

Inter-Korean Economic Cooperation at a Crossroads

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Economic relations between North and South Korea broke major new ground in 2005. Inter-Korean trade increased by more than 50 percent over the previous year and exceeded \$1 billion for the first time. After many years of struggle, Hyundai's Mt. Kumgang tourism project turned in an operating profit. The Kaesong Industrial Complex, located just north of the demilitarized zone (DMZ), began churning out goods in mass quantities, showing what North and South Korea could do if they work together. Also, the inter-Korean railroad linkage project appeared only a test run away from being completed. Last but not least, the September 19 joint statement of principles raised hope that the six-party process would resolve the long-running nuclear crisis on the Korean peninsula and enhance peace and security in Northeast Asia. These positive developments fueled speculation that, after several false starts over the past decade, inter-Korean economic relations had finally entered a new phase of sustained growth.

Such optimism fizzled by the summer of 2006. Almost immediately after the release of the joint statement of principles, the U.S. and North Korea issued polar-opposite interpretations of the document, particularly with regard to the sequencing of steps to be taken in the course of resolving the nuclear crisis.¹ U.S. financial regulatory actions against North Korea, implemented just before the September 19 joint statement, further complicated the situation. Whereas Washington insisted that these measures had everything to do with law enforcement and nothing to do with the six-party talks, Pyongyang saw them as yet additional evidence of U.S. hostile policy toward North Korea. American newspaper articles on the Bush administration's plan to "squeeze" North Korea subsequently confirmed Pyongyang's worst fears.² "Give sanctions a chance" seemed to be the motto for the new policy.

With the hardening of U.S. policy toward North Korea, inter-Korean economic cooperation came under greater scrutiny. In the spring of 2006, some American policymakers raised questions about the human rights of the North Korean workers at the Kaesong Industrial Complex—a curious choice in light of the fact that Kaesong has far better working conditions than anywhere else in North Korea. When this line of criticism proved rather ineffective, the

¹ For a more comprehensive discussion, see Charles "Jack" Pritchard, "Six-Party Talks Update: False Start or a Case for Optimism?," paper presented at the conference on *The Changing Korean Peninsula and the Future of East Asia*, co-hosted by the Center for Northeast Asian Policy Studies (CNAPS), Brookings Institution, and the Seoul Forum for International Affairs and JoongAng Ilbo, December 1, 2005, Seoul. The paper is accessible at: <http://www.brookings.edu/fp/cnaps/events/20051201presentation.pdf>. See also Leon V. Sigal, "The Cabal is Alive and Well," Nautilus Policy Forum Online 05-95A, November 29, 2005, accessible at: <http://www.nautilus.org/fora/security/0595Sigal.html>.

² See, for instance, Joel Brinkley, "U.S. Squeezes North Korea's Money Flow," *The New York Times*, March 10, 2006. In the article, an unnamed senior official "who watches the issue closely" characterized the new policy toward the North Koreans as "Squeeze them, but keep the negotiations going." The six-party talks would then serve as "little more than a vehicle for accepting North Korea's capitulation."

focus of inquiry shifted to Pyongyang's revenue stream from inter-Korean cooperation projects. Whereas South Korea argued that inter-Korean economic cooperation would facilitate reform in North Korea, the U.S. feared that it would only sustain the Kim Jong Il regime while producing minimal changes in its behavior. The friction between South Korea and the U.S. cast a dark shadow over the prospects of inter-Korean economic relations.³

To make matters worse, North Korea increasingly called for the resolution of "the fundamental issues" that were blocking progress in inter-Korean relations—namely, the lifting of South Korea's ban on visits to the Kim Il Sung mausoleum, redrawing of the Northern Limit Line (NLL) in the Yellow Sea, abolition of the National Security Law, and discontinuation of South Korea's joint military exercises with the U.S. In discussing inter-Korean economic projects with major security implications, such as the linking of the railroads, North Korea tried to bring up these age-old, fundamental issues. In fact, Pyongyang abruptly cancelled an inter-Korean train run scheduled for May 2006 when it could not make any progress on the NLL issue contrary to its expectations, which had been shaped by Roh Moo Hyun's gushing remarks on inter-Korean relations in Mongolia earlier in the month. North Korea's missile launch on America's Independence Day further poisoned the atmosphere for inter-Korean economic cooperation. In response to the missile launch, the South went so far as to stop food and fertilizer aid to the North, except for a reduced emergency aid shipment after a flood in the North. Finally, North Korea's nuclear test on October 9 shook up the very foundation of inter-Korean economic relations and prompted serious questions about the possible transfer of proceeds from cooperation projects to North Korea's weapons programs. In particular, the adoption of the United Nations Security Council Resolution 1718 on October 14 led to increasing demand for transparency.

In sum, although inter-Korea economic cooperation seems more commercially viable than ever before, its political foundation has considerably weakened since September 2005. With the six-party process going nowhere and inter-Korean relations at one of the lowest points in recent memory, there is increasing concern about the future of inter-Korean economic cooperation.

This paper looks at the development of inter-Korean economic relations since the late 1980s and draws policy implications for the future. This paper is organized as follows. Section 1 provides an overview of inter-Korean trade, starting with its definition as "intra-nation transaction." Section 2 explains the significance of inter-Korean trade from both the South's and

³ See, for instance, the op-ed exchange in the *Wall Street Journal* between Jay Lefkowitz, U.S. Special Envoy on Human Rights in North Korea (April 28, 2006), and Kwan-sei Lee, South Korea's Assistant Minister of Unification (May 11, 2006).

North's perspectives. Section 3 discusses three policy dilemmas associated with inter-Korean trade: (1) big bang vs. gradualism, (2) economic-security linkage, and (3) economic engagement and human rights. Section 4 concludes.

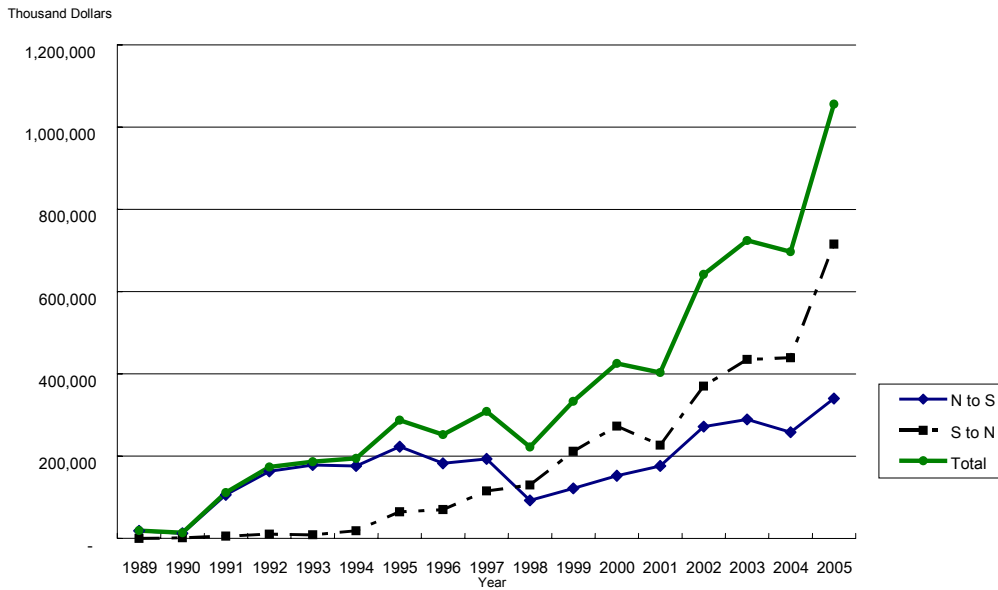
1. Overview of Inter-Korean Trade

In South Korea, according to the Law on South-North Exchanges and Cooperation (1990) and the Special Law on Implementation of the World Trade Organization Agreement (1995), inter-Korean economic cooperation is regarded as an “intra-nation transaction.” In fact, the Law on South-North Exchanges and Cooperation uses terms such as “carry-in” and “carry-out” instead of “import” and “export,” to signify the internal nature of trade between South and North Korea, and explicitly exempts the application of the Tariff Law to goods “carried in” from North Korea. Article 5 of the Special Law stipulates that “trade between South Korea and North Korea constitutes internal trading within a nation and as such shall not be regarded as that between countries.”⁴

