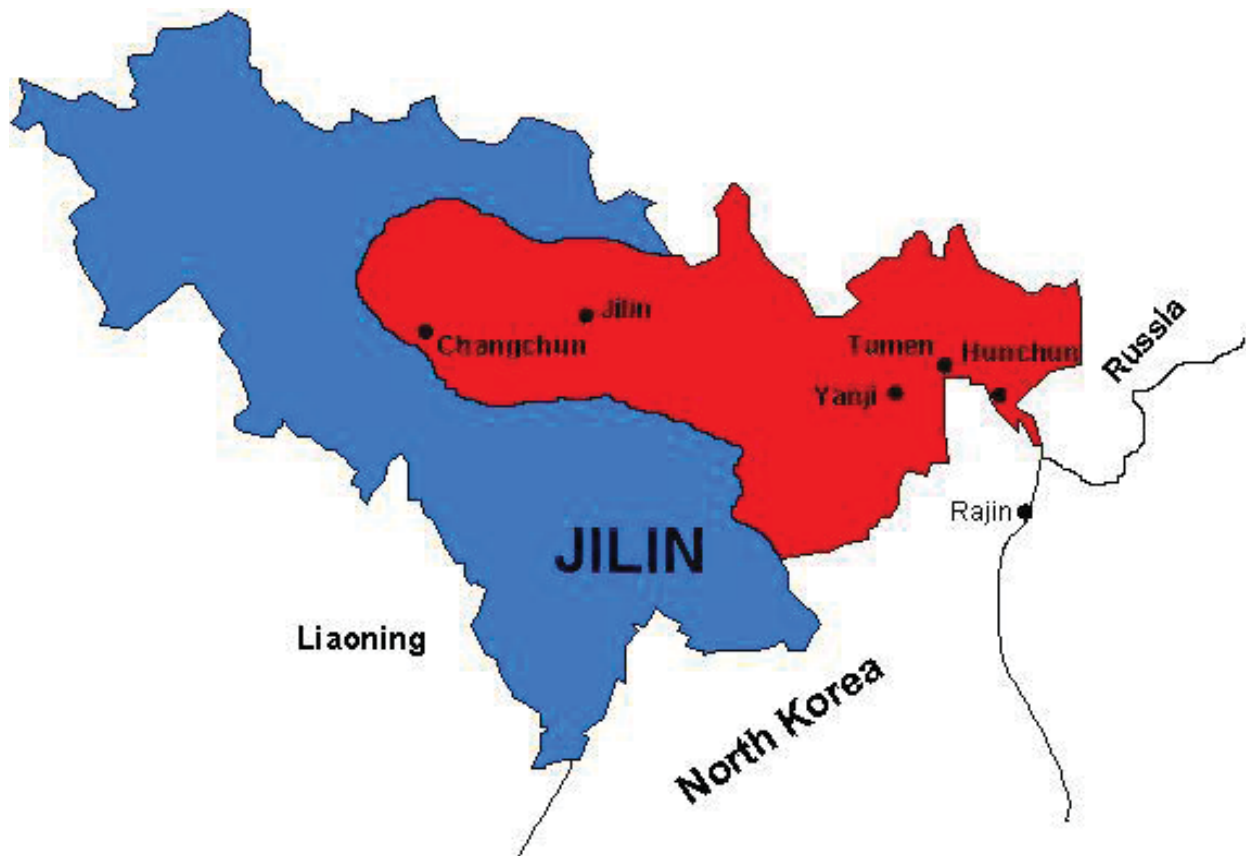
A Port of Our Own: Rajin and the Changjitu Pilot Zone

The provincial governments of Jilin and Liaoning anticipate future reforms and the

⁴⁵ Jung Kwon Ho, “New Yalu Bridge on the Way,” *Daily NK*, 16 October 2009.

opening of North Korea's economy and are investing heavily in their own infrastructure to establish trade hubs that position them to take advantage of commerce with their neighbor. Jilin is constructing a figurative bridge to North Korea in the form of an ambitious regional economic integration plan that has been under development for years and was recently endorsed by China's central government. This vital step, which effectively blesses the Changchun-Jilin-Tumen Regional Economic Development Pilot Zone, will accelerate progress by increasing access to capital and by facilitating approval processes. Known by its short-hand moniker, "Changjitu," this economic zone is intended to spur commerce in the province and eventually link to infrastructure investments on the North Korean side of the border extending as far as the port of Rajin. The zone was given national recognition by President Hu Jintao during a January 2007 inspection tour of Jilin Province for the Asian Winter Games held in Changchun. On the visit, President Hu instructed the province to use pilot projects to advance economic development, though he did not directly address North Korea's expected role.⁴⁶

Figure 2. Changjitu Development Zone in Jilin Province



⁴⁶ “‘长吉图’开发规划纲要即将在京发布,” 23 October 2009.

The fulfillment of northeastern China's hopes for revitalization may depend on North Korea's willingness to pursue more rational economic policies. As previously mentioned, the contribution of foreign trade to Jilin's GDP is significantly less than Liaoning's and other provinces along China's East coast. To remedy this and close the gap with more developed provinces, Jilin hopes the Changjitu regional development program will position the province as a new hub for Northeast Asian trade. Jilin plans to invest heavily in infrastructure to establish a commercial corridor connecting Changchun City, Jilin City, and Tumen City (a key border crossing with North Korea). The project's eventual goal is to link the economic development zone with North Korea's port at Rajin, which sits approximately 50 kilometers from Tumen.



Google Earth Photo of Rajin Port

Ambitions to connect Rajin with northeastern China are not new. The Tumen River Area Development Program (TRADP) was established in 1991 by the United Nations Development

Program as a multilateral forum that would increase regionalism in Northeast Asia. In 2005, it evolved into the Greater Tumen Initiative (GTI), which describes itself as an “intergovernmental cooperation mechanism” for Northeast Asia with a membership of four countries: China, South Korea, Mongolia, and Russia. The GTI was established in 2005 with the main purpose of strengthening regional solidarity and cooperation for economic growth and sustainable development. It aims to provide a platform for economic and technical cooperation in five key areas: transport, energy, tourism, investment, and the environment.⁴⁷ In the transition from TRADP to GTI, these areas of cooperation were given priority, as was geographical expansion and the extension of the intergovernmental agreements until 2015.

China has promoted and participated in the TRADP and the GTI as a means to promote economic development in China’s Northeast and solidify connections to North Korea. In 1991, concurrent with the founding of the TRADP, North Korea experimented with economic reforms and formed the Rajin-Sonbong free economic trade zone. By 2007, the “Road and Harbor” project for Rajin’s port was one of 10 specific projects marketed as “GTI projects” in order to raise additional capital for improvements.⁴⁸ Materials published by the GTI often tout the Changchun-Jilin-Tumen River Pilot Zone’s connection to North Korea, which includes the border crossing at Hunchun as well as Yanbian Prefecture, which is entirely within the zone.⁴⁹

The Changjitu project reflects Jilin’s vision for its future and is the province’s response to Beijing’s challenge to the northeastern provinces to spur economic growth. The Changjitu plan won the central government’s endorsement as a new contribution to Beijing’s strategy to revitalize what it calls the Northeast industrial base. The lack of an export-oriented economy in Jilin was acknowledged as a significant factor affecting the slow pace of economic revitalization. Authorities therefore began formulating the pilot zone concept to address this problem, encouraged by Hu Jintao’s tour of the province in 2007. Jilin’s regional development strategy was formally endorsed by Beijing in November 2009, giving the province the right to pilot cross-border economic cooperation zones and facilitate trade through preferential policies such as expedited customs clearance.⁵⁰

47 Greater Tumen Initiative website, <http://www.tumenprogramme.org/>.

48 Nataliya Yacheistova, “Greater Tumen Initiative and its Activities in the Transport Sector,” (presentation at the Northeast Asia International Conference for Economic Development, Niigata, Japan, 25–26 January 2010).

49 “‘长吉图’开发规划纲要即将在京发布,” 23 October 2009.

50 “长吉图将成为内陆地区沿边开放体制改革创新改革试验区,” *Xinhua*, 19 November 2009.

The Changjitu pilot zone covers one-third of Jilin Province and half of its economic volume.⁵¹ It has an area of 73,000 square kilometers, a population of 11 million and an annual economic output of 360 billion yuan (US\$51.43 billion).⁵² The framework aims to quadruple the regional economy by 2020 and transform the region into an “industrial and logistics center with science and technology innovation and modern agriculture.”⁵³

The Changjitu implementation plan released in January 2010 provides more details about Jilin’s vision for the zone. Changchun, the capital of Jilin Province, will be the first area to test the project. The plan calls for Changchun to become the financial center of Northeast Asia, establishing new industrial development models, increasing urban and rural integration and administration. The first phase will also explore the formation of new institutions such as a Tumen River Bank or a bank supporting small and medium enterprises, as well as other financial mechanisms such as local financial holding companies and financial leasing firms. Increasing the provincial government’s investment and financial advisory services capacity is an important part of the plan. Major proposed projects include vehicle production, oil shale processing, and wind-power equipment production. Additionally, a natural gas pipeline between Changchun and Yanbian and a nuclear power station in Jilin have been proposed.

Improvements in transportation infrastructure are central to the Changjitu plan and build on investments that have been made over the past decade. New expressways between cities in Jilin, an intra-provincial highway network, and improvements to airports and railway freight ports in Jilin have already been made or are planned. The degree of optimism that cross-border trade will someday expand is revealed by three highly visible recent infrastructure projects: the large Tumen Customs House, the “national gate” at Quanhe on the border with North Korea, and the Wonjeong Customs House on the North Korean side opposite Quanhe.

The funding for these investments comes from a variety of sources, including central and local governments and to some degree, capital raised on bourses and from private sources. Officials have expressed interest in exploring other sources of funds to stimulate cross-border cooperation, including the Asian Development Bank. Chinese authorities are considering the establishment of a “Northeast Asia Investment and Cooperation Fund” or a Tumen River Area

⁵¹ “长吉图将成为内陆地区沿边开放体制改革创新改革试验区,” *Xinhua*, 19 November 2009.

⁵² “中国图们江区域合作开发规划纲要—以长吉图为开发开放先导区,” *People’s Daily*, 25 November 2009.

⁵³ “长吉图将成为内陆地区沿边开放体制改革创新改革试验区,” *Xinhua*, 19 November 2009.



Tumen Customs House



Quanhe Border Crossing



Wonjeong Customs House

Industrial Development Fund. To finance trade, Jilin is seeking to establish a branch of the Export-Import Bank of China in the province. Attracting investment from Japanese, Korean, Russian, and more-developed Chinese provinces is identified as another opportunity. Regional cooperation through the Northeast Asia Economic Cooperation Forum and local government liaison offices to the Northeast Asia Summit meeting has also been suggested.⁵⁴

The Port of Rajin: The Gleam in Yanbian's Eye

The Rajin (or Rason) Special Economic Zone is strategically located in the easternmost part of North Korea, close to both Russia and China. Rajin is the northernmost ice-free port in Northeast Asia, which makes it particularly appealing to landlocked Jilin as well as to Eastern Russia. The port currently has three terminals with five piers and periodic announcements that development rights for different quays have been granted give the sense that it is a hub of

⁵⁴ “吉林省探索组建图们江银行,” *City Evening News*, 15 January 2010.

activity. However, for the past 15 years, North Korea has sought to attract investment to the port and special zone, though few of these efforts appear to have come to fruition. Investments intended to promote tourism include a large casino, which a recent visitor reported was empty. Other recent reports suggest that fifty-year development rights have been granted to Russia for Pier 3, Rajin's largest.⁵⁵ At the March 2010 National People's Congress, the governor of Yanbian Prefecture announced that a private Chinese company had secured a 10-year lease on a pier at Rajin, though it was revealed that Chinese interests had already secured 10-year rights to Pier 1 in 2008, and negotiations were underway to extend the agreement for another 10 years.^{56, 57} In December 2010, a Chinese company signed a memorandum of understanding (MOU) with a North Korean counterpart offering to invest US\$2 billion in projects in Rajin's economic zone, including the port's pier, a power plant, road, oil refinery, a steel plant, and the Musan Iron Mine.⁵⁸

Interestingly, despite decades of espousing multilateral approaches to regional economic integration, it is bilateral projects such as the Chinese and Russian leases of different parts of Rajin's port that seem to have the most traction, though it is too early to declare them successful. Furthermore, these projects are unlikely to succeed without massive additional investments in North Korea's rail and road network to connect the zone to Russia and China at least, and possibly the rest of North Korea as well.

Currently, the road to Rajin literally stops at Hunchun in Yanbian Prefecture where Chinese highways become North Korean dirt roads. Planning began in 2003 to develop a functioning transport corridor between Hunchun and Rajin. A common development approach for the two countries was sought under the slogan, "road, port, integration." Chinese capital would underwrite the highways between the port and border. The North Korean proposal to provide the Chinese investors a return on their investment was an offer to develop five to 10 square kilometers of land created as industrial zones. In 2005, two companies from the city of Hunchun in Jilin Province established the first economic cooperation agreement with Rajin authorities for the right to invest within the port and operate a port terminal for 50 years,

⁵⁵ See, for example, Yoo Jee-ho, "In Search of Foreign Capital, North Opens up Rajin Port," *JoongAng Daily*, 9 March 2010.

⁵⁶ "China's Jilin Wins Use of N. Korean Sea Port," *Chosun Ilbo*, 9 March 2010.

⁵⁷ "长吉图成热点:租朝鲜罗津港10年运延边煤," *New Culture News*, 10 March 2010.

⁵⁸ MOU between Shangdi Guanqun Investment Co., and Investment and Development Group, dated December 20, 2010.

reportedly at Piers 3 and 4, despite subsequent announcements that a Russian concern had been granted the rights to Pier 3. Though Hunchun is located on the Tumen River, it cannot function as a port or access the sea. Hunchun Donglin Trade Co., Ltd. and Hunchun Border Economic Cooperation Zone Bonded Co., Ltd. established the Rason International Logistics Joint Venture with the Rason City People's Committee for Economic Cooperation. The joint venture was approved by the North Korean Central Economic Cooperation Board for a cooperative operation period of 50 years. It was also given the right to develop the Rajin Port Road and land in planned industrial parks near the highway and the free trade zone.⁵⁹ In the project's letter of intent, the Chinese partners were responsible for the construction of the road from Wonjeong to Rajin while North Korea kept the highway toll rights, the right to develop tourism along the highway, some land use rights in Rajin, and the right to use the Rajin port terminal in exchange. The cooperation project reportedly involved a total investment of 1.3 billion euros while the Rason International Logistics JV Company had registered capital of 60.904 million euros.⁶⁰ Despite the level of detail and apparent agreement between the two sides reflected in these agreements, however, the project never came to fruition.

