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The Viability of the New North Korean SEZs

By Marc Janke

I. INTRODUCTION

This is a report on the economic viability of the North Korean special economic zones (SEZs), including the two most recently opened SEZs in Rason and Hwanggeumpyeong in June 2011. What follows is an assessment of the investment potential of such regions, comparing widely divergent facts and opinions about the North Korean SEZs. The four SEZs considered are analyzed in two groups: the three northern SEZs (Rason, Sinuiju, and the islands), which were initiated with China in mind; and the Kaesong Industrial Zone, which is a South Korean project. The three northern SEZs will only be successful if China is willing to commit greater resources to their development. Kaesong, on the other hand, is effectively cut off from further growth until a more lenient South Korean political regime comes to power. Ultimately, SEZ development is in doubt because outside powers (China and South Korea) hold the keys to the success of these zones. Additionally, North Korea has not indicated a strong commitment to SEZ development, and thus the prospects are dim.

This essay's first section briefly sketches the background of the development of SEZs in North Korea. The second section introduces the four SEZs under analysis. The third section presents evidence suggesting that these SEZs *can* be successful, outlining factors that will affect success: fundamental factors (economic, physical, infrastructural, etc., that are concrete components of the potential for economic development) and behavioral factors (the perceptions and beliefs that cause people both inside and outside North Korea to behave in certain ways). The fourth section takes these fundamental and behavioral factors and reverses the analysis, giving reasons why the SEZs might *not*, and likely will not, be successful.

The line drawn between fundamental and behavioral factors is somewhat arbitrary. But making this distinction differentiates between what people are *capable* of doing (based on the physical resources at their disposal) versus what people are *willing* to do (based on how they feel about undertaking such action). North Korea, with its tumultuous history and passionate opinions both inside and outside the country, is a unique case in which the difference between *capabilities* and *willingness* gives insight into the country's potential for economic

development. The North Korean government has great potential to implement reform; the key is whether or not the government will be willing to implement such reform.

II. NORTH KOREA'S ECONOMY AND THE DEVELOPMENT OF SEZS

The CIA *World Factbook* provides some basic statistics on the North Korean economy. Estimated gross domestic product (GDP) for 2009 was \$40 billion, which is 350 times smaller than the current GDP of the United States and about 37 times smaller than the South Korean GDP. Per capita GDP for 2009 was roughly \$1,800. The economy is divided into three main sectors: agricultural (20 percent), manufacturing (50 percent) and services (30 percent).

A special economic zone is an area inside a country that has laws and regulations regarding trade, business laws, and other policies that are generally considered pro-free trade and more open than the rest of the country. China—with the creation of its SEZs in parts of Guangdong Province, Fujian Province, Zhuhai (directly across from Macau), and Shenzhen (directly across from Hong Kong)—is credited with this policy innovation.

III. THE NORTH KOREAN SEZS



Source: CIA, *The World Factbook*, North Korea

The Democratic Republic of North Korea (DPRK) currently claims four special economic zones. The first is the Kaesong Industrial Zone (KIZ), established in concert with the South Korean government in 2002 and the most well-known North Korean SEZ in the Western world. The second is Sinuiju. In 1991, the DPRK government made an initial attempt, and failed, to open up Sinuiju, a border city in the country's northwestern corner, directly across the border from Dandong in China's Liaoning Province. The North Korean government attempted to

revitalize Sinuiju in 2002. Following Sinuiju's lackluster performance, the *Financial Times* on June 9, 2011, reported that North Korea plans to open two more SEZs "located in the North Korean border city of Rajin-Sonbong (Rason). The other will be built on the undeveloped islands of Hwanggeumpyeong and Wihwa." Rason is in North Korea's farthest northeastern corner, across from China's Jilin Province and Russia's Primorsky Krai. The choice of Hwanggeumpyeong, Wihwa, and Bidan Islands (which Jamil Anderlini in the *Financial Times* on September 1, 2011 called "swampy undeveloped islets" in North Korea's northwest corner) is more puzzling, as the islands are so near Sinuiju and are surrounded by nothing but undeveloped wilderness.