<Figure 1> shows trends in inter-Korean trade (or, more accurately, inter-Korean flows of goods) since 1989, the year after South Korea made the unilateral July 7 declaration to promote economic exchanges with North Korea. With the Cold War coming to an end, North and South Korea signed the Inter-Korean Basic Agreement in 1991 and provided for the first time an institutional framework for inter-Korean economic exchanges. The total volume of inter-Korean trade reached \$100 million in 1991 and soared to nearly \$200 million in 1992, as processing-on-commission (POC) trade began to expand rapidly. The first nuclear crisis of 1993-1994, however, put a brake on this trend, as South Korea pursued a strategy of linking inter-Korean economic cooperation with the resolution of the nuclear crisis. Although the Geneva Agreed Framework of 1994 provided a renewed impetus, the next four years saw fluctuations in the volume of inter-Korean trade as North Korea's food crisis and South Korea's financial crisis buffeted the two economies. In addition, Kim Young Sam's tendency to link political and economic issues and speculate openly about North Korea's impending collapse was not conducive to cooperation.

⁴ For a more detailed discussion on the domestic and international legal status of inter-Korean economic cooperation, see Dukgeun Ahn, “Legal Issues for Korea's ‘Internal Trade’ in the WTO System,” in Wonhyuk Lim and Ramon Torrent, eds., *Multilateral and Regional Frameworks for Globalization: WTO and Free Trade Agreements* (Seoul: Korea Development Institute, 2005), pp.362-376. Ahn observes that an imminent legal issue regarding inter-Korean trade is the most-favored-nation (MFN) requirement, although its application depends on whether North Korea is treated as a country or at least an entity that has sufficient legal status to become an independent WTO member. The other major issue concerning North Korea is the so-called “non-market economy” provisions associated with trade remedy actions.

<Figure 1> Inter-Korean Trade (Flows of Goods), 1989-2005



Note: The inter-Korean trade figures for 1995 do not include 150,000 tons of rice shipments from the South to the North valued at \$237 million. The South's food aid to the North since 2000 (valued at international rather than domestic prices) is reflected in trade statistics.

South Korea's adoption of Sunshine Policy in 1998 and recovery from the financial crisis in 1999 began to clear these obstacles. The Kim Dae Jung government made clear that it would neither condone the North's armed aggression nor seek unification by absorption, but instead focus on promoting inter-Korean reconciliation and cooperation. The South also gave a green light to companies such as Hyundai to undertake investment projects in the North and began to provide a significant amount of humanitarian aid to the North. The inter-Korean summit of June 2000 marked a watershed as the two sides agreed to push ahead with cooperation projects at a governmental level. The total volume of inter-Korean trade reached \$400 million in 2000 and exceeded \$600 million in 2002. By the end of 2002, three major inter-Korean cooperation projects (Mt. Kumgang tour, Kaesong Industrial Complex, and linking of the railroads) had begun to make significant progress.

Inter-Korean trade covers both commercial and non-commercial transactions. Commercial transactions include general trade and POC trade as well as the flows of goods associated with economic cooperation projects such as the Kaesong Industrial Complex and Mt. Kumgang tour. For example, construction materials and factory equipment to be used by South Korean companies at the Kaesong Industrial Complex are covered under this heading. Non-commercial transactions consist of aid to North Korea (e.g., food and fertilizers) and the flows of goods associated with socio-cultural cooperation projects and the now-defunct KEDO light-water

reactor (LWR) project. As inter-Korean trade statistics basically focus on the flows of goods between the North and the South, payments for services (e.g., entrance fees for Mt. Kumgang tour as opposed to construction materials related to the tourism project) are tallied separately. A new classification system was adopted in 2005 to reflect major developments in inter-Korean trade in recent years. As shown in <Table 1>, the new classification system divides inter-Korean cooperation projects into economic and socio-cultural categories and has a separate subcategory for the Kaesong Industrial Complex. The new system also places the Mt. Kumgang tourism project under the commercial rather than non-commercial category.

<Table 1> Inter-Korean Trade by Transaction Type in 2005

(unit: thousand dollars, percent)

| | | | S to N | N to S | Total |
|-----------------------------|-------------------------------------|-------------------------------------|--------------------|---------------------|--------------------|
| Commercial Transactions | Trade | General Trade | 20,862 (-1.6) | 188,916 (25.8) | 209,778 (22.4) |
| | | POC Trade | 78,503 (15.0) | 131,226 (21.7) | 209,729 (19.1) |
| | | Subtotal | 99,364 (11.1) | 320,142 (24.1) | 419,506 (20.7) |
| | Economic Cooperation Projects | Kaesong Industrial Complex | 156,943 (276.9) | 19,794 (-) | 176,737 (323.9) |
| | | Mt. Kumgang Tour | 87,015 (108.8) | 50 (-52.8) | 87,065 (108.4) |
| | | Others | 6,202 (8.1) | 31 (82.3) | 6,233 (8.3) |
| | | Subtotal | 250,160 (180.9) | 19,874 (-) | 270,034 (202.6) |
| | Total Commercial Transactions | | 349,524 (95.8) | 340,017 (31.7) | 689,541 (57.9) |
| Non-Commercial Transactions | Aid | Non-Governmental Aid | 242,718 (34.7) | 42 (-) | 242,760 (34.8) |
| | | Governmental Aid | 122,258 (56.1) | 19 (-) | 122,277 (56.1) |
| | | Subtotal | 364,976 (41.2) | 60 (-) | 365,036 (41.2) |
| | Socio-cultural Cooperation Projects | Socio-cultural Cooperation Projects | 577 (-65.9) | 204 (-) | 781 (-53.9) |
| | Light-Water Reactor Project | Light-Water Reactor Construction | 394 (-13.5) | 0 (-) | 394 (-13.5) |
| | Total Non-Commercial Transactions | | 365,948 (40.4) | 265 (-) | 366,213 (40.5) |
| Grand Total | | 715,472 (62.9) | 340,281 (31.8) | 1,055,753 (51.4) | |

Note: Figures in parentheses represent year-on-year percentage increases from end-2004 to end-2005.

Source: Ministry of Unification and Korea International Trade Association (KITA), "Trends in 2005 South-North Trade," January 2006 (in Korean).

As <Table 1> shows, the most significant development in inter-Korean trade in 2005 was the rapid growth in the flows of construction materials and equipment into the Kaesong Industrial Complex.⁵ Compared with the previous year's figure, it increased by a whopping 323.9 percent to reach \$176.7 million dollars. During the same period, general and POC trade rose by 20.7 percent, and aid from the South to the North increased by 41.2 percent.