In 2005, the Port of Rajin reportedly had a total area of 38 million square meters with three terminals, 10 berths, a handling capacity of three million tons, and a storage area of 203,000 square meters. With dredging and equipment improvements, the port was expected to achieve berths accommodating ships displacing 50,000 tons, with four terminals and an annual throughput of 300 million tons. The project was touted for its ability to revitalize the Northeast's industrial base by changing the pattern of international logistics and transport in Northeast Asia. Typical trade patterns in the Northeast see goods shipped by train to Dandong or Dalian and then freighted to Japan, arriving in three or four days; goods shipped from Rajin to Niigata will arrive in 10 hours.⁶¹ In 2006, the joint venture established between the Hunchun enterprises and Rajin for "Road Port Integration" was described as part of Jilin Province's implementation of the "going out" strategy.⁶²

⁵⁹ "中朝合作罗津港 出日本海通道开," Heilongjiang Provincial Department of Commerce Information Office, 22 October 2005.

⁶⁰ "中朝合作罗津港 出日本海通道开," Heilongjiang Provincial Department of Commerce Information Office, 22 October 2005.

⁶¹ "中朝合作罗津港 出日本海通道开," Heilongjiang Provincial Department of Commerce Information Office, 22 October 2005.

⁶² "中朝珲春--罗先'国际物流'在朝注册," *Yanbian Daily*, 26 February 2006..

Despite the announcements in 2005, the formal joint venture contract was not signed until February 2006.⁶³ At this time, the Yanbian *Daily News* reported the project's implementation involved two steps. The 48-kilometer highway project connecting Wonjeong to Rajin Port was finalized with ongoing construction design, preparation of the project budget and materials. Plans for expanding Pier 3 of the Port of Rajin and developing the industrial parks and processing zones were developed simultaneously. Construction was planned to begin in May 2006.⁶⁴ According to reports in July 2007, the investors agreed that the port's annual handling capacity was to increase to 50 million tons by 2010 and then reach 100 million tons of throughputs.⁶⁵ However, by 2008 it was apparent that the project made little progress. A January 2008 article published by China's Xinhua News Agency reiterated many of the facts about the original "road, port, integration" project of 2005 and heavily promoted the China-led regional economic development initiatives in the greater Tumen area. However, the article could do little more than point to potential rather than progress. Highlighting the decrepit state of North Korean infrastructure, helicopters are suggested as the preferred mode of transporting foreign investors from Russia and China to Rajin.⁶⁶

In November 2008, the government of Yanbian Prefecture reported that the agreements of 2007 had yet to be implemented and construction of the project had made no substantial progress, despite continued interactions between North Korean authorities and potential foreign investors. At this time, a Russian railways delegation visited Pyongyang and agreed to build a railway link between Hassan, Russia and the Port of Rajin. Various site visits and the signing of related agreements between Russia and North Korea convinced experts in Yanbian that the project would be successful in the near future. Chinese authorities appealed for cooperation at all levels of government, not just at the enterprise level, to more actively promote their projects and to press for implementation of their agreements as soon as possible so China would not be left behind by accelerating cooperation between Russia and North Korea.⁶⁷ In October 2009, Premier Wen Jiabao traveled to North Korea and announced China's intent to develop Rajin's port and construct a new bridge across the Yalu River, indicating support for these projects at the highest

⁶³ "中国公司入股朝鲜罗津港 朝鲜旨在引资," *International Herald Tribune*, 22 September 2005.

⁶⁴ "中朝珲春--罗先'国际物流'在朝注册," *Yanbian Daily*, 26 February 2006.

⁶⁵ "珲春'借港出海'有望改写东北亚贸易格局," *East Asia Economic News*, 27 July 2007.

⁶⁶ "东北亚地区'金三角'构建大物流新格局[图]," *Economic Information Daily*, 21 January 2008.

⁶⁷ "朝俄经济合作步伐加快中朝'路港区-体化'应加快实施," *Yanbian Government News*, 24 November 2008.

levels of both governments.⁶⁸

On August 30, 2009, the Changchun-Jilin-Tumen Pilot Zone development project was formally approved by the State Council, and it was announced by Jilin provincial authorities in October.⁶⁹ The Governor of Jilin Province expressed hope for cooperation with Russia and North Korea, particularly regarding the integration of Rajin port.⁷⁰ China's concerns that bilateral competition and traditional China-Russia rivalries were trumping multilateral efforts were expressed at a 2009 seminar convened by the Jilin Academy of Social Sciences, where speakers said that China needed to take active measures to support the port project.⁷¹ The revelations of new agreement in December 2010 to invest in the port and economic zone might indicate that negotiations with yet more Chinese partners are underway, raising the possibility that North Korean authorities are playing different Chinese investors off against one another, or simply offering development and operating rights at particular piers or berths that have not already been spoken for by investors.

North Korean Policies and Organizations to Attract Investment

Despite its ambivalence towards foreign investors, North Korea has established policies and organizations to promote inbound investment including the promulgation of laws governing joint ventures and the establishment of a development bank. The Pyongyang Chamber of Commerce was founded in 2000 and succeeded by the North Korean Chamber of Commerce in 2004. Closely linked to the Ministry of Foreign Trade, the chamber sees its mission as helping foreign investors find partners in North Korea, organizing trade fairs, and facilitating the settlement of disputes through its arbitration committee. Though the rule of law is notoriously weak in North Korea, the country does have three key laws governing the rights of investors in North Korea and defining contractual joint ventures, equity joint ventures, and foreign investment. Totalling 13 pages, the laws represent an attempt on the part of the government to persuade foreign investors to commit their capital. A fourth law regulates administration of Free Economic and Trade Zones.

⁶⁸ “中国获得朝鲜罗津港码头开发权,” *Yonhap News*, 7 October 2009.

⁶⁹ “长春综合保税区力争2010年申报成功,” *Changchun Evening News*, 17 December 2009.

⁷⁰ “长吉图布局通海战略 30亿中朝路港区项目已启动,” *Daily Economic News*, 19 November 2009.

⁷¹ “长春综合保税区力争2010年申报成功,” *Changchun Evening News*, 17 December 2009.

The Foreign Investment Law of 1992 permits investment in industry, agriculture, construction, transport, telecommunications, tourism, commerce, and financial services; the law provides preferential treatment, including tax exemptions and preferential loans for investments in key sectors including natural resource development, infrastructure construction, and high technology. Under the Foreign Investment Law, a joint venture may take the form of an equity joint venture, a contractual joint venture, or a wholly foreign-owned subsidiary, though wholly foreign-owned joint ventures are only allowed in Free Economic and Trade Zones. The Contractual Joint Venture Law favors ventures in sectors producing exportable goods and in the tourism and service sectors. A Foreign Equity Law provides for the establishment of joint ventures, with preference given to joint ventures in the Free Economic and Trade Zone of the Rajin-Sonbong region established in 1992 and the Special Administrative Zone of Sinuiju established in 2002, though ventures in other regions are also permitted.⁷² Chinese investors and analysts have described these laws as well-developed despite their brevity, but they are seen as largely irrelevant by investors who are subject to predation and the whims of North Korean authorities at various levels. Corruption and extortion are common and investors have few legal remedies with which to protect themselves or seek remedies. Unsurprisingly, many investments have failed.

Pyongyang, however, remains committed to attracting foreign investment, as evidenced by recent reports about North Korea establishing a development bank and associating it with an investment group. The Taepung International Investment Group was established in China and Hong Kong in September 2006 to lure foreign investment to North Korea, though there is little evidence that its efforts to that end have been successful thus far. In January of 2010, North Korean media announced that a State Development Bank would be established to finance national development projects along with the Taepung Group. The announcement also noted the appointment of a Korean-Chinese businessman named Pak Chol-su as president of Taepung. Pyongyang's decision to appoint a foreigner as the chief executive indicates their understanding that a foreign face is needed to successfully attract investment. Pak was born in 1959, graduated from Yanbian University and has an MBA. He reportedly developed close ties with high-ranking North Korean officials by selling Chinese gasoline in North Korea. The board of directors of the investment group includes representatives from the National Defense Commission, the Cabinet, and the Ministry of Finance, as well as prominent leaders including Kim Yang-gon, director of

⁷² Suk Hi Kim, *North Korea at a Crossroads* (Jefferson, NC: McFarland, 2003), 87–88.

the Worker's Party United Front Department and Jang Song-taek, Kim Jong-il's brother-in-law.⁷³

Despite extensive speculation about the role of Taepung and the State Development Bank, media reports and rumors have been impossible to verify. It is believed that the group will promote infrastructure projects rather than financing the import or export of finished goods.⁷⁴ While Taepung is described as a quasi-governmental agency, its source of capital is unclear; some reports have stated its capital at US\$10 billion, while others have presumed that the source of this capital was China's development bank.⁷⁵ Taepung was reportedly involved in a 2007 MOU with Tangshan Iron and Steel and Datang Power to build a processing plant and coal-burning power plant in North Korea, but otherwise has little track record to evaluate.⁷⁶ One Jilin-based analyst in early 2010 was optimistic that this new arrangement would be successful where past configurations had failed because the financing of this venture included both government and private sector capital, reasoning that the private sector would ensure the feasibility and profitability of projects, while both governments' involvement provided necessary political assurances.⁷⁷

In July 2010, a Joint Venture Commission was established under the North Korean Cabinet. Described by North Korean official Hyong Myug-soo to foreign visitors as a "one stop shop" for international investors, the role of this new commission, particularly in relation to the Taepung group, is unclear.⁷⁸ For foreign investors, the existence of a Joint Venture Commission as the one office where regulatory oversight is concentrated is a potential benefit. One particular value to investors is the potential concentration and legitimization of taxes and fees. In a country like North Korea, where rent seeking by officials in different bureaus and by governments at various levels is difficult to control, having a single investment office is a potential benefit—essentially, an investor can pay a tax and get a receipt, rather than be subjected to endless demands amounting to extortion. However, if this new Joint Venture Commission becomes a competing center of influence, then predation and rent seeking behaviors could escalate. The likelihood of this occurring increases when one office is under the Cabinet and the other is

⁷³ "1st Meeting of Korea Taepung I IG Held," *KCNA*, 20 January 2010.

⁷⁴ "N. Korea's Investment Agency Under the Microscope," *Chosun Ilbo*, 23 February 2010.

⁷⁵ Namgung Min, "\$10 Billion Too Much for North Korea, Says NIS Chief," *Daily NK*, 24 February 2010.

See also "N. Korea draws US\$10 billion in foreign investments: source," *Yonhap News*, 15 February 2010.

⁷⁶ "DPRK Establishes National Development Bank in Order to Attract Foreign Capital," *NK Brief* 10-01-22-1, Institute for Far Eastern Studies, 22 January 2010.

⁷⁷ Anonymous Jilin-based analyst, interview by the author, Washington, DC, March 2010.

⁷⁸ Hyong Myug-soo, interview by the author, Washington, DC, October 2010.

controlled by the National Defense Commission. Because the control of hard currency and taxes from investors are important sources of power for the North Korean regime, competition between agencies allied with different segments of the bureaucracy and individual leaders is presumed to exist. Chinese investors could therefore provide unique insights into elite politics and competition as it is reflected in the relative power of regulatory bodies that they interact with.

Chinese Joint Ventures in North Korea

This project seeks to explore the type, scope, and extent of Chinese investments in North Korea, the ramifications of their investments for the resiliency of the North Korean regime, their possible influence on Chinese policy, and their implications for future unification of the peninsula. Through field research in China, interviews with Chinese investors, extensive surveys of open source materials including Chinese government statistics, media reports, and secondary sources, we have compiled a database of 138 Chinese investors in North Korea from 2001 to August 2010, representing the entirety of legitimate Chinese investors recognized by the government. It is likely there are informal and illegal investors present in North Korea, but because they lack any recognized status, their political and economic impact is unlikely to be significant.

The collected data provides unique insights about the Chinese companies that invest in North Korea, the scope of their projects, and their relations with their North Korean partners. Of course, there are obvious limitations to the amount of information that can be collected due to the sensitivity of the China-North Korea relationship. Unsurprisingly, private companies in China (like their counterparts around the world) are reluctant to share commercial information with outsiders. Most of the Chinese investors are not publicly listed companies and therefore under no obligation to report to regulators or the public. Chinese officials are particularly sensitive about relations with North Korea and have been known to apply unique standards inconsistent with trends toward transparency observed in other sectors to the reporting of cross-border activities. For example, Chinese authorities periodically refuse to release information about certain trade activities involving North Korea or couch their statistical reports in euphemisms, such as during a period in 2009 when authorities created a generic description for “other Asia not elsewhere specified,” which appeared to correspond exclusively to trade with North Korea.⁷⁹ Despite the sensitivity of both the Chinese government and the private sector about releasing information related to North Korea, we have been able to consistently identify important, authoritative metrics about Chinese outbound investments, including the official names of the joint venture and Chinese partner, the registered location of the Chinese partner, the date of the investment,

⁷⁹ Chris Buckley, “China Hides North Korea Trade in Statistics,” *Reuters*, 26 October 2009.

and scope of business. Information about North Korean partners and the site of joint ventures in North Korea is less complete, as is the value of investments. Financial data about individual joint ventures, including capital sums committed and utilized, is often proprietary and closely held. In a handful of projects, media reports have referred to registered capital figures, though registered capital is often a poor measure of the actual size of a specific project. For instance, a Chinese company with registered capital of RMB50 million (US\$7.7 million), recently signed an MOU promising US\$2 billion in investment in the Rajin region.⁸⁰

The reluctance of Chinese investors to release information is likely due to a combination of custom and an appreciation of the sensitivities of the Chinese and North Korean governments about the two nations' economic relationship. However, private companies in particular require a certain amount of visibility in order to attract clients and conduct commerce. In light of this fact, it is perhaps unsurprising that 85 percent of the 138 identified Chinese investors in North Korean joint ventures have a web presence of some sort. Sixty-seven companies have dedicated corporate websites and another 50 Chinese investors, while lacking websites of their own, at least post information about themselves on various Chinese business-to-business websites such as Alibaba.com.⁸¹ However, the level of detail available on the Internet is relatively limited and only a minority of companies offers information to the public about their projects in North Korea.