Table 1. Specifications of North Korean SEZs

	Kaesong	Sinuiju	Hwanggeumpyeong /Wihwa	Bidan	Rason
Date Founded	2002	Pre-Korean War industrial center, re-founded in 2002	June 2011	2005	June 2011
Physical Location	on North Korea's southern border, in North Hwanghae Province	Sinuiju Municipality in North Pyongan Province, across the border from Dandong in Liaoning, PRC. (northwestern tip of North Korea)	Currently uninhabited islands near Sinuiju, in the Yalu River between China and DPRK	Large island near Sinuiju in Korea Bay	A combination of the two cities Rajin and Sonbong, which are located at North Korea's extreme northeastern corner, adjacent to China's Jilin Province and Russia's Primorsky Krai administrative region
Current Infrastructure	Most advanced of the four SEZs, due to heavy investment by large South Korean corporations	Some manufacturing facilities, both left from initial development in 1991, and also from its pre-Korean War status as a key Japanese manufacturing location	None, according to reputable blog 38 North	None	Very little, though main road is currently being expanded
Planned sector of economy	Low-end consumer goods such as shoes, clothes, and watches	Textiles, paper goods, enameled iron cookware	Labor-intensive manufactured goods	Financial center	Transportation and cargo shipping
Major international partner	South Korea	China	China	China	China
Current State of Completion	Complete, and operational until drastic cutbacks following the Cheonan sinking incident in 2010. Also curtailed due to US sanctions on North Korean products	Facilities in strong need of upgrades	None	None	Little to none
Possible rationale for location	On the border with South Korea	Former manufacturing site, location on the border with China and on the Korea Bay	Easy isolation as islands, very near China; changing flow of the Tumen River has made the island easier to access from China than from North Korea in recent years	Easy isolation as an island, very near China	Far removed from key population centers; China wants access to a seaport for the northeastern provinces

Kaesong Industrial Zone

The Kaesong Industrial Zone, located south of Pyongyang near the South Korean border, began in 2003 as a cooperative venture between the South and North Korean governments, with the purpose of improving DPRK economic development. South Korean firms were allowed into a special area to establish factories, and their investments were backed by the South Korean government. Hyundai Asan, the South Korean company responsible for management of the KIZ, writes in their informational pamphlet that by September 2011, 123 companies operated in the KIZ, with 48,242 North Korean workers producing about \$323.3 million worth of goods. *Asia Times Online* reported in June 21, 2011 that South Korean companies pay their workers \$61 a month, but including overtime this could be as much as \$90–100 per month. However, the DPRK government takes at least two-thirds of that, leaving North Korean workers \$20–30 per month at most. The *Asia Times* article observed that despite these incredibly low wages, the KIZ provides what are likely the most lucrative legal jobs available for common people in North Korea. Business is booming the KIZ; even though the number of companies operating there has fallen by more than half since 2008, the total number of North Korean workers has doubled over the same period. Choi Seong-keun of the Hyundai Research Institute confirmed in a personal interview that most KIZ factories are currently running at 100–120 percent capacity, unable to expand due to South Korean restrictions.

Sinuiju SEZ

The website *38 North* (www.38north.org) provides an excellent introduction to Sinuiju: “One of only two rail crossing points between the DPRK and China, Sinuiju is the North’s major gateway for rail and truck traffic. Much of Dandong’s [in China] foreign trade (estimates run as high as 80 percent) passes through Sinuiju.” The SEZ, originally established in 2002, was imagined as a transfer point for DPRK and Chinese goods that would develop into a thriving trade center. It was envisioned to have an entirely separate legal system from that of North Korea. He Tai Qing wrote in “*Dongbeiyi IT Gongtongti Zhanlue Yanjiu*” (“A Study on Northeast Asia Community Strategy”) on June 5, 2004 that according to the Sinuiju SAR Basic Law, the Sinuiju area has independent legislative, judiciary, and administrative authority. Excluding diplomatic administrative issues, the DPRK government does not intervene in the legal affairs of the area. The Sinuiju SEZ can administer separate regional visas and has its own regional flag. There is also foreign investment protection and the right to independently own and operate a business. In this sense the Sinuiju law is very much like

China's Shenzhen's law. Some scholars have suggested that the law concerning the political system in Sinuiju was modeled after Hong Kong, whereas the law concerning the SEZ's economic component is similar to Shenzhen. While this is factually true, how these Sinuiju laws operate in practice is a question that remains to be answered.