Overall, commercial and non-commercial transactions accounted for 65.3 percent and 34.7 percent of the total trade volume in 2005, respectively. The share of commercial transactions in inter-Korean trade had swiftly declined from more than 94 percent in 1996 to 55 percent in 2002, in large part due to the implementation of the KEDO light-water reactor project and provision of humanitarian aid from the South to the North. As <Table 2> shows, however, the share of commercial transactions in 2005 reached its highest point since 2000 thanks to increased trade and investment. In particular, the Kaesong Industrial Complex accounted for 16.7 percent of the total trade volume in 2005—a huge jump from 6.0 percent in 2004.

<Table 2> Commercial and Non-Commercial Transactions, 2000-2005

(unit: million dollars, percent)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|-----------------------------|------------|------------|------------|------------|------------|------------|
| Commercial Transactions | 256 [60.2] | 244 [60.6] | 355 [55.3] | 425 [58.7] | 437 [62.7] | 690 [65.3] |
| Non-Commercial Transactions | 169 [39.8] | 159 [39.4] | 287 [44.7] | 299 [41.3] | 260 [37.3] | 366 [34.7] |
| Total | 425 | 403 | 642 | 724 | 697 | 1,056 |

Note: Figures in brackets represent percentage shares in total inter-Korean trade.

Source: KITA

Within the commercial transactions category, <Table 3> shows that the share of longer-term, investment-oriented economic cooperation projects has been rising in recent years. In 2005, the Kaesong Industrial Complex and other economic cooperation projects accounted for 39.2 percent of commercial transactions.

<Table 3> Composition of Commercial Transactions, 2000-2005

(unit: million dollars, percent)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---------------|------------|------------|------------|------------|------------|------------|
| General Trade | 111 [43.4] | 111 [45.5] | 171 [48.2] | 223 [52.5] | 171 [39.1] | 210 [30.4] |
| POC Trade | 129 [50.4] | 125 [51.2] | 171 [48.2] | 185 [43.5] | 176 [40.3] | 210 [30.4] |

⁵ For details on the development of the Kaesong Industrial Complex, see Eul Chul Lim, *Welcome to the Kaesong Industrial Complex* (Seoul: Haenam, 2005), especially, pp.1-67 (in Korean).

| | | | | | | |
|-------------------------------------|----------|---------|----------|----------|-----------|------------|
| Kaesong Industrial Complex | 0 [0.0] | 0 [0.0] | 0 [0.0] | 0 [0.0] | 42 [9.6] | 177 [25.7] |
| Other Economic Cooperation Projects | 16 [6.3] | 8 [3.3] | 13 [3.7] | 17 [4.0] | 48 [11.0] | 93 [13.5] |
| Total | 256 | 244 | 355 | 425 | 437 | 690 |

Note: Figures in brackets represent percentage shares in inter-Korean commercial transactions.

Source: KITA

As for non-commercial transactions, South Korea's humanitarian aid to North Korea is by far the largest item, especially since the phasing out of the KEDO light-water reactor project.⁶ <Table 4> shows South Korea's food and fertilizer aid to North Korea through bilateral and multilateral channels. Humanitarian aid provided through multilateral channels consists of food, medical supplies, and other aid goods from the South to the North via international bodies such as the United Nations Children's Fund (UNICEF), World Food Program (WFP), World Health Organization (WHO), and World Meteorological Organization (WMO).

<Table 4> South Korea's Food and Fertilizer Aid to North Korea, 1995-2005

(unit: thousand metric tons)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|--------------|------|------|------|------|------|------|------|------|------|------|------|
| Food | | | | | | | | | | | |
| Bilateral | 150 | - | - | - | - | 500 | - | 400 | 400 | 400 | 500 |
| Multilateral | - | 4 | 60 | 40 | - | - | 100 | 100 | 100 | 100 | - |
| Fertilizers | - | - | - | - | 155 | 300 | 200 | 300 | 300 | 300 | 350 |

Source: Ministry of Unification

<Table 5> shows the composition of inter-Korean trade by product category in 2005. Of goods transported from the South to the North, chemical products (e.g., fertilizers) have the largest share at 28.3 percent. Agricultural and marine products (e.g., rice) have the second largest share at 20.2 percent. These product categories have mostly to do with humanitarian aid from the South to the North. The next three product categories, machinery, textiles, and iron and metal products, basically represent intermediate goods and raw materials for POC trade and economic cooperation projects such as the Kaesong Industrial Complex. By comparison, of goods

⁶ In 1994, South Korea agreed to pay 70 percent of the estimated cost of \$ 4.60 billion for the two light-water reactors. By the time the KEDO project was terminated in November 2005, South Korea had incurred a total cost of \$1.14 billion, most of which was paid to South Korean contractors. See Ministry of Unification, "A Briefing on the Termination and Liquidation of the Light-Water Reactor Project," January 10, 2006 (in Korean).

transported from the North to the South, textiles have the largest share at 35.4 percent. These are finished products (e.g., track suits, jackets, shirts, pants, and skirts) shipped back to the South after being processed in the North. The next three product categories represent the North's top cash earners in non-POC trade: agricultural and marine products (e.g., clams, dried fish products, mushrooms, and octopuses), iron and metal products (e.g., zinc ingots), and minerals (e.g., sand and gold). This trade pattern clearly shows the underdeveloped state of the North Korean economy.

<Table 5> Inter-Korean Trade by Product Category in 2005

(unit: thousand dollars, percent)

| Product Category | South to North | | | North to South | | |
|---------------------------------------|----------------|--------------|-------|----------------|--------------|-------|
| | Amount | YoY Increase | Share | Amount | YoY Increase | Share |
| Agricultural and Marine Products | 144,644 | 116.3 | 20.2 | 112,609 | 10.6 | 33.1 |
| Minerals | 31,740 | 9.3 | 4.4 | 29,238 | 393.4 | 8.6 |
| Chemical Products | 202,655 | 49.0 | 28.3 | 544 | 170.3 | 0.2 |
| Plastic, Rubber, and Leather Products | 10,973 | 19.3 | 1.5 | 1,674 | 312.1 | 0.5 |
| Textiles | 87,203 | -2.6 | 12.2 | 120,294 | 25.5 | 35.4 |
| Consumer Products | 12,634 | 136.5 | 1.8 | 6,025 | 59.7 | 1.8 |
| Iron and Metal Products | 67,855 | 216.6 | 9.5 | 44,301 | 12.6 | 13.0 |
| Machinery | 114,888 | 166.3 | 16.1 | 10,438 | 658.0 | 3.1 |
| Electric and Electronic Products | 35,026 | 13.1 | 4.9 | 14,460 | 64.2 | 4.2 |
| Miscellaneous Products | 7,857 | 5.9 | 1.1 | 698 | 47.8 | 0.2 |
| Total | 715,472 | 62.9 | 100.0 | 340,281 | 31.8 | 100.0 |

Source: KITA

3. Significance of Inter-Korean Trade

(1) South Korea's Perspective

Inter-Korean trade, at a bit more than \$1 billion in 2005, amounts to a miniscule 0.19 percent of South Korea's external trade with the rest of the world (\$546 billion dollars, excluding inter-Korean trade). However, this metric does not do justice to the significance of inter-Korean trade for South Korea. Credit-rating agencies such as Moody's typically downgrade South Korea's rating by a notch (e.g., from A to A-) due to its "North Korea risks" associated with the eruption of a potential military conflict or an economic catastrophe. To the extent that inter-

Korean trade helps to improve inter-Korean relations and economic conditions in North Korea, it is likely to reduce these risks and raise South Korea's credit rating. Moreover, inter-Korean economic cooperation has a great significance for the integration and unification of the Korean peninsula for the longer term. In fact, there are three major rationales for inter-Korean economic cooperation, each of which is important for unification.