Despite these limitations, from the collected data a picture of Chinese investors in North Korea begins to emerge. Unfortunately, the body of information about the actual workings of Chinese joint ventures in North Korea is small, though tantalizing fragments are sometimes revealed, usually through interviews with investors. So what might a typical North Korean joint venture investment look like? In an effort to attract capital, North Korean agencies and consulting firms often post descriptions of projects seeking investors. These descriptions of how a prospective joint venture might be structured provide some insights into an idealized joint venture. Clearly, however, the actual investment environment is much more difficult than that described in a North Korean sales pitch. One prospectus from an investment promotion firm authorized by North Korean authorities to attract investors paints a rosy picture of the opportunities available to companies willing to invest in the DPRK. This example of an ideal

⁸⁰ “商地冠群投資有限公司,” Website of the Beijing City Government Office of Small and Medium Enterprises.

⁸¹ Internet searches conducted September 2010 on the two largest search engines in China, Baidu and Google.

arrangement for a contractual joint venture offers an investor the opportunity to invest in a factory that would be the exclusive producer of fire extinguishers in North Korea, a market estimated by the agent at 400,000 units per year with demand met currently by imports from China.

According to this offer and others like it, North Korean partners are willing to give foreign partners a majority equity stake in a joint venture. However, in practice, foreigners rarely have the opportunity to actually control the operation of their joint ventures. The fire extinguisher prospectus offers a choice between a 70-30 or 60-40 partnership with the North Korean partner retaining the minority share, stating that management of the plant will remain with the “foreign side.” The duration of the contract is suggested at 10 to 20 years. For a 70-30 joint venture, the foreign partner is expected to provide investment of US\$1 million for construction of the factory, production equipment, and a “floating fund.” The North Korean partner provides the land, workers, and basic construction materials to build the factory. The prospectus also predicts a generous rate of return. With predicted sales of 150,000 fire extinguishers per year at US\$17 each, the projected profit is US\$1,050,000 in the first year, though a 25 percent corporate tax would be imposed after a three year exemption. According to the prospectus, the lucky foreign investor holding a 70 percent stake would recoup their investment in two years and by the second year expect profits on a scale of more than 50 percent annually.⁸² *Caveat obsido.*⁸³

Unsurprisingly, the North Korean investment environment is far from ideal and an untold number of Chinese investors have lost money or closed their operations in North Korea. The Chinese Ministry of Commerce’s investment guide to North Korea states, “Overall, recent Chinese enterprises investing in North Korea have major problems.”⁸⁴ Widespread corruption, the lack of rule of law and even personal violence make North Korea a brutal investment destination. Chinese authorities and official documents alike warn Chinese companies seeking to invest there of the difficulties awaiting them. The inability to independently conduct market research or to acquire North Korean economic and demographic data or any other statistics

⁸² “Information about Contractual Joint Venture, monopolized production of Fire Extinguishers in the DPR of Korea,” International Korean Business Centre.

⁸³ Investor beware. 投资者注意。

⁸⁴ “总体看，目前中国企业对朝投资主要存在以下问题。” Quoted from “Foreign Investment and Cooperation Guide: North Korea,” Chinese Academy of International Trade and Economic Cooperation, People’s Republic of China Ministry of Commerce Investment Promotion Agency and Commercial Attaché of the Embassy of the People’s Republic of China in the DPRK, 2009, 53.

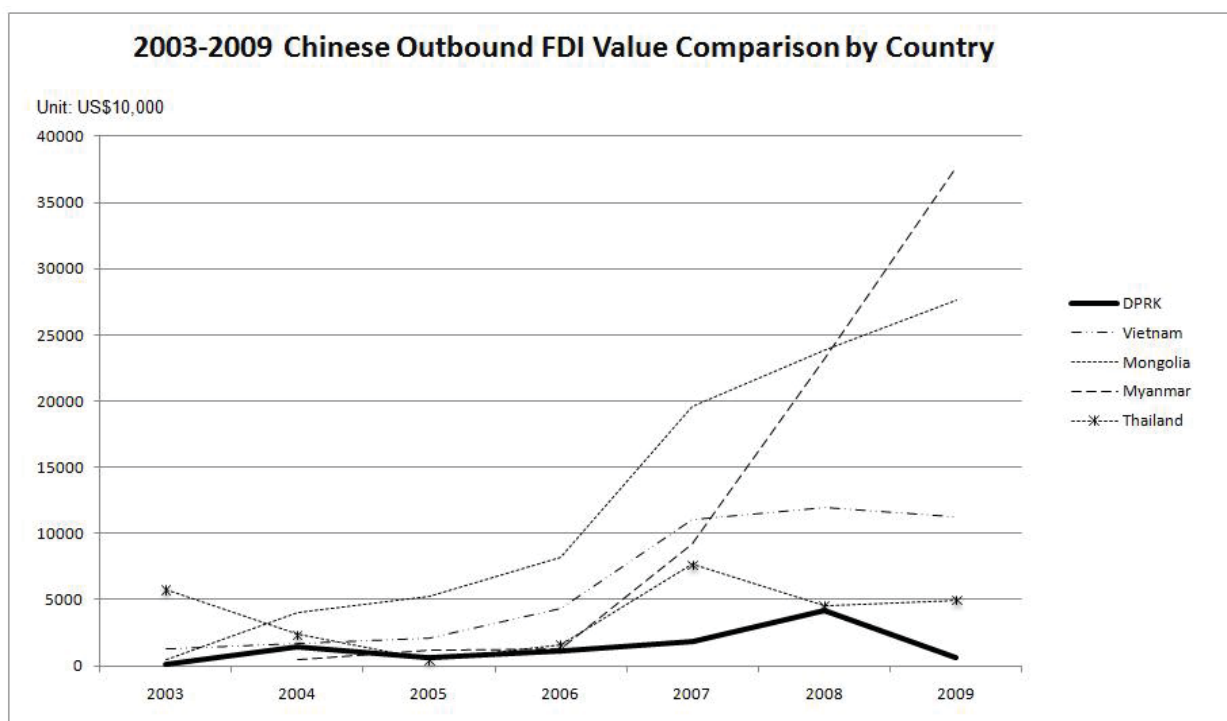
make it impossible for Chinese investors to assess risk or verify claims such as those made in investment solicitations. The Ministry of Commerce investment guide describes Chinese enterprises investing in North Korea as existing in a “state of blindness.” It further laments that some Chinese companies are “out of their depth,” and relegated to a “passive position and unfavorable situation” in their investment projects.⁸⁵ According to a western diplomat in Pyongyang, China’s Ambassador to North Korea was recently advising Chinese businessmen considering investments in North Korea to direct their capital elsewhere. We don’t know why the Chinese ambassador was reportedly warning away Chinese investors. However, we can speculate at least three possible factors: the terrible business environment, a complicated and sensitive diplomatic relationship, and unwelcome international attention.

To some degree, China’s discomfort with its North Korea commerce is due to international scrutiny of what the international community considers an aberrant relationship. While much of the rest of the world seeks to impose sanctions on North Korea and isolate the country in order to coerce it into giving up its nuclear weapons and other provocations, Chinese trade continues, though one can hardly say it is flourishing. In some ways, China’s growing share of North Korea’s trade comes at the expense of countries who have curtailed their economic relationships in the wake of aggressive North Korean behavior. Additionally, South Korea is particularly concerned that Chinese economic dominance in North Korea will bring Pyongyang closer to Beijing’s orbit at Seoul’s expense.

Two critical Chinese motivations for continuing and protecting this trade are the economic benefits accruing to its northeastern provinces and the desire to ensure the continued survival of the North Korean regime. While China has a strategic interest in preventing a sudden collapse of the North Korean economy and the regime in Pyongyang, Chinese investment patterns in North Korea appear consistent with outbound investment to other countries on China’s periphery. In this context, Chinese investments in North Korea do not appear to be unique or made with strategic intent. If anything, Chinese investment projects in North Korea are smaller and less successful than projects in neighboring states. For example, from 2003 to 2009, Chinese outbound investments to North Korea totaled US\$98.3 million, compared to US\$1.2 billion to South Korea, US\$273 million to Thailand, US\$437 million to Vietnam, US\$729.8 million to Myanmar, and US\$890.7 million to Mongolia over the same period.

⁸⁵ “Foreign Investment and Cooperation Guide: North Korea,” 53–54.

Figure 3. 2003-2009 Chinese Outbound FDI Value Comparison by Country



Furthermore, as the above chart indicates, beginning in 2006, Chinese outbound investment began to increase steadily in a number of neighboring states including North Korea, though to a much lesser degree. Interestingly, the total value of Chinese investments in North Korea fell more than 85 percent in 2009, to US\$5.8 million, down from an all time high of US\$41 million in 2008.

Table 1: Chinese Outbound Investments to North Korea by Year and Value

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--------|---------|-------|---------|--------|---------|--------|
| \$1.12 | \$14.13 | \$6.5 | \$11.06 | \$18.4 | \$41.23 | \$5.86 |

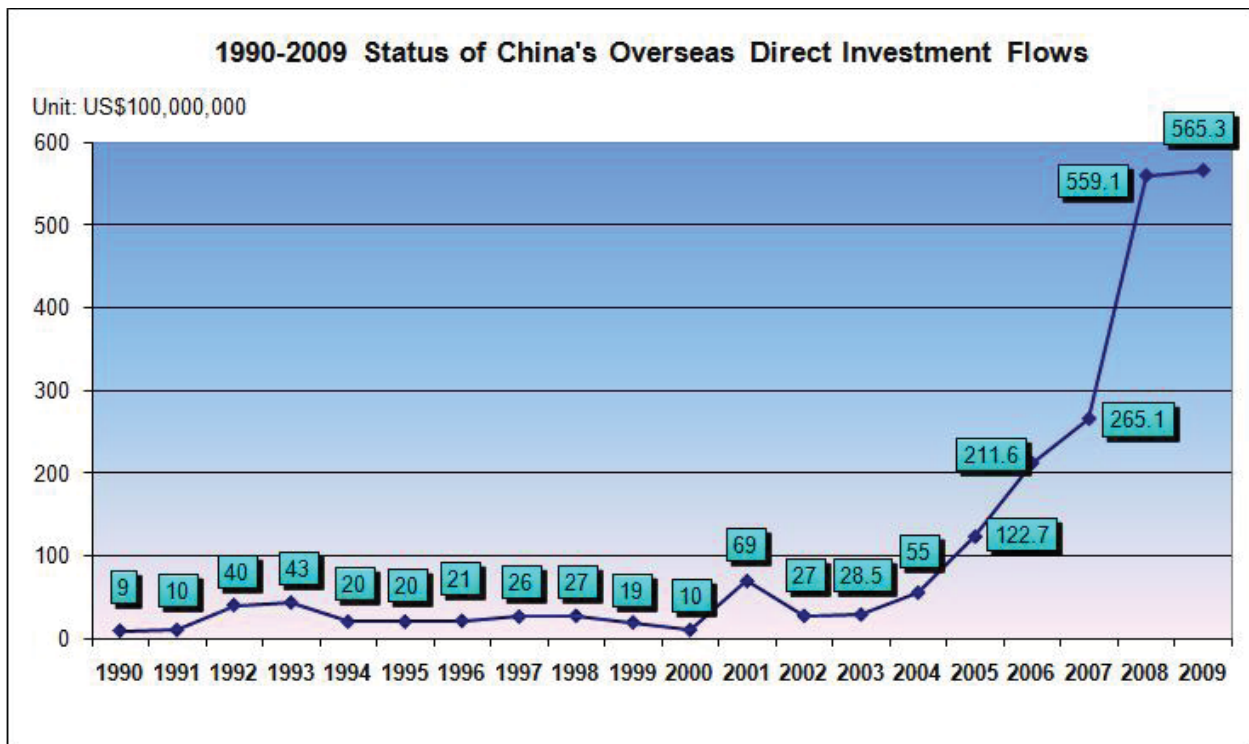
Unit: millions of US\$.

Who is Investing in North Korea?

Since the end of the Korean conflict, China has made significant contributions to rebuilding North Korea, with critical investments in both industries and infrastructure. However, trade, aid, and investments that occurred during the planned-economy period prior to the reform and opening of China's economy were of a completely different nature and are not considered

in this study. The first two decades following China’s reform and opening in 1979 were focused largely on rebuilding China’s economy and attracting foreign capital, technology, and expertise from the West, rather than on investing abroad. The volume of China’s outbound investments prior to the year 2000 was relatively small. Tellingly, from 1990 to 2001, the Ministry of Foreign Trade and Economic Cooperation (the organizational predecessor of the Ministry of Commerce) did not even track Chinese outbound investment. To this day, the Ministry of Commerce relies on United Nations statistics when plotting outbound investment trends prior to 2002.