38 *North* lists some industries that continue to function in Sinuiju despite the dramatic recent curtailing: A Rakwon Machine Complex (quoted as being a "key production base providing equipment for much of the North's industry"), the Namhung Youth Chemical Plant, the September General Iron Enterprise, a textile machine plant, the Ryangchaek Bearing Factory, the Chonma Electrical Machine Factory, the Taeahungan Machine Factory, and the Sinuiju Condenser Factory. Kim Jong-il visited nearly all of these sites many times in order to emphasize their importance to the North Korean economy. In addition, a few remnants of the Japanese occupation remain. The Japanese attempted to build up Sinuiju as a center of light industry in the 1920s during the occupation period, and certain well-known factories, such as an enamel cookware factory, still remain from those times, although that particular factory is reportedly in dire need of an upgrade.

38 *North* writes that the Chinese are helping to build a bridge across the Tumen River from Sinuiju to Dandong to facilitate trade. The Inter-Korean Economic Cooperation program's plans to upgrade the railroad system from Sinuiju to Kaesong have been put on hold since Lee Myung-bak became South Korea's president in 2008. Liu Ming wrote in "*Chaoxian de jingji gaige: di san tiao daolu de tansuo ji bu queding de weilai*" ("DPRK Economic Reform: Exploring the Third Road and Its Uncertain Future") in June 2008 that China plans to build an "enormous residential area" in Sinuiju.

Rajin-Sonbong (Rason) SEZ

From a pre-SEZ attempt to establish a casino in 2000 and forced closure by the Chinese government, the Rajin-Sonbong SEZ (abbreviated Rason) was reborn in June 2011. Rason's strategic location is its single strongest asset for potential investment. It is located on the border of China, in an area that would give China a much-coveted seaport to the East Sea and enable its northwestern landlocked provinces to ship goods much more cheaply than they do now (first via land down the coast, then to the sea). The port is the northernmost ice-free port in the region, and China's support of development in the area is one of the most promising factors in evaluating this SEZ's potential success.

However, the Chinese government's actual commitment to the enormous investment that such a port and accompanying infrastructure will require remains to be seen. Andrei Lankov of *Asia Times Online* wrote in June 21, 2011 that there is only one single-lane paved road that connects Rajin to Sonbong. *38 North* reports that this 50-kilometer road to the border with China has been improved significantly and additional improvements are planned to be made. But such improvement is only a miniscule beginning of what would inevitably be a program of many years and billions of dollars.

In 1995, the DPRK government announced a new strategy for Rason: to turn it into a transfer point for traded goods from 2001 to 2010. There were grandiose plans for foreign investment of sums surpassing \$4.7 billion, but by the end of December 2000, only \$120 million had been collected. The majority of this was in the form of hotels, restaurants, and stores (service sector) from Chinese investors, which made up two-thirds of the investment total. Another 20 percent came from Japanese-North Korean Association funding, and less than 10 percent came from Western economies.

Virtually no information is available on Hwanggeumbyeong or the smaller island of Wihwa. Various Chinese sources, such as Ding Yuanmei in "*Zhongchao jingji hezuo xianzhuang yu duice yanjiu*" ("Chinese-DPRK Trade Partnership and Related Regulations") in 2007, and Liu Ming in the article mentioned above claim that the Chinese government is planning to assist North Korea in building a financial center on Bidan Island. These areas have been described as a "sandy island" and a "large rock." An ROK Ministry of Unification presentation in Seoul in November 2011 provided one insight into why North Korea may have chosen Hwanggeumbyeong: Though the island is undisputed DPRK territory, in recent years the flow pattern of the Tumen River separating China and North Korea has changed. The main current is now much stronger between North Korea and Hwanggeumbyeong than it is between China and Hwanggeumbyeong, making the island more difficult for North Korea to access. According to Seongkeun Choi of the Hyundai Research Institute, perhaps this was perceived as a benefit, in order to more effectively keep unauthorized North Koreans away from the island.