First, inter-Korean economic cooperation would help North Korea to see a way out of its current predicament as “a rogue state” or “a criminal regime.”⁷ Through economic exchanges, North Korea would be able to earn money the old-fashioned way rather than through questionable transactions involving counterfeiting, narcotics, or weapons.⁸ Also, by helping North Korea to get accustomed to market principles, inter-Korean economic cooperation would have the effect of facilitating and consolidating North Korea's economic reform. It is a critical component of South Korea's engagement policy, which is based on the principle of “change through rapprochement.”⁹

In this regard, the current U.S. policy toward North Korea's illicit activities puts South Korea in an interesting position.¹⁰ While the South Korean government would be willing to join

⁷ It would be one thing to state that Pyongyang has engaged in some illicit activities, but it would be quite another to imply that the North Korean regime is criminal by nature—and beyond redemption. For “the criminal state” view, see David L. Asher, “The North Korean Criminal State, its Ties to Organized Crime, and the Possibility of WMD Proliferation,” *Nautilus Policy Forum Online* 05-92A, November 15, 2005, accessible at: <http://www.nautilus.org/fora/security/0592Asher.html>. If this view represents the Bush administration's position on North Korea, there really is little point in going ahead with the six-party talks.

⁸ The North Korean regime has quite a few skeletons in the closet. At the North Korea-Japan summit in September 2002, Kim Jong Il tried “confessional diplomacy” with abductions (issuing a formal apology as North Korea's leader but taking no direct responsibility), but it did not quite work the way he had hoped. Although Junichiro Koizumi was serious about normalizing relations between Japan and North Korea and he did get Kim's apology in exchange for his expression of regret regarding Japan's brutal colonial rule, he could not do anything about Japanese politicians, NGOs, and media expressing their outrage and raising further questions about other missing Japanese nationals and their possible link to North Korean abductions. Pyongyang now has to deal with counterfeiting. So far, North Korea has officially denied any involvement in counterfeiting but reaffirmed its commitment to international norms on counterfeiting, adding that it understands U.S. concerns about the soundness of its currency.

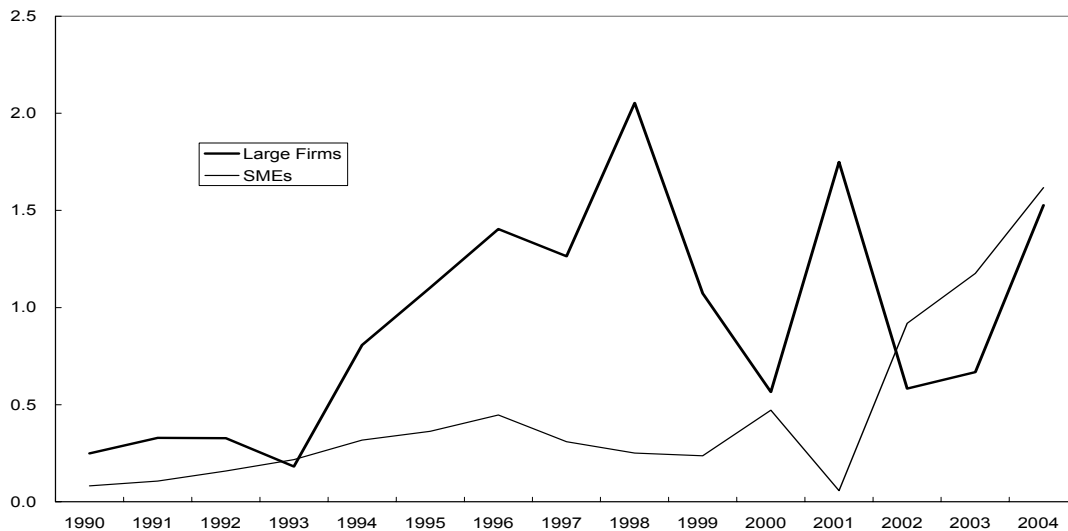
⁹ On the basic premise of engagement policy, see Wonhyuk Lim, “When in Doubt, Blame South Korea: The Politics of Food Aid to North Korea,” *Nautilus Policy Forum Online* 06-13A: February 16, 2006, accessible at: <http://www.nautilus.org/fora/security/0613Lim.html>.

¹⁰ Although some analysts estimate that North Korea annually derives as much as \$500 million from its illicit activities to finance its current account deficit, the very idea of focusing on the current account without taking a serious look at the capital account is fundamentally flawed. Congressional testimony by responsible U.S. government officials also suggests that these estimates may be greatly inflated. For instance, at a Senate hearing on North Korea's illicit activities on April 25, 2006, a Secret Service official noted that the total amount of high-quality counterfeit bills (known as “the Supernote”) seized since 1989 was \$50.0 million, or approximately \$2.8 million per year. In comparison, lower-quality counterfeit notes seized in Colombia since 1989 amounted to \$380.0 million, and U.S. currency in circulation worldwide is \$750 billion (see <http://hsgac.senate.gov/files/042506Merritt.pdf>). At the same hearing, another official from the Bureau of Narcotics and Law Enforcement Affairs in the State Department indicated that the extent of

international efforts to block North Korea’s illicit activities, it would be reluctant to impose blanket sanctions on North Korea that would choke off legitimate economic transactions as well.¹¹ Seoul’s position is that a policy of positive reinforcement rather than sweeping sanctions would be more effective in changing Pyongyang’s behavior. In fact, blocking legitimate economic transactions runs the risk of making Pyongyang *more* dependent on illicit activities and arms sales, with negative implications for regional and global security.

<Figure 2> Outward FDI by South Korea’s Large Firms and SMEs, 1990-2004

(unit: trillion won)



Source: Export-Import Bank of Korea

Second, inter-Korean trade would help South Korea to undertake industrial restructuring in a less painful manner. South Korean firms in the labor-intensive manufacturing sector face increasing competition from China and other late-developing countries, and the “hollowing out” of the economy caused by outward foreign direct investment (FDI) is increasingly becoming a concern. In particular, as <Figure 2> shows, a rapid increase in outward FDI by small and medium-size enterprises (SMEs) since 2001 is unmistakable, with negative consequences for facility investment and employment in South Korea. Given North Korea’s willingness to

opium production and North Korea’s direct involvement in cigarette counterfeiting might be quite limited (see <http://hsgac.senate.gov/files/042506Prahar.pdf>).

¹¹ Interestingly, the U.S. Treasury statement on September 15, 2005, clearly states that the Banco Delta Asia, “a willing pawn for the North Korean government to engage in corrupt financial activities through Macau,” also handled “the bulk of the DPRK’s precious metal sales”—presumably legitimate economic transactions.

experiment with special economic zones, these companies may find investment in North Korea a viable alternative, with positive linkage effects in South Korea.