Figure 4. 1990 to 2009 Status of China’s Overseas Direct Investment Flows



The first Sino-DPRK joint venture was announced in 1989 and reportedly engaged in aquaculture in Chongjin (Ch’ngjin) with a reported initial capitalization of US\$1 million.⁸⁶

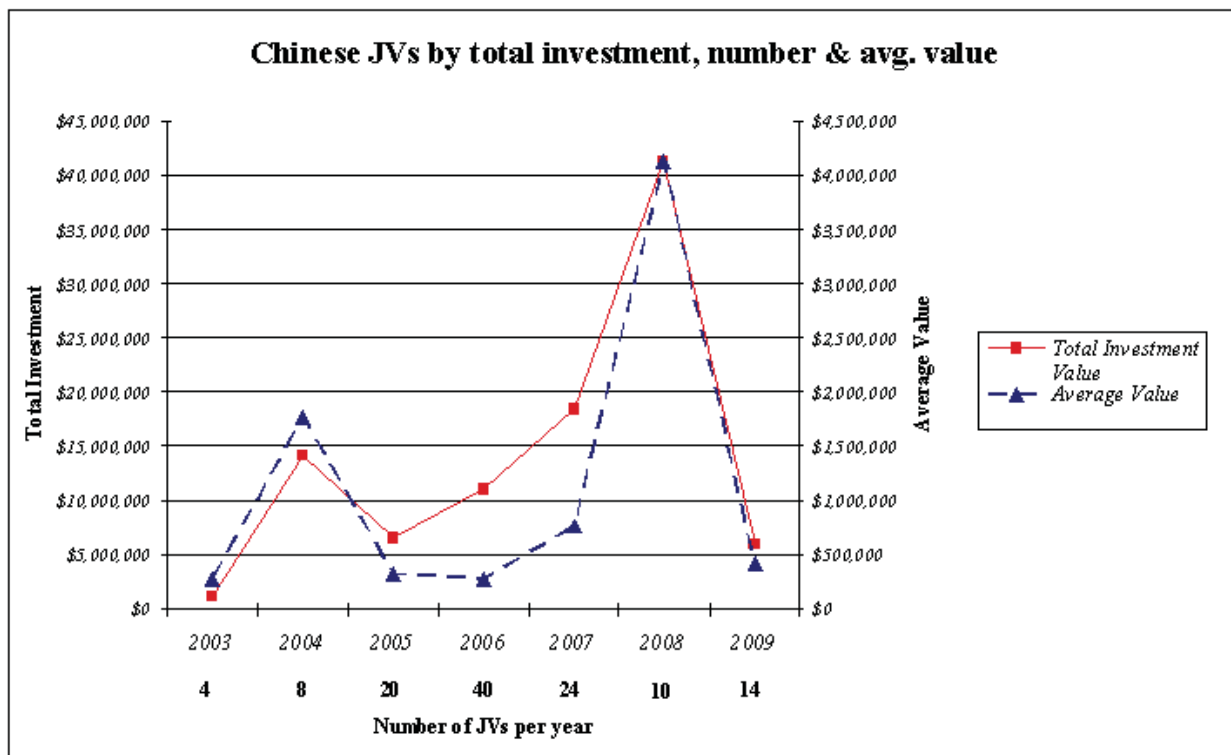
The first Chinese joint venture identified in this study’s database is a fertilizer factory founded in 1997 outside Pyongyang. In 2001, a Liaoning-based company partnered with a North Korean bank and began offering Internet services in Pyongyang. In 2002, three separate joint ventures were formed to manufacture computers and electronics, including one involving

⁸⁶ “North Korea: Foreign Investment and Joint Ventures,” Library of Congress Country Studies (June 1993).

the Nanjing Panda Electronics Company. Four joint ventures were formed in 2003, and eight in 2004. From 2005 to 2006, there was a marked increase in the number of Chinese companies registering joint ventures in North Korea, with 20 in 2005 and 40 in 2006. Despite rising values of investment, the number of new joint ventures tapered off to 24 in 2007 and 10 in 2008, indicating that in those two years, the size of joint ventures increased noticeably.

Chinese investments in North Korea are relatively small. However, a small number of large investments, such as infrastructure projects and equity stakes in mines, tend to skew the statistical averages. For example, in 2006, the average value of Chinese investments in North Korea was US\$276,500, though in 2008, the 10 joint ventures formed in North Korea had an average value of US\$4,123,000. Between 2003 and 2008, the average value of all joint ventures was US\$1,256,236, however, that figure might be misleading because of a handful of large investments.

Figure 5. Chinese Joint Ventures by Year, Total Investment and Average Value



Who Are the Chinese Investors?

The majority of Chinese investors in North Korea are small and medium-sized

enterprises. Only two of China's top 100 companies (as identified in Forbes' China 100 list for 2007) are investors in North Korea—Wuhan Iron and Steel and Tangshan Iron and Steel. A handful of other “brand name” companies have North Korean joint ventures, including Nanjing Panda Electronics, China Minmetals Corporation, China Nonferrous Metal Mining Group, Wanxiang, and the Wellhope Group. Clearly, the majority of Chinese investors in North Korea are not SOEs controlled by the central government, but privately owned companies and provincial, prefecture, and municipal-owned SOEs. As far as one can tell, only four out of the 138 investors are central-government owned companies. When asked why more of the top Chinese companies were not investing in North Korea, one Chinese investor from a small company stated, “if there were big profits to be made in North Korea, the big conglomerates would push in and drive us out.”⁸⁷

Where Are They From?

Chinese investors in North Korea are geographically concentrated in the two northeastern provinces bordering North Korea. Twenty-eight percent of Chinese companies involved in joint ventures are from Jilin, and 34 percent are from Liaoning. This parity between the two provinces is notable because approximately 80 percent of all trade between China and North Korea passes through the port of Dandong in Liaoning Province. However, while the amount of investment might be balanced between the two provinces, Liaoning trading companies, particularly those based in Dandong, appear to have a dominant stake in China-North Korea trade. To give one indication of this influence, at the 2010 Pyongyang Spring Trade Fair, held in May 2010, 57 percent of the exhibitors were Chinese and 42 percent of the Chinese companies were from Dandong. It is important to remember, however, that while some Dandong companies have opened offices across the border, these trade fair attendees do not necessarily have registered investments in North Korea.⁸⁸

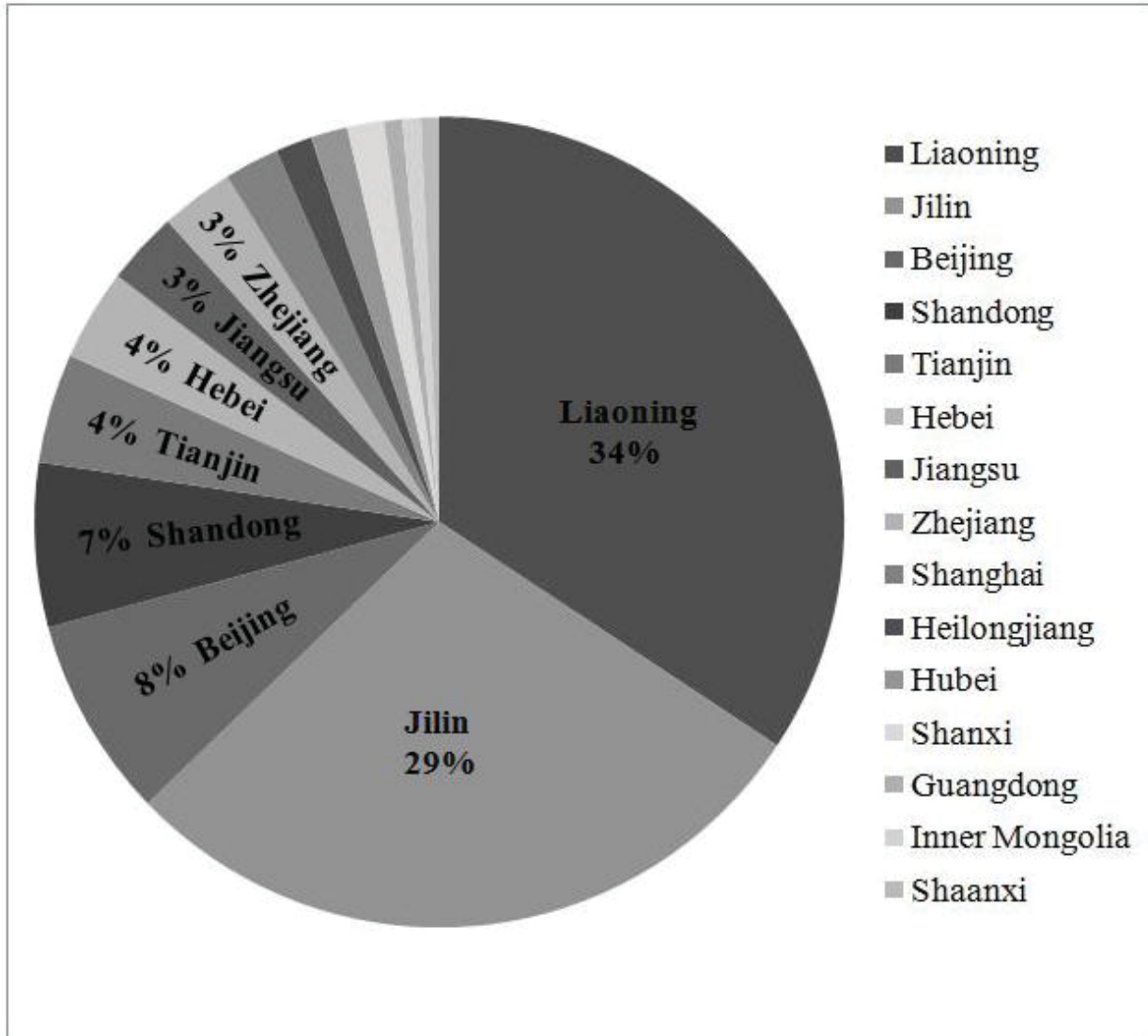
The predominance of investors from Liaoning and Jilin is striking compared to the handful of legitimate investments in North Korea by companies from other provinces. Besides Liaoning and Jilin, the largest number of Chinese joint venture partners is from firms based in Beijing, with 11 companies accounting for eight percent of the total. Other investors include

⁸⁷ Anonymous Chinese investor, interview by the author, Beijing, China, November 2009.

⁸⁸ “朝鲜平壤国际商品展上丹东企业唱‘主角’” *Dandong Daily*, 21 May 2010.

nine companies from Shandong, six from Tianjin, four each from Jiangsu and Zhejiang, and only three companies based in Shanghai.

Figure 6. Chinese Investors by Province



Mining and Extractives Industry Joint Ventures

In seeking to understand the scope of Chinese investment in North Korea, this project categorized all identified Chinese-invested joint ventures into four industrial sectors: heavy industry, light industry, mining/extractives, and services. Of the 138 joint ventures established between 1997 and August 2010, 41 percent are in extractive industries, 38 percent light industrial, 13 percent services, and eight percent heavy industry.

Because mining and extractive industry joint ventures are the largest category, the sector is worthy of special attention. North Korea is rich in resources and China is the dominant investor in North Korea. Therefore, it is not surprising that minerals comprise a significant percentage of North Korea's exports to China and are a valuable source of hard currency for the regime. According to KOTRA, 41 percent of North Korea's exports to China in 2008 were mineral resources.⁸⁹ Mineral exports to China increased from US\$15 million in 2003 to US\$213 million in 2008.⁹⁰ Chinese investments in the sector are critical to North Korea's ability to maintain its raw material output for both domestic use and export. The most important commodities include coal, iron, copper, gold, zinc, nickel, and, notably, rare earth elements.⁹¹

Chinese investment in this sector is a relatively new phenomenon. There were no legitimate mining investments prior to 2004 and only one extractives joint venture was established that year. In 2006 and 2007, the number of mining projects benefiting from Chinese investment increased notably and significant media attention was directed at two large-scale projects: the Musan Iron Mine (Asia's largest open-pit mine) and the Hyesan Youth Copper Mine. This increase in investments and greater publicity caused concern in South Korea that China was seeking to dominate North Korea's mining sector.

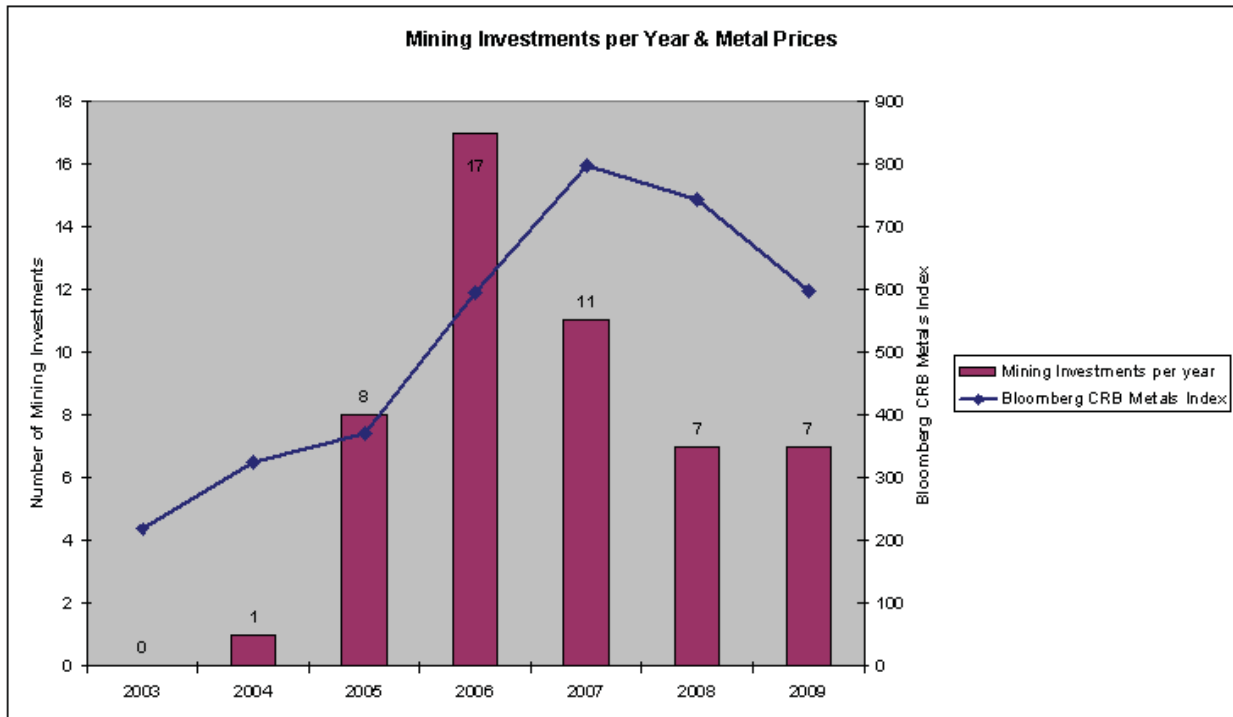
Though Chinese investment in North Korean natural resources causes anxiety in some quarters, trends toward greater Chinese investment were driven by prices as well as by policy. The increase in mining joint ventures is consistent with rising commodity prices prior to the global financial crisis, suggesting commercial rather than political motivations for investment, though clearly such investments are consistent with Chinese strategic goals of ensuring access to raw materials. Despite the immense challenges of investing in North Korea, record-high commodity prices made these North Korean investments particularly attractive at that time, or at least attractive enough to induce Chinese companies to disregard the myriad political risks. Because of North Korea's isolation from international markets, Chinese investors likely anticipated a wider gap between cheaper North Korean-sourced ores and higher prices on the international market. As the following chart illustrates, there is a correlation between the number of Chinese extractives joint ventures initiated in North Korea and commodity prices.

⁸⁹ Kang Hyun-kyung, "Pyongyang's Growing Dependency on Beijing Worries Seoul," *Korea Times*, 25 November 2009.