IV. THE NORTH KOREAN SEZS: CAN THEY BE SUCCESSFUL THIS TIME?

Though the odds are stacked against success for the DPRK special economic zones, useful insight can be gained by looking at the factors that might lead to such economic development success. To avoid the ambiguity of lumping together concrete capabilities with behaviors, we can separate these elements into two groups: fundamental factors (such as lack of electricity and modern

infrastructure) and behavioral factors (such as lack of trust within the international system).

One fundamental factor that supports North Korean SEZ development is the growth of trade. The June 7, 2011 *Chosun Ilbo* reports that first-quarter 2011 DPRK-China trade doubled compared to the previous quarter. Organizations like Inter-Korean Economic Cooperation (IKEC), as part of the Ministry of Unification, continue to work toward greater DPRK economic development. An IKEC presentation created circa 2007 reveals relatively ambitious plans for inter-Korean development, including expansion of existing facilities in the Kaesong Industrial Zone in addition to “tourism, residential and commercial districts.” Since 2007, these plans have been put on hold indefinitely—given today’s strained relationship between North and South Korea, it is doubtful that economic development projects between the North and the South will be fruitful in the near term. China’s plans, too, are largely projections rather than projects that have actually started. There are not enough real results yet to claim that the one-quarter increase in DPRK-China trade is more than a temporary bump based on renewed promises that will eventually fall through.

Another fundamental factor working in North Korea’s favor is its good educational system relative to its economic condition, especially in the information technology (IT) sector. Despite the deterioration of many DPRK school buildings and lack of necessary supplies, 99 percent of North Koreans, male and female, are literate and attend school up to at least middle school. The country’s relatively high level of human capital could be an advantage were it able to open up to international trade and foreign investment.

Nowhere are the results of this educational system more evident than in the IT industry. He Taiqing, in “A Study on Northeast Asia IT Community Strategy,” points out that North Korea may have advantages overlooked by many Western analysts. He claims that the DPRK software industry is “somewhat competitive” due to a talent-nurturing program begun in the mid-1980s: “North Korea in 1985 established a four-year institution for training computer technicians—called Choson Computer Science University—which in 1986 and 1990 established institutions for research and development of computer software, Pyongyang Information Center and Choson Computer Center.” He suggests that North Korea is supposedly attracted to IT development because it satisfies the strategy of “limited opening without systemic reform.” Paul Tjia, a Dutch strategy consultant with expertise in North Korea, wrote an article for *38 North* on October 31, 2011 supporting North Korea as an “up-and-coming IT outsourcing

destination,” particularly for European firms. He named website design, animation, administrative software, radio and mobile communication, medical diagnostics as IT fields in which North Korean firms have prior experience.

Still, while North Korea’s cheap IT sector will likely continue to grow, there are reasons to be skeptical. The first, as He Taiqing notes, is that North Korea is still agonizingly slow with such development. The second is that domestic IT development will be mercilessly scrutinized by the United States and other nations for its likely role in piracy and Internet crime. According to an October 17, 2006 Congressional Research Service report, despite North Korea being removed from the list of nations that sponsor terrorism, there are many US-imposed sanctions that will severely hamper development of a North Korean IT industry. These include steps to impede DPRK financial transactions internationally, ending the “supply, sale, or transfer to North Korea of conventional weapons, spare parts, delivery systems, or related items” and “prevent[ing] illicit trafficking in nuclear, chemical, or biological weapons,” among many other economic sanctions.

One main behavioral factor that could promote SEZ development is domestic pressure. Many scholars suggest that the North Korean government may have less of a choice on the issue of economic development than it did in the past. Bradley Babson, in a blog post “Rethinking Engagement with North Korea” on March 11, 2011, reported that the government experienced significant backlash in response to its crackdown on markets and has had difficulty controlling domestic inflation despite announcements to the contrary.