Third, inter-Korean economic cooperation would have the geopolitical significance of counterbalancing China's increasing influence in North Korea. Clearly, to benefit from China's spectacular economic growth and to create a geopolitical environment conducive to peace and security in Northeast Asia, South Korea would like to maintain a close relationship with China. At the same time, however, South Korea has a strong incentive to hedge against China's "non-peaceful rise" and harbors strategic anxiety regarding China's increasing influence on North Korea.¹² According to Chinese statistics, in 2004, China's non-financial foreign direct investment flow into North Korea was \$14.1 million, more than a ten-fold increase from \$1.1 million in 2003. In March 2005, China and North Korea signed an investment promotion and protection accord. In December 2005, the two governments reached an agreement on joint exploration of seabed oil in the Yellow Sea.¹³ In fact, in South Korea, there is a growing concern that North Korea might become "China's fourth Northeastern province" if China's economic and geopolitical influence on North Korea continues to rise. As a result, inter-Korean trade is increasingly regarded as a means of preventing North Korea from becoming a Chinese satellite. This rationale for inter-Korean trade is somewhat reminiscent of West Germany's effort to keep East Germany from slipping further into the arms of the Soviet Union.

(2) North Korea's Perspective

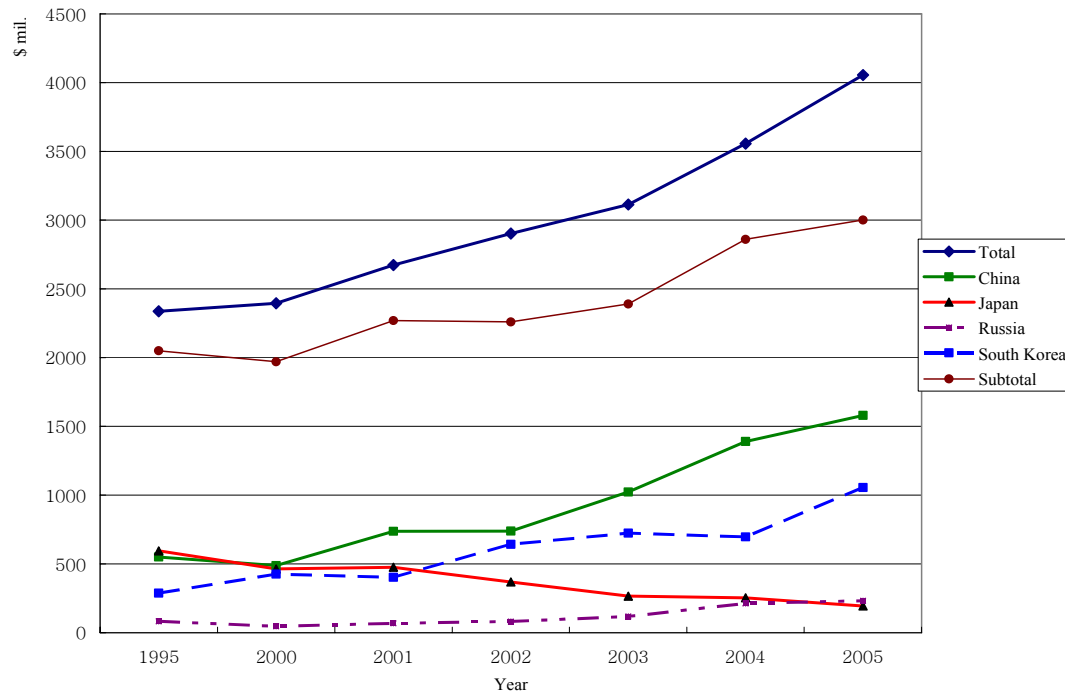
For North Korea, inter-Korean trade represents a significant part of its overall trade with the outside world. The prominence of inter-Korean trade is all the more noteworthy given that North Korea's total trade has been rising sharply since 2000, when North Korea improved bilateral relations with China, South Korea, and Russia by holding summits with those countries in May, June, and July of that year. Between 2000 and 2005, South Korea's share in North Korea's total trade increased from approximately 18 percent to 26 percent. By comparison, China's share in North Korea's total trade increased from 20 percent to 39 percent while Japan's share plummeted from 19 percent to 5 percent during the same period. In fact, in 2005, for the first time since the early 1990s, Russia, at 6 percent, had a larger share of North Korea's total

¹² See, for instance, Myung-Chul Cho and Moon-Soo Yang, *The Increase of North Korea's Economic Dependence on China and Its Implications for South Korea* (Seoul: KIEP, 2005) [in Korean].

¹³ See Wonhyuk Lim, "Kim Jong Il's Southern Tour: Beijing Consensus with a North Korean Twist?" Nautilus Policy Forum Online 06-16A, February 25, 2006, at <http://nautilus.org/fora/security/616Lim.pdf>.

trade than Japan. <Figure 3> shows the relative importance of inter-Korean trade in North Korea's total trade, and <Table 6> provides more detail on North Korea's exports and imports.

<Figure 3> Composition of North Korea's Trade



Note: "Subtotal" sums up all North Korea's external trade except its trade with South Korea.

<Table 6> North Korea's Exports and Imports, 2001-2005

(unit: million dollars)

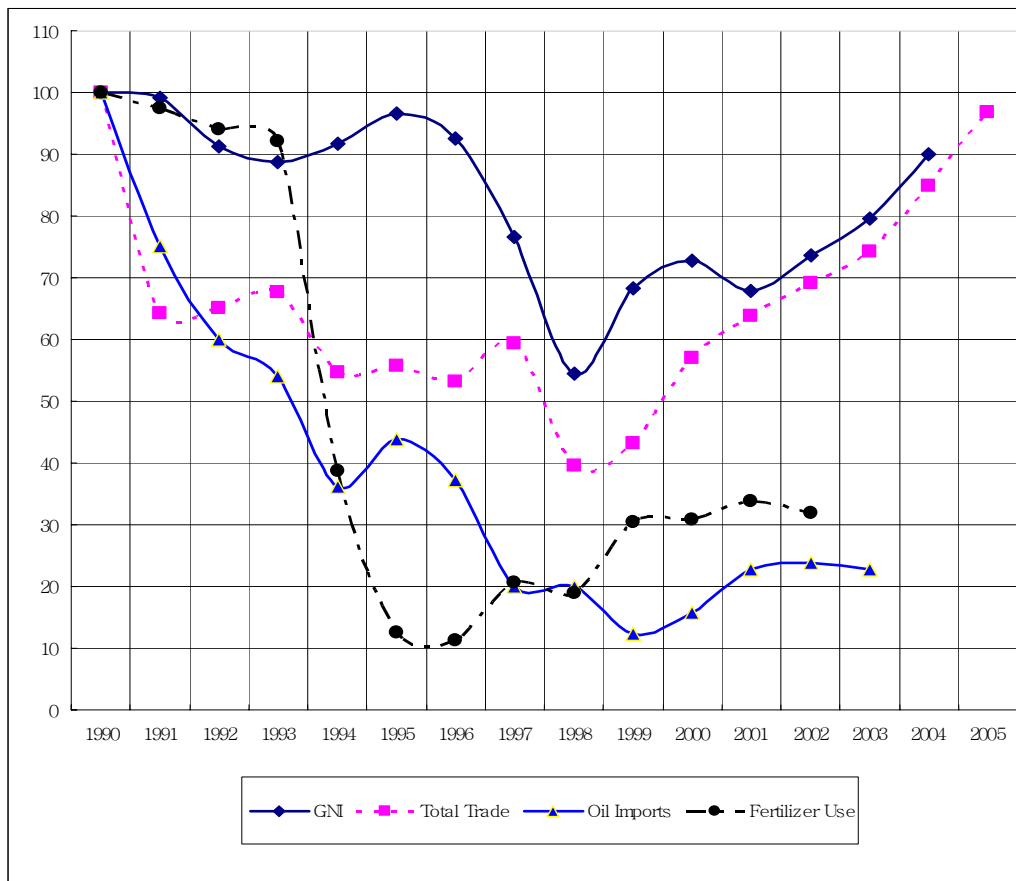
| North Korea's Exports to: | 2001 | 2002 | 2003 | 2004 | 2005 |
|---------------------------|------|------|------|------|------|
| China | 167 | 271 | 395 | 586 | 499 |
| Japan | 226 | 234 | 174 | 163 | 131 |
| Russia | 5 | 4 | 3 | 7 | 8 |
| South Korea | 176 | 272 | 289 | 258 | 340 |
| Total | 826 | 1007 | 1066 | 1278 | 1338 |