⁹⁰ Scott Snyder and See-won Byun, "China-Korea Relations: China Embraces South and North, but Differently," *Comparative Connections* 11, no. 4 (January 2010).

⁹¹ Wu, "The Mineral Industry of North Korea," *2007 Minerals Yearbook: North Korea*, 14.1.

Figure 7. Mining Investments per Year



Besides price, important policy conditions enabled this rapid increase in cross-border investment in the extractives sector. As previously mentioned, China’s maturing outbound investment regulatory environment enabled Chinese companies to access hard currency and legally set up joint ventures abroad, consistent with *zouchuqu* policies formulated around the time of China’s WTO accession in 2001. At the same time, North Korea began more actively courting international investment. It is important to note that North Korea was seeking (successfully, in many cases) to attract investment from several nations, but of course Chinese companies were particularly competitive. Beginning around 2003, North Korean authorities began systematically to survey the country’s mineral resources; subsequently, the authorities identified and allocated specific mining project opportunities and marketed them to potential Chinese and German investors.⁹² In 2005, the South Korean government opened a liaison office in Pyongyang to facilitate South Korean investments in the mining sector and successfully established a graphite mining joint venture with South Korean investment.⁹³ North Korea’s opening up of the mining sector combined with the active interest of international investors opened the door to a rush of investment in subsequent years targeting a wide array of critical

⁹² Wu, “The Mineral Industry of North Korea,” *2005 Minerals Yearbook: North Korea*, 15.2.

⁹³ Wu, “The Mineral Industry of North Korea,” *2005 Minerals Yearbook: North Korea*, 15.1.

minerals, including rare earths.

Beyond Hegemony: Rare Earths and the China-North Korea Molybdenum Axis

The strategic importance of critical elements and minerals became front page news in September 2010 when media reported that China had embargoed the export of rare earths to Japan in response to the arrest of a Chinese fishing boat captain who ventured too close to disputed islands and collided with Japanese government vessels.⁹⁴ While China denied that an actual embargo was enacted, the episode attracted considerable international attention to China's almost complete control of the market for rare earth elements. The period between China's accession to the WTO in 2001 and the global financial crisis in 2007 saw a confluence of rapidly rising Chinese demand for and skyrocketing prices of key industrial commodities, which stimulated a rush to exploit newly accessible North Korean mineral resources. The scramble was particularly acute for ores and minerals critical to industry and infrastructure.

China has near monopoly power as a supplier of some rare earths and enjoys a competitive pricing advantage for a handful of other strategic metals, leading some to believe that Beijing has considerable political leverage over countries that are dependent on imported rare earths and strategic metals. China restricts the export of these critical materials through a system of quotas and export duties. It appears that China's export quotas are shrinking while Chinese domestic demand is steadily rising. In light of apparent Chinese efforts to use access to rare earths as a form of economic coercion, major consumers including Japan and the United States are expected to increase efforts to diversify their supplies and to enlarge strategic stockpiles. Interestingly, however, Chinese mining and metals companies are also seeking to increase their access to sources of ore bearing critical metals and oxides that are in growing demand by the global economy. North Korea is an important factor in this strategy because it is a significant source of a number of unique minerals that are highly sought after. In addition to coal, iron, lead, zinc, gold, and copper, North Korea has significant untapped reserves of magnesite, tungsten, and molybdenum and is believed to be a source of rare earths. Both molybdenum and the 17 rare earth elements are similar in that they are hard to process. It is costly, complicated, dangerous, and environmentally damaging to extract and refine them. Like the rare earths,

⁹⁴ See, for example, Keith Bradsher, "Amid Tension, China Blocks Vital Exports to Japan," *New York Times*, 22 September 2010.

molybdenum and tungsten are essential to the manufacture of high-grade steels, electronics, and the latest generation military technology.

Because North Korea does not reveal the extent of its rare earths reserves, it is impossible to know how significant a supplier it might one day become. However, there are known sources of critical ores, such as the niobium-tantalum mine at Apdong.⁹⁵ As far as can be determined, there are no legitimate Chinese investments in North Korean rare earths mines, though it is possible that there are illegal or informal arrangements. However, Chinese companies have made significant legitimate investments in molybdenum projects in North Korea. While molybdenum, niobium, and tungsten are not considered rare earths by chemists, they are equally important in the manufacture of high-performance metal alloys, consumer electronics, and defense systems. Likewise, the process to extract and refine them is similarly complex and environmentally damaging. China's focus on extracting these minerals that are critical for not just infrastructure, but for information technology, energy supply systems, and green technologies provide potential insights into how China might approach a systematic exploitation of North Korea's rare earth mineral resources.

Rare earth metals are found in deposits all over the globe; however, China is the world's largest producer. Ironically, most of the rare earth metals can be commonly found in the Earth's crust, so the term "rare earth" is a "historical misnomer; persistence of the term reflects unfamiliarity rather than true rarity."⁹⁶ According to U.S. Assistant Secretary of Energy David Sandalow, more than 95 percent of the global supply of rare earths is produced in China.⁹⁷

China's control of this critical resource has raised concerns around the world. Rare earths are critical inputs in industrial sectors such as green energy technology, optical fiber communication systems, steel and alloy production, and consumer electronics. However, one reason China overwhelmingly dominates production is because companies in other countries have backed away from producing rare earths due to fluctuating prices for the metals and steep environmental costs. Although rare earth metals are also found in the United States, Australia, Brazil, South Africa, India, and several other countries, it is difficult to profitably extract them

⁹⁵ Aidan Foster-Carter, "States Stalled: Business as Usual?" *Comparative Connections* 3, no. 2 (July 2001). Note: niobium and tantalum are often erroneously described as rare earths.

⁹⁶ Gordon B. Haxel, James B. Hedrick and Greta J. Orris, "Rare Earth Elements—Critical Resources for High Technology," U.S. Geological Survey, Fact Sheet 087-02 (2002).

⁹⁷ David Sandalow, keynote address at the Technology and Rare Earth Metals Conference 2010, Washington, DC, 17 March 2010.

without significant time and cost.⁹⁸ Despite expectations of exploding demand for these metals, it is important to note that the scale of global consumption of rare earths is relatively small at about 130,000 metric tons each year or around a tenth of the amount of copper produced in only the month of February 2009.⁹⁹

North Korea might be an increasingly attractive investment destination for Chinese mining companies seeking to extract and process rare earths and other critical ores. Illegal mining of rare earths is believed to be rampant in China, though media exposés and subsequent crackdowns create uncertainty for investors and instability in the market. Importantly, both illegal and legal mines have a tremendous environmental impact, seriously harming the health of residents in nearby villages and towns, causing resentment against mining companies and authorities who turn a blind eye to egregious pollution. Domestic pressure to improve the environment in China might lead Chinese mining companies and investors to shift their attention to North Korea, where the need for capital and access to the Chinese market creates a more permissive investment environment. This will be increasingly true for Chinese investments in the mining sector targeting Iron Age minerals such as copper, zinc, and lead in addition to more exotic ores.

China is also a key source of molybdenum, which is similar to rare earths in that it is an important component of high-technology alloys used in expanding industries, is often found in ores bearing other metals such as copper, and is costly to refine. Three of the six largest molybdenum mines in the world are located in China, and the two provinces bordering North Korea are particularly important sources of the metal. Daheishan in Jilin Province is one of the world's largest molybdenum mines, and the mines of Huludao prefecture in Liaoning reportedly yielded 30 to 40 percent of molybdenum produced in China in 2005.¹⁰⁰

Rising interest in securing access to molybdenum and other critical metals has paralleled China's growing appetite for natural resources fueled by expanding industrial production and massive investments in infrastructure. However, China does not enjoy the same hegemonic ability to control supply to the global market that it does for rare earths. The U.S. and China each

⁹⁸ Cindy Hurst, "China's Rare Earth Elements Industry: What Can the West Learn?" Institute for the Analysis of Global Security (March 2010), 4, <http://www.iags.org/rareearth0310hurst.pdf>

⁹⁹ Charles Homans, "Are Rare Earth Elements Actually Rare?" *ForeignPolicy.com*, 15 June 2010.

¹⁰⁰ "Exports and Imports of Molybdenum by China in Jan.–Sep. 2005," *The TEX Report*, 28 November 2005.

produce about one-third of world molybdenum output.¹⁰¹ North Korea also has large reserves, though the lack of infrastructure and capital make it an insignificant producer.

Molybdenum is prized for its ability to enable materials to better withstand temperature fluctuations and for its corrosion resistance. Steels and cast iron are the biggest market segments for molybdenum though it is also valuable in diverse products such as super alloys, nickel base alloys, lubricants, chemicals, and electronics. A key industrial application of molybdenum is the production of pipeline steel.¹⁰² Molybdenum is also the most stress-resistant low alloy steel available to use in deep water oil wells often contaminated with corrosive materials.

Chinese domestic production as well as China's interest in securing access to North Korean molybdenum ore is largely a function of global demand. Demand for molybdenum grew by 35 percent from 2003 to 2007, an increase that the International Molybdenum Association attributes to a global drive to invest in industrial infrastructure. Price increases far outstripped increases in demand during this period. From a price per pound below US\$4 prior to 2002, the price jumped to a high of US\$32 per pound in 2005.¹⁰³ With fluctuating prices and few substitutes for molybdenum available, securing access to the metal is an increasingly critical concern.

Until trading in molybdenum was begun on the London Metal Exchange in February 2010, there was no established global market reference price for the metal, and the molybdenum market prior to 2010 was characterized by wide price swings.¹⁰⁴ This stoked fears, particularly in China, about access to the metal. After a peak price in 2005, price fluctuations in 2006 and 2007 further increased concerns about China's ability to secure supplies of molybdenum, and these concerns were reflected in new regulations governing trade in rare earths. Policy changes during this period increased pressure on domestic mines as well as motivating some companies to invest in overseas projects and decrease exports of rare earths. Output in China's Northeast actually declined in 2005 despite rising demand due to increased regulation of mining operations. Many mining permits were revoked by the central government in 2005 as a result of accidents and new

¹⁰¹ Desiree E. Polyak, "Molybdenum," Mineral Commodity Summaries, U.S. Geological Survey (January 2010), 106–107. See also Desiree E. Polyak, "Molybdenum," *2008 Minerals Yearbook*, U.S. Geological Survey (March 2010).

¹⁰² James Finch, "Is Molybdenum Another Way to Ride the Energy Bull?" *Stock Interview.com*, 26 July 2006.

¹⁰³ Hans Imgrund and Nicole Kinsman, "Molybdenum: An Extraordinary Metal in High Demand," *Stainless Steel World* (September 2007), 21.

¹⁰⁴ Stephen Rosenman, "Molybdenum Poised for Massive Comeback," *SeekingAlpha.com*, 7 January 2010.

checks on health, environmental impacts, and safety. In 2007, Chinese regulators enacted an import/export licensing scheme and export tariffs on critical metals and rare earth ores, including molybdenum, to reduce the level of exports and ensure adequate supply for domestic use. A licensing scheme on exports of ferroalloys and other minor metals was implemented in 2007. The Customs Tariff Commission of the State Council also implemented temporary export tariffs of five to 15 percent on raw rare earth metal ores in 2007.¹⁰⁵

With increasing regulatory pressure on domestic mining operations and as prices of molybdenum appeared poised to spiral upward, Chinese concern grew in 2005 about access to molybdenum. Further exacerbating the worries of Chinese miners, their costs were steadily increasing as well. Despite rich reserves, China's concentrate is lower in metal content compared to that from sources in the United States and Chile, so Chinese production costs are higher. According to some analysts, grades of Chinese ores were worsening in 2005.

These pressures, particularly in the Northeast, made extracting molybdenum in North Korea a more attractive prospect. The lack of a global reference price for molybdenum, combined with North Korea's difficulty accessing international markets, gave China an advantage in determining prices for North Korean molybdenum, particularly in the period leading up to peak prices in 2005. Half of the North Korean joint ventures related to molybdenum were established in 2006, likely in response to these domestic and global pressures.

Of the 56 Chinese joint ventures in North Korea's extractives industry, eight targeted molybdenum and six of those companies came from Jilin and Liaoning.¹⁰⁶ An additional three joint ventures are involved in copper mining, which often produces molybdenum as a byproduct. One Jilin company, Yanbian Haigou Eastern Import Export Company,¹⁰⁷ established a joint venture in 2007 at Hoeryong (会宁) to mine molybdenum, investing US\$1.3 million in capital, equipment, and technology and taking a 50 percent stake. Also in 2007, a Liaoning company, Huludao Dingshiye Company,¹⁰⁸ established a joint venture to mine molybdenum in North Korea with an investment of US\$1.2 million.

Another Chinese investor in North Korean molybdenum, the Guangshou Group, signed

¹⁰⁵ Pui-Kwan Tse, "The Mineral Industry of China," *2007 Minerals Yearbook: China*, U.S. Geological Survey (February 2009), 9.8.

¹⁰⁶ Liaoning, 4; Jilin, 2; Hebei, 1; Zhejiang, 1.

¹⁰⁷ 延边海沟东部进出口贸易有限公司.

¹⁰⁸ 葫芦岛久鼎实业有限公司.

a joint venture agreement with its North Korean partner in March 2005. The Guangshou Group, based in Wenzhou, Zhejiang Province, claims more than 10 years of mining experience with enterprises established in five Chinese provinces and investments in North Korea, Indonesia, Thailand, and Myanmar. The company is involved in the mining of molybdenum, lead, zinc, copper, manganese, iron, silver, gold, and coal with a total of six mines, three mineral separation factories, and two coking factories under its control in China and around the world. The Guangshou Group established mining joint ventures in 2007 in Indonesia and Thailand for the production of coal, manganese, and iron ores.¹⁰⁹

In North Korea, Guangshou Group established a joint venture called the North Korea Daguang Cooperative Company in 2005 and the company's overseas investment was officially approved by the Ministry of Commerce in January 2006. The joint venture controls two molybdenum mines in North Korea: the first is in the village of Ryonghŭng-ri (룡흥리/龍興里), Ryonggang County (룡강군/龍岡郡), South Pyongan Province (P'yŏngannam-do/平安南道/평안남도); the second is in Sep'o-gun (세포군/洗浦郡), Kangwŏn Province (강원도/江原道). Construction on the project began in May 2005 and production began in September 2006 with the molybdenum shipped for sale in China. With an investment of US\$2.42 million, Guangshou Group holds a 65 percent stake in the joint venture.