Related to this domestic pressure from the North Korean public is the pressure inherent in the succession of Kim Jong-un. Some Korea analysts have posited that Kim Jong-un could be eager to embrace reform in order to revive the economy, which would further stabilize and legitimize his succession. Patrick McEachern, in *Inside the Red Box*, published 2010 writes that there is strong evidence of institutional power struggles within the North Korean government. Though much of the government, as well as the military, does not want to open up the economy, the establishment of the SEZs indicates the search for a new strategy in the face of continued failure. Nevertheless, the overwhelming evidence, both in words and actions, points to a continuation of the status quo and an unwillingness to open up the economy. The power struggles between elites that McEachern writes about demonstrate different institutional interests within the DPRK state but do not suggest that the people who are fighting for power are necessarily looking for reform.

A final behavioral factor that might lead to successful development of SEZs in North Korea involves China. Simply put, China wants much of what North Korea has: namely, the Rason SEZ port (at Rajin), North Korea's abundant minerals, and the country's cheap labor.

Regarding the Rason SEZ port, Andrei Lankov wrote in the *Korea Times* on July 3, 2011:

With the Rason SEZ things appear to be quite straightforward—it's about reducing the cost of shipping. Northeast China, often referred to as Manchuria, is landlocked. Only a narrow strip of Russian and Korean territory, nearly 10 kilometers wide, divides it from the waters of the Pacific. Nonetheless, this is enough to create a logistical nightmare for Chinese business, in order to ship something overseas they have to first transport the goods to the nearest Chinese sea port, which is some 1000 km away. It is far more expensive to move things by land than by sea, so easy access to a North Korean seaport and shorter land routes would save a small fortune for Chinese business.

The Rason SEZ port is also the northernmost ice-free port in the region, which makes it especially valuable. Liu Ming wrote in *DPRK Economic Reform* published in June 2008 that a DPRK-China agreement on ports has been in effect for several years:

In July 2005, two Chinese companies from Hunchun signed an agreement with the North Korean government to rent the Rajin port for 50 years (Harbor number 3 and 4). The port will be managed by the joint venture company—Rason International Transport Company Limited, of which 50 percent is owned by the North Korean government and 50 percent is owned by the Chinese companies.

China also wants North Korea's mineral resources. North Korea is among the top 10 countries for copper, lead, and zinc deposits and also holds an abundance of coal and wood. It leads the world in deposits of tungsten, molybdenum, barite, and fluorite—in total, seven strategic metals—and also limestone from Musan. In all, 80 percent of DPRK land has minerals in it, with an estimated value of \$1 trillion, including 3–4 billion tons of magnesite (more than half the world's supply), 26 million tons of iron ore, and 4 million tons of immediately accessible uranium.

But North Korea is unable to utilize its natural capital, as its industrial infrastructure is on the verge of collapse. This is precisely where China could (and would be willing to) help. China and North Korea reportedly have an agreement that grants China exclusive access to rich stores of magnesite, which is a key component of glass and cement. In fact, Kong Jun, in “*Zhongguo dui chaoxian jingji yuanzhu neimu*” (“Behind the Scenes in China’s Investment in North Korea”) published on June 17, 2009, discloses that North Korea has allowed China privileged access to almost all DPRK mines, which has frustrated Japan and South Korea. According to media reports, China’s Shandong Guoda Gold Company has signed an €8 million, 25-year copper-extraction contract that will give it exclusive access to the lucrative copper stores in North Korea’s mountains. Prior to this, China’s Jilin Province Chamber of Commerce signed a contract with the North Korean government worth RMB 7 billion to secure Musan’s lucrative iron ore deposits. Beyond this, Beijing is also working with Pyongyang to get access to molybdenum mines near the North Korean capital as well as to oil fields in the Western Sea.

Another important aspect to consider is how the development of North Korea fits into China’s own northeastern development plan. The northeastern provinces of China have been relatively underdeveloped compared to its eastern seaboard. North Korean economic development would undoubtedly be a great boost to the region, as trade would increase between these provinces and North Korea. Likewise, there would be an increase of demand for Chinese industrial goods, which are often produced in China’s northeast. This was, in fact, one of the main hopes behind the initial development of North Korea’s SEZs. China’s belief in North Korea’s economic potential, however, has since become less optimistic. China’s hope for North Korea now seems focused on Rason as a transportation hub rather than as a site for domestic North Korean economic growth, as political risks associated with DPRK investment have not appreciably diminished. While China would undoubtedly like to see North Korean economic development as part of its own northeastern province development plan, to say that such development is more likely *because* it fits into China’s plan is a weak argument.