| North Korea's Imports from: | 2001 | 2002 | 2003 | 2004 | 2005 |
|-----------------------------|------|------|------|------|------|
| China | 570 | 467 | 628 | 800 | 1081 |
| Japan | 249 | 135 | 92 | 89 | 63 |
| Russia | 64 | 77 | 116 | 206 | 224 |
| South Korea | 227 | 370 | 435 | 439 | 715 |
| Total | 1847 | 1895 | 2049 | 2276 | 2718 |

Source: Kotra

The expansion of North Korea's trade with South Korea and China (and to a lesser extent with Russia) had a very positive effect on the North Korean economy. <Figure 4> shows how the North Korean economy has recovered since around 1999 after a sharp contraction during the "arduous march" period. A growth decomposition analysis shows that between 1999 and 2003, North Korea's growth owing to its expanding commercial and non-commercial transactions with South Korea amounted to 2.3 percent per year. North Korea's economic growth stemming from its rising trade with the rest of the world was 2.4 percent per year. Had its external trade remained stagnant, its national income would have declined by 1.9 percent per year.¹⁴

<Figure 4> Economic Trends in North Korea, 1990-2005



Source: North Korea's GNI, trade volume, crude oil imports, and fertilizer use estimates are provided by the Bank of Korea, Kotra and the Ministry of Unification, Korea Energy Economics Institute, and FAO, respectively.

Note: Level values are converted to index numbers and normalized at 100 in base year 1990. Base-year values are as follows: GNI, \$23.1 billion; trade volume, \$4.2 billion; oil imports, 18.5 million barrels; and fertilizer use, 832,000 tons.

¹⁴ See Young-Hoon Lee, "An Analysis of the Impact of North Korea's External Trade and Inter-Korean Trade on North Korea's Economic Growth" (Seoul: Bank of Korea, 2004) (in Korean).

Inter-Korean trade also helps to alleviate the balance-of-payments problem for North Korea. Although a casual glance at inter-Korean trade statistics may suggest that the North is running a deficit in its trade with the South, it is important to remember that these statistics essentially record flows of goods rather than payments. In fact, if non-commercial transactions (mostly humanitarian aid) and the flows of goods associated with economic cooperation projects (mostly equipment and construction materials to be used by South Korean companies in North Korea) are excluded, North Korea is actually running a surplus in its trade with South Korea.¹⁵ In 2005, the North recorded a surplus of \$221 million in its general and POC trade with the South.¹⁶ The corresponding figures for 2003 and 2004 were \$169 million and \$168 million, respectively.

<Table 7> North Korea's Hard Currency Earnings from Business Contracts and Services

| Items | Amount (\$ million) | Notes |
|--|---------------------|---|
| Hyundai's Seven Long-Term Development Projects | 500.00 | Industrial Complexes (Kaesong, Shinuiju, and Tongchon); Railway and Road Construction; Electricity and Energy; Communications; Tongchon Airport; Imjin River Dam; Tourism |
| Mt. Kungang Tour | 456.92 | largely lump-sum payment from Nov. 1998 to 2002 for a subtotal of \$ 400.7 million; thereafter, park entrance fees from tourists averaging \$ 14 million per year |
| Others | 4.01 | Pyongyang and Kaesong tour, etc. |
| Total | 960.93 | As of end-August 2006 |

Source: Ministry of Unification, "A Briefing on the Amount of Aid to North Korea," October 18, 2006 (in Korean).

Note: Wages for North Korean workers (\$ 8.89 million) and the 50-year land lease fee for the Kaesong Industrial Complex (\$12 million) are excluded, because they would be reflected in the value of goods transported back from the North to the South and hence captured in inter-Korean trade statistics.

¹⁵ More generally, equating the flows of goods with hard currency payments in North Korea's trade may lead to serious errors in estimating the magnitude of North Korea's balance-of-payments problem and presumed need to finance this deficit through illicit activities or arms sales. For instance, although North Korea appears to have run a deficit of \$582 million in its trade with China in 2005, the figure shrinks to \$346 million if China's crude oil exports, provided on a loan basis, and aid to North Korea are excluded. In addition to these adjustments, remittances from North Korean workers and business people in foreign countries would have to be included to estimate the magnitude of North Korea's balance-of-payments problem.

¹⁶ Strictly speaking, this figure represents the differences between the values of goods transported to and from South Korea, and as such, overstates North Korea's surplus from its general and POC trade with South Korea. The reason is that South Korean companies typically transport goods between the North and the South and charge shipping and handling costs, which are reflected in the value of final goods.

In addition to this surplus from inter-Korean flows of goods, North Korea earns hard currency by providing services (e.g., tourism) and granting exclusive rights to development projects in North Korea. The best known example for the latter may be Hyundai's seven development projects for which contracts were signed in May and August 2000, just before and after the historic inter-Korean summit. They included exclusive rights to develop industrial complexes in Kaesong, Shinuiju, and Tongchon (Hyundai's late chairman Chung Ju Young's hometown just north of the DMZ on the east coast); railway and road construction; and electricity and energy projects.¹⁷ <Table 7> summarizes North Korea's hard currency earnings from these services and business contracts. These items are not included in inter-Korean trade statistics, which focus on flows of goods.

In addition to playing a significant role in North Korea's economic growth and alleviating its balance-of-payments problem, inter-Korean trade is important for North Korea as a means of facilitating economic reform. Of course, the impact of inter-Korean trade on North Korea's economic reform is not without controversy. For example, there is a debate as to whether the Kaesong Industrial Complex should be regarded simply as a cash cow for North Korea; a Trojan horse dispatched by South Korea; or a goose that lays golden eggs for both sides. However, the evolution of North Korea's economic policy over the past two decades seems to indicate that Pyongyang has become more favorably disposed toward economic reform and opening, in large part as a result of the famine in the 1990s, and inter-Korean economic cooperation is likely to be an important element of its new policy package.¹⁸

Back in the first half of the 1990s, lengthy articles in North Korea's official propaganda channels argued that the reforms undertaken by former socialist countries led to their demise and that North Korea with its "unique characteristics" had no need for fundamental reform. Even when Pyongyang opted for some economic opening in this period, such as the establishment of the Rajin-Sonbong Free Economic and Trade Zone in 1991, the emphasis was on limiting the influx of foreign influence rather than ensuring commercial viability. Although Pyongyang talked about plans to set up several special economic zones, the only place where it made substantive progress was Rajin-Sonbong in the remote northeastern corner of North Korea, far removed from Pyongyang and unattractive to investors.

Since the food crisis in the second half of the 1990s exposed serious problems in the

¹⁷ For details, see Eul Chul Lim (2005), pp.3-15.