The presence of molybdenum in Liaoning and Jilin as well as in North Korea is a not a geologic coincidence. Chinese mining companies based in Northeast China that have experience mining molybdenum are likely attracted to investment opportunities in North Korea. These companies have the skills and infrastructure to develop projects and leverage their own resources nearby in China. While molybdenum is not a rare earth metal, Chinese companies that have successful molybdenum extraction projects in North Korea likely possess the skills and experience needed to systematically prospect for and exploit deposits of critical elements and rare earths in North Korea, refining the ore either close to the mine or in Chinese smelters. The development of an axis of Chinese-backed projects to mine critical elements would have the potential to exacerbate growing fears around the world that China is seeking to corner markets and manipulate world supplies of these materials, which are critical to the economic and energy strategies of many developed nations.

¹⁰⁹ Guangshou Group (广寿集团有限公司) corporate website: <http://www.gsjt.cc/en/default.asp>.

Profiling Chinese Investors in North Korea

It is important to note that this review does not capture informal investments or other Chinese financial interests in North Korea such as exporters and trading companies that have left deposits or other guarantees with their Korean trading partners and therefore have no official investment in the country despite their financial commitment. An unknown number of companies have entered into informal relationships, which are not protected under law, with North Korean partners; this may reflect a lack of faith in the North Korean legal system and in the Chinese government's ability or willingness to intervene on their behalf in the event of a major dispute. Several brand-name Chinese companies (including TCL, Changhong, Haier, and Yalu Beer) appear to have significant business interests in North Korea but they are not classified as investors, though they clearly have a financial stake in North Korea's economy.¹¹⁰ For example, Henan-based Frestech Corporation, a major appliance manufacturer, has participated in the Pyongyang Trade Fair every year since 2006 and one of its refrigerator models reportedly has 20 percent of the North Korean market while its freezer has 50 percent, though Frestech does not have a registered investment in North Korea.¹¹¹

Legitimate investors in North Korea are an important manifestation of China's strategic interest in the northern half of the Korean peninsula. Interestingly, there is no typical Chinese investor in North Korea. While not distributed evenly, these companies come from different parts of China, have different ownership structures, and vary in scale and industry sector. Unlike trading companies, these investors have rights that both the Chinese and North Korean governments are obligated to recognize. The Chinese government has reasonable expectations that the North Korean government will respect and protect these tangible Chinese interests. Likewise, these investors potentially have political influence that shapes policymaking at local and national levels, though perhaps to a limited degree. This section will profile three Chinese investors in order to provide insight into the diversity of the investors themselves and their unique experiences investing in North Korea. The first is an anonymous, private company owned by a Korean-Chinese with a successful business model; the second an optimistic Chinese entrepreneur yet to turn a profit; and the third is a large conglomerate owned by the central

¹¹⁰ "Chinese Enterprises Shine at Pyongyang Trade Fair," *Xinhua* via *People's Daily*, 20 May 2010.

¹¹¹ "新飞: 朝鲜平壤国际商品展览会上领风骚," *ChinaByte.com*, 7 June 2010.

government, which divested from its North Korean investment.

Dalian-based Holding Company

Mr. Jin is the director of a Dalian-based holding company with investments in a variety of industries including information technology, aquaculture, and other light industrial projects in China, North Korea, and Japan. Mr. Jin is a Korean-Chinese who speaks both languages, divides his time between Beijing and Dalian, and has been doing business with North Korea since 1991. Mr. Jin's main business is importing zinc and zinc ore from North Korea to Dandong and Dalian; his company typically imports lots of approximately 100 rail cars per month on average. He pays about US\$6 million per month in cash for these shipments. Mr. Jin encounters significant problems regarding the security of his investments in North Korea. Ensuring that his Korean business partners do business only with him and do not shop around for different buyers every time they have a shipment ready requires substantial effort on the part of Mr. Jin. He described the operating environment in North Korea as terrible and very different from the sometimes-chaotic transition from planned to market economy in China in the 1980s. Despite having laws protecting investors, the North Korean legal system does not function properly. Corruption is rampant and uncontrolled. Infrastructure is decrepit and desperation leads to looting of assets. North Korean officials and companies lack a long-term perspective and see transactions only as opportunities to earn cash. Building relationships and trust is difficult in an atmosphere where rent seeking is the norm.

In order to protect his North Korean zinc business, Mr. Jin engages in elaborate hedging strategies to deter his partner from cheating him while at the same time protecting his North Korean colleagues. Mr. Jin's partner is the Light Industry Bureau (LIB), part of the Korean Workers' Party. The LIB is controlled by Kim Jong-il's sister Kim Kyong-hui, who was recently elevated to the rank of four-star general. Despite its name, the Light Industry Bureau oversees all mining interests in the country.

In addition to his zinc transactions, Mr. Jin provides the LIB with additional investments in mining equipment and light industrial factories and engages in regular trade in goods. Mr. Jin ships Chinese textiles, corn, and edible oils to his North Korean partner's trading firm, often at subsidized prices or for no charge at all. Mr. Jin has low expectations of this trade, which

makes little or no profit, but views these transactions and ventures as strategic investments; their purpose is to protect his core zinc ore business. It is clear from Mr. Jin's hedging that there is little trust between the two sides. The relationship with his North Korean partner began with an initial investment of US\$3 million to purchase mining equipment, at which point the two parties signed a contract stipulating how much ore would be shipped from North Korea each year. The mine sends a shipment every month, with a value of about US\$6 million and Mr. Jin pays them about half the shipment's value (in U.S. dollars) upon delivery. The following month, he pays the second US\$3 million installment for the shipment. Mr. Jin does not expect to get his original investment in the mine's infrastructure back, but the cash infusion to purchase equipment started the ore export cycle, essentially enabling the North Koreans to provide Mr. Jin the equivalent of credit terms. As this credit-like arrangement is structured, Mr. Jin is assured that his North Korean partner will always ship the agreed monthly amount of ore to settle the previous month's debt.

Mr. Jin stated that his zinc mine is near Tanchon and that ore processing takes place near Kimchaek in South Hamgyong Province on North Korea's eastern coast. The U.S. Geological Survey (USGS) reports that the Komdok (Kimchaek) Mine near Tanchon is North Korea's main zinc production site, accounting for 60 to 70 percent of North Korea's lead and zinc production in 2005. According to the USGS, production remained below capacity for several years because of a lack of electricity and the low grade of ore mined.¹¹² In 2008, the USGS reported that zinc production increased significantly in 2007 after the renovation of the Tanchon zinc refinery in 2005 and the completion of two new shafts at the mining complex in 2007.¹¹³

Besides the mining venture, Mr. Jin invested RMB50 million worth of cash and equipment in a plastic recycling factory owned by the LIB in 2004. Located on the North Korean side of the border close to Yanbian Prefecture, Jilin, the factory recycles about 30–40 tons per batch of South Korean plastic scrap and exports the finished plastic product to China. Like most Chinese investments in North Korea, this one has a fixed term. When the contract on the factory ends, Mr. Jin expects to donate the equipment to his partner and will continue to buy the finished product from them. However, he believes the business will not survive much longer as there is less and less plastic scrap from South Korea to process. The recycling business has not been as

¹¹² Wu, "The Mineral Industry of North Korea," *2005 Minerals Yearbook: North Korea*, 15.1.

¹¹³ Wu, "The Mineral Industry of North Korea," *2007 Minerals Yearbook: North Korea*, 14.2.

profitable as the zinc business, but he sees the joint venture as a way to enhance his relationship with the LIB and deter them from selling their zinc ore to other potential buyers.

In addition to the US\$6 million in monthly payments for the zinc, Mr. Jin also provides 2,700 tons of corn and 720 tons of rice each month to the LIB as a donation. These food donations as well as shipments of Chinese consumer goods provide his LIB partners with an additional means to generate cash for themselves and to gain leverage over other North Korean agencies and officials.

Mr. Jin also invested in a seaweed and kelp harvesting and processing business with the LIB. However, recently his partners were preparing to harvest the kelp from the farm off the beach that they control, but the North Korean military declared that they were conducting an exercise and restricted all access to the coast for a few days. A Hong Kong businessman witnessed them stealing all the kelp.

The investments in the plastics factory, seaweed farm, and import-export business are all with the same partners in the LIB. These other businesses create mutual dependencies; the LIB is dependent on Mr. Jin to provide these Chinese commodities and they would pay a cost were they to divert their zinc ore output to another potential buyer. Additionally, the commodities that are donated or sold at favorable terms empowers the LIB managers with whom Mr. Jin works. By having access to these imported goods and food, they can gain influence with other departments, protect Mr. Jin's investments and business, and protect themselves from predation by other North Korean agencies.

Mr. Jin described the policies and government services in North Korea as dysfunctional and identified inadequate infrastructure and obsessive secrecy as barriers to investment. Chinese investors only have access to the information North Korean regulators provide because independent surveys are illegal and even census data is closely held or unreliable. When asked why most investors in North Korea were relatively small companies and entrepreneurs, he explained that big companies have no interest because the risks are too high, the demands too great, and the profits too low. He advised not investing in North Korea until one has visited three times (implying that some investors had rushed to failure). Mr. Jin once accompanied a big "Western mining company" to look at investments and the company subsequently lost US\$1 million.

China-North Korea Border Trade City

Another Chinese investor in North Korea, Wang Yuangang, CEO of China-North Korea Border Trade City, started out in business in the 1980s making garments in Dandong for the domestic market. In 1999, he opened a street market with stalls for vendors to sell items to North Koreans right on the Chinese side of the bridge crossing the Yalu river. The city razed the market for a street improvement a few years later. In 2002, Mr. Wang set up a barter-trade market in Pyongyang and worked closely with Yang Bin, the Dutch-Chinese businessman who was named head of the Siniuju Special Administrative Region but was subsequently arrested and jailed by Chinese authorities for tax evasion before he could take up the post. At that time, most trade was by barter and the market was ultimately unsuccessful because of policy restrictions in North Korea.

In September 2009, after two years of study and applications, Mr. Wang's company was approved to invest in a factory in Pyongyang making buses and cargo trucks. His firm has a 52.2 percent stake, but for all intents and purposes, it is a 50/50 joint venture. Mr. Wang invested RMB40 million in registered capital to start up the factory and he has another RMB40 million in operating capital. Because the scope of the business is small and they are just starting up, they do not yet pay taxes. His company appoints a general manager and other managers who make brief visits to the factory in North Korea. Their production target is 300 buses in 2010, but they will probably miss that goal, though they plan to assemble 1,000 buses in 2011. All of the parts for the trucks and buses are from China; the factory in North Korea is responsible for assembly. Mr. Wang's factory has exclusive rights to import the necessary parts duty free. There are North Korean companies that make buses and trucks and there is a South Korean-backed project that makes light trucks, but otherwise he has no competition. Mr. Wang's factory is still making test products and trying to discover what configurations will sell best in the North Korean market. Once the product is finalized, they will print brochures and expand marketing efforts. The factory is not part of the planned economy so they must find customers themselves and their output is not directed to specific clients. It is a cash-and-carry business—no credit is offered. Trucks and buses are now assembled in the same facility but Mr. Wang hopes to separate production into two plants.

Mr. Wang has a variety of reasons to be cautious regarding his North Korean business. The November 2009 currency revaluation caused complete market disruption. Mr. Wang's

factory stopped production completely and did not restart until May 2010. He continued to pay his workers, who are paid directly about 30 euros in cash each month, at a loss to the firm. Mr. Wang's factory employs about 30 people who are assigned by the Korean partner and will hire more workers as business improves. He must do so cautiously, however, because once workers are hired they cannot be sent back to the North Korean partner if business slows.

Mr. Wang's investment does not appear to have a significant transformational effect on North Korean society. His Chinese managers do not engage the workers directly. They can speak freely with the North Korean managers but they avoid discussing politics or policy. The standard of living for their workers is higher than that of other North Korean citizens because they are paid regularly and their wages are higher than in other factories. The workers live in the neighborhood rather than in dormitories and commute to work by walking or taking the bus. Mr. Wang describes labor relations as good. The only real problem is that if there is a problem with an individual worker, they cannot be fired—they still have an “iron rice bowl.” Mr. Wang describes North Korea as similar to China in the 1970s, and the structure of joint ventures in North Korea today is similar to the structure of joint ventures in China in the early 1980s. The North Korean partner provides the land and workers and is responsible for interacting with government, so selecting a trustworthy partner is particularly important for Chinese investors. Mr. Wang claims that he has not experienced problems with corruption or with predatory government or army units. Since Mr. Wang's plant is in Pyongyang, he does not face challenges that investors in more remote regions may encounter. His partner manages government relations, so any time there is an issue with authorities or a client, Mr. Wang and his partners simply try to resolve issues themselves since the courts are ineffectual.

In addition to applying to the Ministry of Commerce in Beijing, prospective Chinese investors must seek the endorsement of the Chinese Embassy in Pyongyang as well. There are many unregistered companies operating in North Korea, but they are small-scale or are working on fixed-period projects and therefore do not qualify as investors. These companies can expect little or no protection or support from the Chinese government if they run into trouble, which is why investors such as Mr. Wang feel that registering their outbound investments is important. Mr. Wang also owns a Singaporean-backed real estate project in Dandong and the China-North Korea Border Trade City is actively seeking investors for a number of other potential joint ventures in North Korea, but no deals have been completed yet.

Sinosteel

A senior executive at Sinosteel, a state-owned conglomerate that supports the Chinese steel industry, shared his insights about overseas investment, including investment bound to North Korea, in a November 2009 interview. Sinosteel itself does not make a single ton of steel, but steel companies are dependent on Sinosteel for raw materials including iron, manganese, and nickel as well as for sales of their finished products. Sinosteel has 86 subsidiaries under its administration—60 in China and 26 abroad. Though Sinosteel was involved in a project in North Korea at one point, the executive emphasized the importance of a stable business environment to senior management and identified the lack of stability as an important factor in the company's decision to withdraw from their North Korean joint venture. He also stated that the company was uninterested in pursuing further projects in the DPRK.

Large Chinese SOEs require a certain level of transparency and a stable business environment for their overseas investments. According to the executive, Sinosteel has no direct investments in Mongolia, Vietnam, Myanmar, or North Korea. Despite some discussions with Mongolia about a possible project, there has been no progress because transparency, transport infrastructure, and access to water are lacking. Myanmar presents similar issues for foreign investors, particularly the lack of transparency, corruption, and political risk. Instead, Australia and South Africa have proven themselves to be far more attractive destinations for Sinosteel.