Given that China wants a port and mineral resources, the North Korean government does not have much leverage, especially in light of the enormous amount of aid that China continues to provide. As Kong Jun asserts in an excerpt from his 2009 article, “80 percent of oil aid to Korea and 92 percent of grain aid comes from China.” According to Kong, every year China sends 500,000 tons of oil to North Korea. Not only is this oil much cheaper compared to other sources,

but China often waits more than two years for payment. In 2006, says Kong, China's investment in North Korea was \$113 million, which was 97 percent of North Korea's total foreign aid for that year. Kong's statistics are somewhat questionable, as he assumes that the DPRK economy is half the size estimated by the CIA *World Factbook*, but there is little doubt that China provides the vast majority of foreign assistance to North Korea. As this aid dependence increases, North Korea may have to give in to China's will and put extra effort into making the SEZs a reality.

Even if China is successful in getting access to both the port at Rason and to DPRK minerals, it is doubtful that this will lead to significant economic development on the North Korean side. For one, the Chinese are infamous for sending in teams of their own laborers to complete projects in foreign countries (such as in China-sponsored infrastructure development in Africa). Even more importantly, both transportation and mining are industries in which it is relatively easy to skim off economic rents without reinvesting in domestic development. This fits the goals of the current DPRK regime quite well, making it unlikely that development based on China's self-interest can lead to economic development in North Korea's SEZs.

V. SEZ DEVELOPMENT: WHY IT WON'T WORK THIS TIME

There are several convincing arguments for why North Korea's special economic zones will not be successful this time around. As with the reasons for possible success, they break down into fundamental factors (physical capabilities) and behavioral factors (willingness of the parties involved).

The first fundamental factor is physical shortages—lack of food, electricity, and infrastructure. Choe Sang-Hoon in an October 24, 2011 *New York Times* article reported that North Koreans are currently suffering especially severe levels of malnourishment. From a basic labor productivity perspective, this undoubtedly makes DPRK workers less efficient than those of wealthier countries. Many public buildings and basic infrastructure, like sewage pipes and electric wiring—and even the machines to build them—are broken or nonexistent. In North Korea electricity is variable and unreliable; Hyundai Asan developed its own power plant in 2007 for use in the Kaesong Industrial Zone for this reason.

The primary behavioral factor working against North Korea is the way that it has gradually eroded the trust between itself and China. My interviews with North Korean experts revealed that China is only lukewarm about assisting

North Korea with its economic development. Marcus Noland, a senior fellow at the Peterson Institute for International Economics, expressed that the fact that upgrading the railroad from the Rason SEZ to Hunchun in China took 14 years “underscores the depths of North Korean insecurity and paranoia” toward opening up to the outside world. Noland wrote in “More China-North Korea Economic Cooperation” that because “China-DPRK trade has a noticeable seasonal pattern, dropping quite significantly during the winter months when the weather makes passage over mountainous dirt roads hazardous,” the improvement of the railroad to facilitate trade is a sorely needed and utterly obvious move. That it took so long is a demonstration of the massive psychological wall that the DPRK regime has to overcome to accept foreign trade.

There are also empirical indications that the DPRK government is not committed to reform. Choi Seong-keun of the Hyundai Research Institute in Seoul provided me with a fascinating chart that shows how North Korea alternates between China and South Korea when pursuing trade relationships. The chart demonstrates a clear inverse relationship between the growth rates of trade patterns between China and North Korea versus those between North and South Korea. This strongly suggests that DPRK overtures toward reform are not genuine but rather are only ways to sustain the status quo. In my interview with Mr. Choi, he postulated that the projections for 2011 would once again show further separation of the of Chinese and North Korean trade, with China increasing and South Korean trade changing to a downward trend.