¹⁸ For a detailed discussion, see Wonhyuk Lim, "North Korea's Economic Futures: Internal and External Dimensions," in *Korea: The East Asian Pivot*, ed. by Jonathan D. Pollack (Newport, RI: Naval War College Press, 2004), pp.171-195, also at http://www.brookings.edu/fp/cnaps/events/lim_20051102.htm.

North Korean economy, however, this policy approach has become untenable. After a decade of economic crisis in North Korea, Pyongyang realized that only the infusion of external capital would put economic growth on a more stable trajectory. Even the July 2002 reform had failed to generate a sufficient supply response primarily due to limited domestic resources. As a result, Pyongyang has made decisive moves to ensure commercial viability, acknowledging that there are few venues in North Korea that are both commercially attractive and politically safe.

Although skeptics might argue that the Kaesong Industrial Complex is “a limited export enclave” just like Rajin-Sonbong, an hour drive from Seoul to Kaesong would show that this assessment is off the mark. Rajin-Sonbong was *not* an export enclave, not even a limited one, because few investors wanted to set up production facilities and manufacture exports there in the first place. By contrast, while Pyongyang is still concerned about regime stability, it has made serious efforts to ensure commercial viability for companies in Kaesong. As <Table 8> shows, wage, tax, and land lease rates at Kaesong were set at levels competitive with China’s rates.

<Table 8> Comparative Factor Prices in Kaesong, China, and South Korea

| | Unit | Kaesong (A) | China (B) | South Korea (C) | A/B | A/C |
|--|---------|-------------|-----------|-----------------|-----------|------|
| (Minimum) Monthly Wage | dollars | 57.5 | 100-200 | 423 | 0.29-0.58 | 0.12 |
| Working Hours Per Week | hrs. | 48 | 44 | 44 | 1.1 | 1.1 |
| Corporate Income Tax Rate | percent | 10-14 | 15 | 23-28 | - | - |
| Land Lease Rate Per Pyong (36 Sq. Ft.) | won | 150,000 | 50,000 | 407,550 | 3 | 0.37 |

Source: Seok-sam Park, “An Analysis of the Economic Impact of the Kaesong Industrial Complex” (in Korean) (Seoul: Bank of Korea, 2004).

The first 15 South Korean companies operating at Kaesong are cautiously optimistic about their business. Shinwon, a well-established apparel maker, has exceeded the break-even point already. Samduk, the maker of Stafild shoes, is expanding its operations at Kaesong. The amount of planned investment for the South Korean companies at the Kaesong Industrial Complex ranges from 3 billion to 17 billion won, with the median at 4 billion won. South Korean companies at Kaesong are already employing more than 10,000 North Korean workers. When the Kaesong Industrial Complex is completed in 2012, it is projected that some two thousand

factories will hire a total of 350,000 workers. In sum, although Kaesong, as it currently stands, is an export enclave, Kaesong is likely to have spillover effects over time on the rest of North Korea as in the case of special economic zones in China.¹⁹

3. Policy Dilemmas

(1) Big Bang vs. Gradualism

In pursuing engagement policy, one of the earliest policy questions South Korea faced was how best to promote inter-Korean economic cooperation. There were basically two schools of thought on this issue. One school urged gradualism. People advocating gradualism feared that inter-Korean economic cooperation ran the risk of substituting nationalist sentiment and political ambition for commercial logic. They believed that pursuing a series of economically sound projects in labor-intensive sectors, undertaken primarily by small and medium-sized enterprises, would educate North Korea about market principles and ensure the long-term sustainability of inter-Korean economic cooperation. The other school called for a big bang approach. Members of this school of thought believed that inter-Korean economic cooperation would go nowhere unless it received a clear endorsement from North Korea's top leadership. After all, Kim Jong Il is "the decider" in North Korea, and technocrats are fearful of being purged for threatening the stability of the regime. This school argued that it was critical to kick-start inter-Korean economic cooperation on a scale grand enough to draw Kim Jong Il's attention. They also noted that, because of the poor physical infrastructure in North Korea, SMEs would have a limited success, unless the South Korean government or large companies led the way by providing electricity, water, communication links, and other essential business supports.

Both approaches proved wanting in practice. SMEs that ventured into North Korea on their own were exposed to a great deal of idiosyncratic risks, and most failed to undertake any significant and viable investment projects in North Korea. Large companies that paid inadequate attention to the commercial side of business also fared poorly. Hyundai may be the most notorious example in this regard. In 1998, the company secured Kim Jong Il's endorsement for inter-Korean economic cooperation by launching its ambitious Mt. Kumgang tourism project, promising to pay out \$942 million over 75 months (\$25 million each for the first 6 months, \$8 million each for the next 9 months, and \$12 million each for the remaining 60 months, from

¹⁹ See Ministry of Unification, "Answers to Frequently Asked Questions about the Gaeseong (Kaesong) Industrial Complex," May 21, 2006.

November 1998 to January 2005). Hyundai also secured exclusive long-term rights for seven major projects by providing \$500 million to Pyongyang at the time of the inter-Korean summit in June 2000. However, Hyundai's big bang approach could not be sustained when the cash flow from its projects in North Korea failed to meet its expectations.²⁰

Subsequently, it became clear that successful inter-Korean economic cooperation would have to combine the desirable features of the gradual and big bang approaches. While securing the endorsement of North Korea's top leadership and providing for necessary infrastructure, business projects also had to have commercial viability.

The evolution of the Mt. Kumgang tour shows how this new principle was applied in practice. When Hyundai could not meet the payment schedule for \$942 million, Pyongyang initially balked at renegotiating the terms of the contract. As a result, tourist services were interrupted at times. However, Pyongyang came to realize that playing brinkmanship with a company on the verge of bankruptcy would not work and subsequently agreed to make the tourism project more viable.

<Table 9> North Korea's Revenue from the Mt. Kumgang Tourism Project

(unit: million dollars, persons)

| | Nov. 1998- Dec. 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|-----------------------|-------------------------|---------|--------|--------|--------|---------|---------|
| Revenue | 206.0 | 136.0 | 37.2 | 21.5 | 13.1 | 15.3 | 13.5 |
| Number of Tourists | 158,628 | 213,009 | 57,879 | 84,727 | 74,334 | 268,420 | 298,247 |

Source: Ministry of Unification

In place of the fixed monthly payment schedule, the two sides agreed on a flexible scheme by which North Korea would charge a park entrance fee per tourist starting in September 2001. A tourist staying for one, two, or three days would pay \$15, \$35, or \$70, respectively.²¹ North Korea would now have an incentive to improve tourist services as its revenue from the project is directly linked to the number of tourists coming to Mt. Kumgang. Also, to make the tourism project commercially profitable, North Korea agreed to open a ground route to Mt. Kumgang. Hyundai no longer needed to lease expensive cruise ships and could offer relatively

²⁰ For a critical yet sympathetic look at the development of Hyundai's projects in North Korea, from its late chairman Chung Ju Young's life-long aspirations to Hyundai's subsequent business and political troubles, see Jay Solomon and Hae Won Choi, "Southern Exposure: At Huge Korean Conglomerate, Bridge to North Takes Its Toll," *The Wall Street Journal*, March 4, 2003.

²¹ These entrance fees have been raised to \$30, \$48, and \$80, respectively, in 2006.

inexpensive tour packages since October 2003. As a result of these changes, the number of tourists visiting Mt. Kumgang increased from 57,879 in 2001 to 298,247 in 2005. The Mt. Kumgang tourism project turned in an operating profit of 5 billion won in 2005. <Table 9> shows trends in North Korea's revenue from the Mt. Kumgang tourism project.