In 2005, Sinosteel was involved in a project led by Tonghua Iron and Steel Group to develop the Musan Mine in North Korea. According to news reports in November 2005, the Tonghua Group was granted rights to develop the mine, the largest iron ore deposit in North Korea with exploration rights of 50 years. The company's total investment was reported to be US\$867.41 million, with US\$247.83 million for construction costs, primarily for roads and railways to connect Musan and Tonghua in Jilin Province, and US\$619.58 million invested in equipment and technology for the project. Yanbian Tianchi Stock Holding Co. and Sinosteel Corporation also joined the project as minority partners.¹¹⁴ In December 2005, media outlets reported that the joint venture had been suspended. By 2006, China Minmetals Corporation had reportedly replaced Sinosteel in the consortium of companies planning to invest in the Musan

¹¹⁴ "China Expanding Steel Industry in North Korea," *Interfax-China* via *ResourceInvestor.com*, 1 November 2005.

iron ore project.¹¹⁵ While the future of Chinese investments in Musan Mine are uncertain, the Indian newspaper *Economic Times* reported in February 2010 that Pramod Mittal, the head of Global Steel Holdings, was negotiating with Pyongyang for development rights to Musan.¹¹⁶ Likewise, as previously mentioned, other Chinese companies were actively negotiating investments at Musan in December 2010.

The Sinosteel executive described the company's experience in North Korea as "unsatisfying" and the structure of the investment as overly complicated and therefore unlikely to succeed. The isolation of North Korean society creates wide cultural differences between China and North Korea which further mitigates against successful cooperation.

¹¹⁵ John C. Wu, "The Mineral Industry of North Korea," *2006 Minerals Yearbook: North Korea*, U.S. Geological Survey (September 2007), 18.2.

¹¹⁶ M.V. Ramsurya, "Pramod Mittal Eyes Stake in North Korea's Musan Mines," *Economic Times*, 5 April 2010.

How Might Investments in North Korea Shape Chinese Policy?

Trade and investment with North Korea is consistent with China's broad national interest in promoting stability in North Korea and supporting economic development in the northeastern provinces. Beijing's strategy of engagement with North Korea was recently described by one Chinese scholar as intended to "shift the international focus from geo-politics to geo-economics."¹¹⁷ The presence of Chinese-backed joint ventures in the DPRK is part of this focus on economic engagement. It is unlikely, however, that the companies themselves enjoy significant influence on the formulation of Beijing's policies towards North Korea. The companies involved number less than 200 and their relatively small sizes limit their ability to lobby China's central government.

The fact that China's investment presence in North Korea consists of a small number of generally small companies does not mean that Chinese joint ventures are not a factor in policymaking. Chinese and foreign scholars are currently considering the influence of new actors and interest groups in foreign policymaking.¹¹⁸ While strategic choices in China's foreign policy were once shaped almost exclusively by the "Three Ps"—Politburo, Party, and PLA (People's Liberation Army)—this is no longer the case. Today, actors on the margins of the traditional foreign policymaking apparatus can affect China's foreign policy decisions. Interest groups such as the business sector, local governments, research institutions, the media, and Internet users seek to influence the formulation of foreign policy.¹¹⁹ Scott Kennedy's book, *The Business of Lobbying in China*, examines how Chinese firms in different sectors promote their interests (primarily through business associations) and influence policy on the national level.¹²⁰ In the case of corporate interests, most attention has been placed on major firms, particularly those in the energy and infrastructure sectors. Because these Chinese corporate giants are often owned

¹¹⁷ Sunny Lee, "Kim Jong-il's China Visit Was About Economy," *Korea Times*, 6 September 2010.

¹¹⁸ See, for example, Tang Shiping, "Projecting China's Foreign Policy: Determining Factors and Scenarios," in *Charting China's Future: Political, Social, and International Dimensions* edited by Chae-ho Chong (Lanham, MD: Rowman & Littlefield, 2006), 137.

¹¹⁹ Linda Jakobson and Dean Knox, "New Foreign Policy Actors in China," Stockholm International Peace Research Institute Policy Paper 26 (September 2010).

¹²⁰ Scott Kennedy, *The Business of Lobbying in China* (Harvard University Press, 2005).

by the central government, often major recipients of government financing, and are frequently led by executives who also hold senior positions in the government and the Chinese Communist Party, they are a more obvious case of state capitalism at work. It is unclear whether a diverse collection of small companies primarily headquartered in China's northeastern provinces, would have the political capital to effectively lobby Beijing to protect their interests.

In the course of normal business operations, the small and medium-sized enterprises from Jilin and Liaoning that dominate the North Korean investment scene, for the most part, do not rely on contacts with the Chinese government for the success of their businesses. Essentially, they are silent partners in the relationship between China and North Korea. In the event of any dramatic change on the peninsula, however, these companies might abandon their low-profile approach. Like all companies, if faced with the loss of their business, they would likely respond vocally and press their case with the Chinese government. While their investments might be small on a national scale, any losses incurred would be substantial at the firm and possibly local levels. Some of the Chinese investors are owned by provincial or sub-provincial government departments and the loss of those investments would affect local government balance sheets. The privately owned investors based in the Northeast would likewise seek assistance from their provincial governments, particularly in a crisis, and would use their local governments as conduits to Beijing. Despite their distance from the capital, a variety of bureaucratic mechanisms and personal connections could be utilized to remind Beijing of northeastern interests.

Both Jilin and Liaoning have considerable ability to influence the central government. The bureaucracy itself has normal channels between the various stovepipes such as the ministry-provincial bureau track, the governor's office-State Council links, and of course, the ever-present Party network. The two provincial governments of Jilin and Liaoning as well as the governments of Yanbian Prefecture and Dandong City each have representative offices in Beijing to coordinate their contacts with the central government and influence policymaking.¹²¹

Additionally, interpersonal networks are particularly important and can reach the highest levels. Li Keqiang, currently executive vice premier and likely future premier, is the former party

¹²¹ "Implementation Plan of the province to strengthen and standardize management of the Beijing offices" (全省加强和规范各地政府驻京办事机构管理的实施方案), General Office of Liaoning Provincial People's Government Document No. 18, General Office of Liaoning Provincial People's Government, 30 April 2010; "Implementation Plan of the prefecture government's establishment of overseas investment offices" (州人民政府办公室转发州招商局关于设立驻外招商办事处工作实施方案的通知), Yanbian Prefecture Government Official Letter No. 12, 24 February 2002.

secretary of Liaoning. Vice premier Zhang Dejiang was party secretary of both Jilin Province and Yanbian Korean Autonomous Prefecture. He is a Korean-speaking graduate of Yanbian University who also studied at Kim Il-sung University. In 2009, Sun Zhengcai, the minister of agriculture, became the Jilin party secretary, replacing Wang Ming who became the party secretary of Liaoning, while Han Chengfu, the former governor of Jilin, became the minister of agriculture. All provincial governors and party secretaries concurrently serve in the central committee and some serve on the Politburo itself. The “chutes and ladders” career track between the central government and provinces ensures that national and local interests remain closely intertwined.

The Chinese central government is well aware of the vital role North Korea plays for the economies of China’s northeastern provinces, particularly in the border regions. About 70 percent of trade between China and North Korea passes through the port of Dandong in Liaoning Province.¹²² Border trade and economic cooperation with North Korea is described by local officials as an important component of Liaoning’s strategy for economic development and interpreted locally as consistent with China’s national interests.

The ultimate success of regional development plans in the Northeast is predicated on the successful launch of a reform and opening process in North Korea. Local analysts have determined that the massive infrastructure investment taking place in China’s Northeast is justified because it will make the border provinces highly competitive in a reformed and opened North Korean market. Certainly, greater openness and growing prosperity in North Korea would benefit the provinces of Jilin and Liaoning, whose companies represent more than half of Chinese investors in North Korea. For these reasons in particular, Chinese leaders have actively sought to promote economic opening in North Korea, though they remain frustrated with the slow pace of reform. Even a partial opening would be a welcome development. Dreams that Jilin and Liaoning could form a new hub for Northeast Asian trade are more likely to come true if development plans for Rajin are realized and the port can be connected to the Changjitu corridor.

¹²² “中国企业:开发朝鲜岛屿系炒作,” *Xinhua*, 8 March 2010.

Chinese Investment in North Korea and the Geostrategic Balance

Investment and trade with North Korea is consistent with China's geostrategic outlook toward the peninsula. China's broad national interests vis-à-vis North Korea are to maintain a stable regional security environment, ensure the survival of the North Korean regime, support economic development in the Northeast, and achieve a nuclear weapons-free peninsula. Beijing seeks to achieve these objectives through a comprehensive approach of economic engagement with trade, aid, and investment; bilateral interactions, and multilateral engagement such as the Six Party Talks process. Encouraging the development of a robust economic relationship between China and North Korea is an important component of China's strategy, not only for the benefits that it brings for Chinese businesses, but also because it is presumed that trade and investment contributes to regime security and social stability thereby preventing a North Korean collapse. Chinese officials and analysts also recognize that North Korea is unlikely to willingly negotiate away its nuclear weapons unless there is greater internal stability and the regime's security is assured. By this logic, Chinese investments in North Korea are potentially indirect contributors to the Pyongyang regime's security.

Despite the fact that they have geostrategic significance, Chinese joint ventures in North Korea are not state-directed investments. It is difficult to conceive how China's central government could exert meaningful control over the actions of investors who are mostly small and privately held. China can encourage outbound investment but cannot effectively control it. Likewise, the central government cannot realistically direct large-scale outbound investment to a particular country without imposing considerable opportunity costs. For example, were the government to subsidize or otherwise incentivize outbound investment to North Korea for geostrategic purposes, it might fall foul of the WTO. Furthermore, other countries might seek equal treatment as they compete for foreign direct investment from China. Regardless of the government's desire to encourage more investment with North Korea, such an effort is unsustainable and impractical if business conditions preclude reasonable profits or some other return on investment.

Survival of the North Korean Regime and Regional “Balance”

Economic engagement with North Korea, including direct investment, brings China important strategic benefits, primarily through enhancing and ensuring North Korea’s continued survival. Trade and investment are presumed to contribute directly to the survival of the Pyongyang regime. In the Chinese authorities’ view of the region, the survival of North Korea is necessary to maintain regional security and a balance of power in Northeast Asia. Despite globalization and China’s deepening integration with the rest of the world, a sense of isolation and encirclement persists in the minds of some Chinese strategists. China prefers to ensure the survival of the current North Korean regime and maintain the geopolitical *status quo* rather than face the possibility of a peninsula unified in South Korea’s image and the possible presence of United States military forces on China’s border. Beijing also assumes that economic growth, by increasing regime resiliency, will increase Pyongyang’s sense of security and reduce its tendency to lash out at others in the region.

Stability in North Korea

There is optimism in China that trade and investment in North Korea will not merely contribute to the survival of the regime but also increase stability within North Korea. Stability in North Korea, in turn, will contribute to domestic stability in China’s Northeast. Certainly, the prospect of social stability in North Korea lessens anxiety in China that chaos might someday spill across the border into Jilin and Liaoning. From Beijing’s perspective, enhancing stability in North Korea contributes to China’s own security.

Furthermore, it is conventional wisdom that Chinese trade and investment contributes to the survival of the Kim family regime and the North Korean state. It is very difficult to measure whether and how a volume of trade or investment affects North Korea’s society or political economy. However, there is little question that foreign commerce benefits the regime. According to John Park, Senior Research Associate with the United States Institute of Peace, virtually all hard currency transactions with foreign partners generate income for Kim Jong-il and the most senior North Korean leaders.¹²³ That income is believed to be used by Kim Jong-il to buy

¹²³ John Park, “North Korea, Inc.: Gaining Insights into North Korean Regime Stability from Recent Commercial Activities,” *United States Institute of Peace Working Paper* (22 April 2009).

the loyalty of allies in the military and the government, so it can be inferred that all commerce contributes to eliminating domestic opposition and enhancing the regime's legitimacy among key constituencies. By that measure alone, Chinese trade and investment in North Korea can be considered an important factor in the North Korean political dynamic, though it is impossible to estimate what impact it has on the broader economy or society.

Economic Prosperity in Northeast China and the Reform and Opening of North Korea

Encouraging trade and investment with North Korea may create a win-win situation for China: generating wealth on both sides of the border supports the survival of the Pyongyang regime while also benefiting the strategically important provinces of Jilin and Liaoning. Furthermore, success would justify the Changjitu economic development plan and the substantial sums of money that have already been poured into infrastructure in the border region. However, the risk remains that northeastern economic development might stall without more rational economic policies being enacted in North Korea.

Permitting Chinese investment is consistent with a wider Chinese strategy concerning economic reform in North Korea. As previously mentioned in this report, from President Hu Jintao on down there has been a national-level effort in China to encourage Kim Jong-il to reform and open the North Korean economy.

North Korea's Reluctance

Mutual mistrust characterizes the relationship between China and North Korea, especially in the economic sphere. North Korea is dependent on China for trade, aid, and investment but is wary of being "hollowed out" by Chinese investments in its natural resources, particularly in the mining sector. Without other security allies and with no larger trading partner or investor than China, North Korea has little choice but to engage with its northern neighbor. Despite China's abundant capital and immense experience building infrastructure around the world, North Korea has remained cautious about deepening its dependency on China. However, Pyongyang likely views China as less of a threat than the risks posed by improving ties with South Korea, which might result in ideological exports that would undermine the foundation of North Korea's

system. Beijing offers a model that promises the pursuit of economic reform while maintaining strict political control. From the perspective of some Western observers, in the event of unification there seems to be a greater probability that the South Korean model will overtake the North's communist regime on the peninsula.¹²⁴ Of course, China and the Kim regime are resolute in their intent to prevent this outcome. Chinese strategic concerns about a unified peninsula, which is antithetical to their interests, underpins China's commitment to North Korea's long-term survival. Economic engagement with North Korea is therefore a critical component of China's overall grand strategy for its own security.