Figure 1. Comparison of China-DPRK Trade and ROK-DPRK Trade

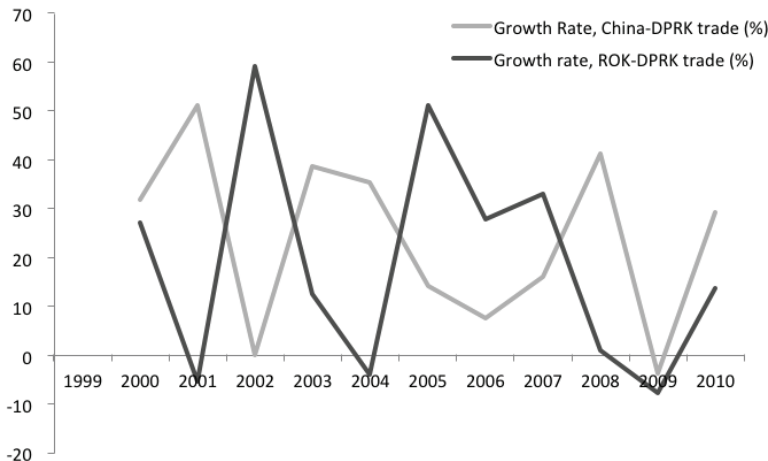


Table 2. Comparison of China-DPRK Trade and ROK-DPRK Trade

Year	China	Growth Rate, China-DPRK trade (%)	South Korea	Growth rate, ROK-DPRK trade (%)
1999	370		334	
2000	488	31.89	425	27.25
2001	737.5	51.13	403	-5.18
2002	738	0.07	642	59.31
2003	1023	38.62	724	12.77
2004	1385.2	35.41	697	-3.73
2005	1580.3	14.08	1055	51.36
2006	1699.6	7.55	1350	27.96
2007	1973.9	16.14	1798	33.19
2008	2787.3	41.21	1820	1.22
2009	2680.7	-3.82	1679	-7.75
2010	3465.7	29.28	1912	13.88

North Korea has a fundamental trust problem in developing the SEZs. Zhang Liangui, Professor of international strategic research at China's Central Communist Party School told the *Financial Times* in September 1, 2011 that "North Korea's past experience of working with other countries has left it with a serious credibility problem and this will stop a lot of foreign investment from even considering these new zones." This time around, the Chinese have more experience with DPRK fraud vis-à-vis investment projects. Chinese scholar Liu Tong writes in "*Zhongguo dui chaoxian touzi qianjing ji xu zhuyi de wenti*" ("The Prospects of Chinese Investment in North Korea and Issues that Require Attention") published in July 2009 that uncertainty and the way that international political events affect such investments constitute the biggest risk that companies face in China. He provides the example of October 2006, when North Korea tested its first nuclear weapon: the Dandong branch of China Construction Bank immediately ended a financial cooperation program, which made it extremely inconvenient for Chinese companies in North Korea to settle their accounts. A *Wall Street Journal* blog entry by Jo Dong-ho, an economist from Ewha University, commented on Kim Jong-il's May 2011 meetings in China, saying that "the Chinese side listed five points of agreement between the two countries, while North Korea listed only three." This demonstrates that the two sides have a fundamental communication problem, even though they are supposed diplomatic friends.

Another behavioral factor that impedes North Korean SEZ development is the country's culture of corruption and graft. Liu Tong is quite frank on the issue of local management inadequacies: "You must understand that some rent-seeking behavior is inevitable. Many DPRK officials have a weak and underdeveloped

understanding of the market,” says Liu, and, owing to many different reasons, “North Koreans regularly breach contracts, resulting in heavy losses for our [Chinese] companies. Examples of this are myriad. We need to do a strict credit analysis of these companies before doing business with them.” Hazel Smith, Professor at Cranfield University has written in “Don’t Expect a Pyongyang Spring Sometime Soon,” October 28, 2011: “In North Korea the market economy is irreversible but it is a market economy that is institutionalized within a culture of simulation, surveillance, and endemic cynicism.” She suggests that this “toxic heritage” could be “as detrimental to the future united Korea as the unregulated and unsafe development of nuclear power also taking place in the North right now.” Culture can change, of course, but if her estimation of North Korean business culture is accurate, this may well take a generation or more to fix and will be a severe impediment to business activity in the SEZs.

The final main behavioral factor that stands in the way of SEZ development is South Korean politics. According to a representative for Hyundai Asan from an interview conducted in November 2011, the conservative Lee Myung-bak administration hampered efforts toward North Korean economic development by denying further expansion of the Kaesong Industrial Zone after the sinking of the *Cheonan* in March 2010. Many believe that North Korean development would pick up again if a more liberal president comes into office. This is not to say that the Lee administration’s decisions were unjustified given the circumstances, but only that South Korean political sentiment is a significant barrier to SEZ development. To restate the example provided earlier, business in the Kaesong Industrial Zone is booming at 100–120 percent of capacity and would undoubtedly expand if the Lee administration would allow it.

VI. CONCLUSION: FAILURE PREDICTED

North Korean special economic zones will likely only be successful under the following specific conditions that depend heavily on factors external to North Korea:

- Continued resource shortages in China that will provide stronger motivation for China to pursue development in Sinuiju and transportation networks in Rason.
- A more liberal South Korean government that will allow continued investment in the Kaesong Industrial Zone.
- A nondestabilizing transfer of power from Kim Jong-il to Kim Jong-un in the near term. As Patrick McEachern writes in *Inside the Red Box*, Kim

Jong-un will likely need to do something to legitimize his hold on power, and developing the North Korean SEZs could be what he needs to bolster his rule.

If these conditions were fulfilled, North Korea would have a strong motivation to initiate economic reform. Even now, there are compelling reasons why North Korea would want to begin the process in earnest. One is the increasing monetization of the economy. Liu Ming notes in “*Chaoxian de jingji gaige: di san tiao daolu de tansuo ji qi bu queding de weilai*” (“DPRK Economic Reform: Exploring the Third Road and its Uncertain Future”) in June 2009 that recent developments in North Korea have shown increasing use of currency substitution for the previous rationed-goods distribution system. There has also been rampant inflation of the DPRK won on the black market in recent years. Liu notes that while the official DPRK won to US dollar rate is 141:1, it is trading for 2000:1 on the black market; euros trade at 180:1 officially and 3500:1 on the black market. In addition, says Liu, “forced planning on companies has reduced dramatically, and state-owned enterprises have more autonomous management capability.” Another benefit of reform from a North Korean strategic perspective is that it would build up a foreign reserves buffer against the continued imposition of sanctions. This would also decrease North Korea’s dependency on foreign aid. A reduction in dependency on aid would in turn further improve the strategic position of the DPRK and lessen the effects of negative public opinion toward the regime’s inability to provide adequate food to its people.

Despite these strong motivations, the three major conditions necessary for SEZ success are not likely to come to pass. China, while desiring North Korean mineral resources, already failed in developing SEZs in North Korea a decade ago and will not be naïve enough to repeat its previous mistakes. From the South Korean side, the increasing polarization of public opinion in South Korea makes it hard to believe that more lenient economic policies toward the North will come about anytime soon. Finally, even a successful transition of power from Kim Jong-il to Kim Jong-un would not guarantee the continued development of the SEZs. On the contrary, it is perhaps the uncertainty surrounding regime change that the Chinese have been moving so slowly.

The development of North Korea’s SEZs is held back both by fundamental factors, such as poor infrastructure and lack of electricity, as well as by behavioral factors, such as North Korean government paranoia and China’s lukewarm attitude toward investment prospects on the border. Under a specific set of

circumstances, the SEZs could provide a significant economic base for North Korea. Unfortunately, it is more realistic to say that North Korea is not yet ready to prove it can be a trustworthy international trade partner. What is perhaps most worrisome is that the reestablishment of these SEZs can be seen as a desperate move on the part of the DPRK regime to find a strategy that works in the longer term, and the initiative indicates just how precarious a position North Korea is in. Therefore, if these SEZs do fail, it will likely set the stage for something even more dramatic (and internationally newsworthy) in the near future.



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