Sudden Change, Unification, and South Korean Interests

Sudden change in North Korea or unification of the peninsula under certain circumstances would present a national security concern to China's central government as well as to local political entities. This report is not intended to consider all the possible scenarios and contingencies on the peninsula, nor provide a net assessment or discussion of how the presence of Chinese joint ventures might shape Chinese responses to the different scenarios of sudden change in North Korea. However, it is important to highlight a number of concerns relevant to Chinese investors. Chinese joint ventures will undoubtedly be affected by and potentially influence the future of the peninsula. In addition to the previously mentioned regional balance, Chinese companies would lose out if North Korea as a political entity disappeared. Their North Korean partners are all state-owned, so the stakes of all joint ventures would become unclear if the state suddenly ceased to exist. Chinese fears of dispossession or the nationalization of Chinese investments will need to be addressed in any transition scenario.

Regardless how unification occurs—smoothly or otherwise—China has strategic concerns about a unified peninsula. Whether one believes that a unified peninsula would be dominated by the political elite from Seoul or from Pyongyang, China's preference for the *status quo* reflects a desire to ensure it has a Korean neighbor that is appropriately weaker than China but does not threaten Chinese interests by its own collapse.¹²⁵ Concerns about irredentism also

¹²⁴ Victor D. Cha, "Korean Unification: the Zero-Sum Past and the Precarious Future," *Asian Perspective* vol. 21, no. 3 (Winter 1997), 63-92.

¹²⁵ Drew Thompson and Natalie Matthews, "China's Goldilocks Strategy: Getting North Korea Just Right" (paper presented at the Korea Economic Institute symposium, "Tomorrow's Northeast Asia," Washington, DC, 20-22 October 2010).

cloud the China-Korea relationship. Beijing worries that the government of a unified peninsula, particularly one dominated by the current South Korean political elite, might not respect Sino-DPRK boundary agreements. Should Korean nationalism dominate political discourse following unification, it is possible that ancient or contemporary Korean claims to what is now Chinese territory might arise. Chinese contributions to North Korea's survival preclude unification and possible future threats on its own border.

In addition to strategic concerns, the possibility that certain Chinese economic interests might be harmed by unification increases China's wariness of any sudden changes on the peninsula. Unification of the peninsula in South Korea's image would likely result in a steep decline in South Korean investment to China as Korean capital becomes concentrated in rebuilding the North. Ironically perhaps, both South Korea and China share a desire to maintain the *status quo* considering South Korean concerns over the cost of rebuilding and rehabilitating the North. China is the top destination for South Korean overseas investment with the United States coming in second. According to KOTRA, South Korea's cumulative outbound foreign direct investment to China from 2001 to the third quarter of 2008 was US\$20.8 billion, compared to US\$14.8 billion to the United States.¹²⁶ Certain regions in China, particularly the provinces of Liaoning and Shandong, would suffer from a dramatic reduction in South Korean capital inflows should it shift to the northern half of the Korean peninsula.

Unification is not the only scenario on the peninsula that worries Beijing. There are fears that collapse and chaos in North Korea could spread across the border into northeastern China. The possibility of chaos spilling over from North Korea to Jilin and Liaoning is a national security issue and a potential problem for local authorities. One area of concern includes the reputational harm to the Northeast that would be caused by international perceptions that Jilin and Liaoning were rendered insecure by their proximity to North Korea. Negative international perceptions, resulting in high opportunity costs such as lost investment or trade opportunities, might be more damaging than waves of North Korean refugees being corralled in Chinese camps. China has planned extensively for natural disasters and other potential domestic crises and has a range of capabilities and mechanisms to deal with them. These capabilities would be applicable to scenarios impacting the Northeast as a result of changes in North Korea, and though the details of China's contingency plans are not publicly available, there can be little

¹²⁶ Chung Chul and Hyun Hea-jung, "Korea's Investment and Trade Outlook," *Korea Focus*, February 2009.

doubt that such plans exist.¹²⁷

Though national plans are doubtless in place to address various contingencies on the Korean peninsula, significant enterprise-level concerns certainly endure. Chinese investments in North Korean joint ventures will likely dissolve if the North disappears. Should Chinese companies' North Korean partners suddenly cease to exist, the Chinese investors would face significant economic losses. Even in the event of a peaceful and orderly change on the peninsula, Chinese companies would face significant uncertainty about the legality of contracts with North Korean entities no longer in existence. Should a complete breakdown of law and order occur, dispossession and looting are possible. Any harm to Chinese investors or businesspeople would likely spark public calls for the central government to intervene to protect Chinese citizens and investments.

Chinese joint ventures in North Korea are considered an asset to China, regardless of the state of the North Korean state or how it changes. Currently, joint ventures serve China's broad purposes in North Korea. In addition, Beijing's policy of ensuring North Korean regime survival also suits Chinese investors for now. Chinese joint ventures contribute to the North Korean economy and thus to social stability on both sides of the border. The Chinese joint ventures are likely contributing to stability in North Korea by stimulating economic activity, transferring technology, and increasing employment. The impact of Chinese trade and investment is probably limited, however, as the volume of trade remains small and the activities are geographically restricted due to North Korea's closed economy. Even so, access to Chinese foodstuffs and consumer products likely enables and stimulates private markets that supplement the unreliable public distribution system and are important sources of nutrition and income for large numbers of North Koreans.

Chinese joint ventures have the potential to be an important vehicle for "interpreting" the Chinese experience of reform and opening for their North Korean counterparts, fostering an orderly reform process that would preserve the North Korean regime for the time being, but perhaps also enhance the possibilities for an agreeable North-South unification in the more distant future. Chinese joint ventures are substantially affected by the unfavorable North Korean

¹²⁷ Drew Thompson and Carla Freeman, "Flood Across the Border: China's Disaster Relief Operations and Potential Response to a North Korean Refugee Crisis," U.S.-Korea Institute at SAIS and The Nixon Center (April 1, 2009). See also Drew Thompson, "Border Burdens: China's Response to the Myanmar Refugee Crisis," *China Security* 5, no. 3 (2009), 11–21.

regulatory environment and by disruptions to the domestic economy. Chinese investors report they are subject to predation by the North Korean government and military. They express disdain for the North Korean legal system and have been adversely affected by policy decisions such as export restrictions on coal and other ores, periodic closing of the border, and the disastrous currency revaluation of 2009. In this difficult environment, Chinese investors would welcome change if their investments were to be protected. Much as foreign investors in China have increasingly opted for wholly owned investments over equity joint ventures with state partners as the planned economy has receded, Chinese investors in North Korea would likely prefer to operate independently, hire North Korean workers directly, and sell their products in a free market in exchange for a convertible currency. In the event of significant positive changes on the peninsula, Chinese joint ventures might make important contributions to rebuilding the northern half of the peninsula if they were to receive credible assurances about the security of their investments.

Despite the potential importance of Chinese joint ventures on the peninsula, they are silent partners in the Sino-DPRK relationship where the nuclear issue is concerned. Chinese investors, while aware of geopolitical tensions surrounding North Korean provocations such as nuclear tests, missile launches, and the unprovoked attacks on the ROKS *Cheonan* and Yeongpyeong Island, prefer to avoid politics and focus on their businesses. However, Chinese investors are not immune to the effects of the political and security situation on the Korean peninsula. North Korea's provocations, threats, stubborn survival, and isolated position in the world undermine some of Beijing's objectives for the region and places Chinese investors and traders at a disadvantage as well. The inhospitable North Korean business environment is only made more challenging by the political risk imposed by international sanctions and geopolitics. Business people in China's Northeast suffer the consequences of heightened tensions resulting from North Korean provocations, just as they suffer from predation and the capricious policies of North Korean authorities.

China faces several dilemmas stemming from North Korea's obdurate pursuit of a nuclear program. The United States' chief concern about the North Korean regime is its nuclear program and the threat it poses to U.S. allies in the region. The primary U.S. foreign policy tool toward North Korea is sanctions, including encouraging China to employ them or to otherwise persuade Pyongyang to alter its behavior. The presence of Chinese investment in North Korea likely hinders Beijing's freedom of action and creates liabilities that are not well understood. In

general, Beijing is uncomfortable with sanctions. The existence of Chinese investments affects Beijing's ability to endorse sanctions, which would harm Chinese companies in addition to undermining whatever trust exists between Beijing and Pyongyang. Though China's default position is to protect "normal trade" from sanctions, there is likely still concern about the impact of increased sanctions in Northeast China. North Korea's isolated resources and markets represent a unique opportunity for Chinese companies who enjoy the benefits of semi-privileged access and proximity. Therefore, Beijing defends its economic relationship and protects "normal trade" with North Korea from the U.S.-led strategy of sanctions.

Economic coercion likely undermines Beijing's message to North Korea about economic reform and opening, with the added possibility of increasing Pyongyang's mistrust of Chinese intentions. Efforts to encourage North Korea to pursue Chinese-style reform and opening make Beijing reluctant to use financial tools to coerce Pyongyang. Supporting sanctions would undermine Beijing's strategy to reform North Korea through engagement, in particular by encouraging the isolated country to open up and take advantage of China's market.

Chinese officials also undoubtedly harbor concerns about North Korean retaliation against Chinese investments should Beijing resort to economic coercion. Pyongyang has demonstrated its willingness to use South Korean investors in the Kaesong Industrial Zone as political pawns in its relations with the South. North Korea might use Chinese joint ventures as leverage if China were to waver in its support. At present, it is unclear if North Korea has considered employing such a strategy with China. Likewise, it is uncertain whether a diverse collection of small and medium-size enterprises with their headquarters in the provinces have the political wherewithal to effectively lobby Beijing to protect their interests in the face of North Korean pressure.

China is torn between its perceived national interests and international pressure on the issue of Pyongyang's nuclear program. Though Beijing has no desire to see a nuclear-armed North Korea, China's is more concerned with preventing the collapse of the North Korean regime than with discouraging the regime's development of nuclear weapons—which are presumably not pointed at Beijing. Chinese analysts believe that a dual-track approach encompassing both the Six Party Talks and the opening of the North Korean economy will be necessary to separate Pyongyang from its nuclear weapons. Unfortunately, Chinese investment in North Korea has thus far failed to catalyze economic reforms, much less prevent North

Korean provocations. Beijing's policy of engagement has failed to prevent aggressions such as the *Cheonan* and Yeonpyeong incidents, nuclear proliferation activities, and the continued development of Pyongyang's nuclear program, making it as unsuccessful as Washington's policy towards the North. However, the continued presence of investors and other Chinese economic interests in North Korea makes consideration of how these commercial interests can contribute to the region's shared desire for peace and prosperity important.

Conclusion

These admittedly extreme examples of sudden change have a low probability of occurring. Few people, if any, are actively concerned about Chinese investors upsetting delicate security balances in the region. Chinese joint ventures could potentially play a significant role, however, in other ways which might be equally dramatic when viewed over time. It is more likely that investment from abroad will contribute to gradual change among North Korean elites and workers, just as it changed China.

China's decision to open its economy and attract foreign capital and technology led to dramatic social and economic changes. When the third plenum of the Eleventh Communist Party Central Committee convened from December 18 to 22, 1978, China's leaders approved Deng Xiaoping's proposal to reform and open the country, though likely few participants that week were able to envision the China of today. However, the announcement three days earlier that the U.S. and China would normalize relations made it apparent that dramatic change was in the air and that the master-strategist Deng Xiaoping had calculated that the success of China's reform and opening was predicated on formalizing relations with the United States. Unlike North Korea, which today is unwilling to open up and reform, much less attract large-scale international investment, China determined 30 years ago that reform and opening meant letting the West in and abandoning old ideologies, thereby setting off on a course that made it the world's second largest economy.

Of course, during the advancement of reform and opening, Communist China struggled with the social and political dislocation that accompanied greater intercourse with the outside world, just as Qing Dynasty conservatives feared that reform and imported foreign technology would undermine their privileged positions in a delicately balanced society. Chinese fears of "peaceful evolution" and "colored revolution" have led the Communist Party to reject political reform, censor media, and clamp down on dissent, even as individual social freedoms have increased as dramatically as middle-class incomes. Like China, North Korean elites presumably fear that exposure to the outside world and access to information contradicting the government's assertion of the necessity of sacrifice, *juche*, and armed struggle would cause widespread disillusion or worse.

By itself, Chinese investment is unlikely to cause a eureka moment for North Korea's leadership, somehow catalyzing the notion that economic reform and opening to China and the West are the keys to North Korea's long-term survival. Of course, the presence of Chinese investors in North Korea (and the promise of more capital in the future), coupled with pressure and constant messaging from Beijing that reform and opening is the only way, increase the possibility that a future ruling clique in Pyongyang might buy into the so-called Chinese model. In that sense, the conduct of Chinese companies in their dealings with North Korean counterparts is potentially important. Nascent acceptance of modern business practices such as "Corporate Social Responsibility" (CSR) and "sustainability" in China reflects the influence of Chinese companies' and regulators' evolving relationship with multinational corporations. Now that China is an increasingly important outbound investor, those investors can be increasingly expected to incorporate good business practices into their own models—having learned at home that CSR and sustainability are competitive advantages—and lobby foreign governments to ensure level playing fields and good governance become the norm. This type of subtle, bottom-up pressure on the North Korean government might yield important developments over time and lead to incremental economic reforms and increased social freedoms.

Beijing's strategic approach to North Korea is banking on the hope that Pyongyang will eventually accept what China sees as inevitable and open up. Investment in China's Northeast and the handful of small-scale Chinese investments in North Korea reveal an array of Chinese actors with a common strategy of seeking to position themselves for a future opening of the DPRK. Should reform and opening take place, successive waves of investment could dramatically alter the political and economic landscape of North Korea and ultimately, the peninsula itself. But for now, the biggest barrier to expanded Chinese investment in North Korea as well as peace and stability on the Korean peninsula is the DPRK itself.

中朝边境·温馨提示

National Border of P.R.C. and D.P.R.K. Reminder

- 一、请勿攀爬、穿越铁丝网等拦阻设施。 1、Please do not climb or cross separation obstacles such as barbed wires.
- 二、请勿向界外投掷任何物品。 2、Please do not throw any objects over the border.
- 三、请勿与界外人员交谈、交换物品。 3、Please do not converse or exchange objects with people on the other side of the border.
- 四、请勿对军事设施照相、录像。 4、Please do not take pictures or videos of the military installations.

辽宁省边海防委员会办公室 宣

General Office of the Border/Ocean Defense Committee of Liaoning Province



U.S.-Korea Institute at SAIS

Johns Hopkins University

1717 Massachusetts Avenue NW, 6th Floor

Washington, DC 20036

www.uskoreainsitute.org