In short, as demonstrated by the examples of the Mt. Kumgang project and Kaesong Industrial Complex, inter-Korean economic cooperation has become much more systematic and market-oriented. Drawing lessons from the failure of exclusively gradual or big bang approaches, North and South Korea are seeking to make inter-Korean economic cooperation more commercially viable and sustainable.

(2) Economic-Security Linkage

Whether to link inter-Korean economic cooperation to security issues is a question that has haunted South Korean policymakers since the nuclear crisis of 1993-4. Many argued that continuing to engage in inter-Korean economic cooperation in the face of North Korea's provocative behavior would send a wrong signal: North Korea would think it could get away with such behavior, and the U.S. and other countries would conclude that South Korea does not take North Korea's threat seriously. Others had different ideas. They argued that while economic cooperation could not be completely de-linked from political and security issues, a tight linkage strategy would shut down important channels of communication with North Korea and run the risk of making South Korea a helpless by-stander. They added that cutting off inter-Korean exchanges would adversely affect the lives of ordinary people in North Korea and make Pyongyang more dependent on China and Russia.

The first nuclear crisis of 1993-4 showed that these concerns were not unfounded. The Kim Young Sam government tightly linked inter-Korean economic cooperation to the resolution of the nuclear crisis. The government banned South Korean entrepreneurs' visits to North Korea and postponed economic cooperation projects. Kim Young Sam made it clear that there would be no inter-Korean summit before the resolution of the nuclear crisis. He apparently did not think that an inter-Korean summit could help to create conditions conducive to progress in nuclear negotiations. As a result, South Korea was reduced to being a by-stander, and when North Korea and the U.S. signed the Agreed Framework, South Korea had little to do but agree to provide 70 percent of the construction cost for the light-water reactors. Even after the signing of the Agreed Framework, the Kim Young Sam government tended to link political and economic issues,

making improvement in inter-Korean economic relations contingent on progress in contentious political and security areas.

The Kim Dae Jung government took a different approach to linkage and adopted the principle of “separating politics from commerce.” This new approach was essentially eclectic, combining realist and liberal ideas: It tried to contain North Korea’s threat through deterrence and arms control under the principle of mutual threat reduction; and also promote internal changes in North Korea through broad economic engagement. Although the idea that economic exchanges can contribute to peace has been around for a long time, there is a limit to how much economic exchanges—or, banning of economic exchanges, for that matter—can resolve security issues when vital interests are at stake.²² When two sides can realize gains by trading with each other, they are likely to try to work out contentious issues between them and develop this mutually beneficial relationship further, but as long as security risks are perceived to exist, economic interaction alone will not lead to peace. In particular, it would be unrealistic to expect one side to disarm unilaterally just because it receives external economic assistance, as long as it continues to believe it is faced with a security threat. At the same time, however, it would be counterproductive to do away with economic engagement altogether, for that would tend to reduce the chance of internal change. A parallel-track strategy of concurrently pursuing political reconciliation and economic engagement would be more effective than using economic levers to force unilateral disarmament or broadening economic engagement regardless of its security implications.

Following this line of thought, the Kim Dae Jung government pushed for within-issue linkage rather than cross-issue linkage. In other words, it linked humanitarian with humanitarian issues, economic with economic issues, and security with security issues, but not economic issues with security issues.²³ This new approach proved quite successful. Although there was little

²² See Edward Hallett Carr, *The Twenty Years’ Crisis, 1919-1939* (New York: St. Martin’s Press, 1939), where the author criticizes the liberal claim that economic interdependence enhances the prospects for peace.

²³ Even this pragmatic policy on linkage and reciprocity initially ran into trouble in practice. When the South Korean delegation demanded that South Korea’s fertilizer aid be linked to the reunion of separated families at the first inter-Korean meeting held under the new government in early 1998, the North Korean delegation argued that humanitarian assistance should be provided without any strings attached. Although the South saw the reunion of separated families as a humanitarian issue that could be linked to humanitarian aid, the North apparently regarded it as a deeply political issue with a potential to destabilize their regime. The talks broke down, and there was no official dialogue for more than a year. North Korea’s food crisis worsened, and separated families could not meet for yet another year. When the North and the South met again for fertilizer talks in subsequent years, both sides took lessons from this experience and made adjustments in their positions. The North agreed to the reunion of separating families, starting with those citizens in whose loyalty Pyongyang had confidence. Also, instead of pressing the North in a “do-

progress in official inter-Korean dialogue for the first two years of the Kim Dae Jung government, companies like Hyundai and various nongovernmental organizations (NGOs) were able to make much headway in economic cooperation and humanitarian assistance. Inter-Korean confidence-building through such people-to-people interaction helped to create an environment conducive to political reconciliation at the governmental level. Hyundai, in particular, came to believe it was in the long-term interest of the company as well as the Korean nation as a whole to have an inter-Korean summit. The company thought it could benefit by securing support from the leaders of both sides for its development projects in North Korea, and made every effort to facilitate such a historic meeting in 2000. Under the parallel-track strategy, inter-Korean economic cooperation had outpaced political reconciliation, giving economic actors an incentive to serve as political mediators. The summit, in turn, helped to usher in a new era in inter-Korean economic cooperation.

The parallel-track strategy was effective as long as the U.S. was willing to engage in serious negotiations with North Korea regarding its nuclear and missile programs. The nature of North Korea's weapons programs, with significant implications for regional and global security, made it impractical for South Korea to play little more than a facilitating role in these negotiations. It would have been rather unwise for South Korea to link inter-Korean economic cooperation to progress in these negotiations, over which South Korea had little control. At the same time, South Korea would have found economic engagement a difficult position to defend if the U.S. had refused to negotiate with North Korea on security matters and North Korea had responded by escalating tension.

Under the Agreed Framework of 1994, North Korea agreed to the phased dismantlement of its nuclear program in exchange for multilateral energy assistance and a U.S. promise to move toward normalization. When the North Koreans failed to secure the kind of political relationship they had expected from the U.S., they complained bitterly even as they maintained the freeze on their plutonium program. In 1998, however, North Korea launched a long-range test missile and also procured from Pakistan some equipment that could be used for enriching uranium.²⁴ Although the Clinton administration did obtain bits of intelligence information on this transaction between North Korea and Pakistan, it decided against scrapping the Agreed Framework in response to this remote threat and instead opted for a “more-for-more” approach. Through the

this-or-else” manner, the South implicitly—and successfully—linked food and fertilizer aid to the reunion of separated families.

²⁴ See Christopher O. Clary, “The A. Q. Khan Network: Causes and Implications,” Master’s thesis (Monterey, California: Naval Postgraduate School, December 2005), Chapter IV.

Perry process in 1998-9, the U.S. worked together with South Korea and Japan to develop a coherent policy toward North Korea. In particular, the U.S. and South Korea essentially agreed on a division of labor by which the U.S. would address security issues through direct negotiations with North Korea and South Korea would promote internal changes in North Korea through economic engagement. Recognizing the danger of letting the Agreed Framework unravel, the U.S. made a more decisive move toward normalization with North Korea in exchange for more comprehensive restrictions on North Korea's missile and nuclear programs. As encapsulated in the October 2000 joint communiqué, the U.S. reached an understanding with North Korea to secure better access in North Korea as bilateral relations improved. Through this more-for-more approach, the U.S. sought to resolve suspicions about North Korea's "hole in the ground" at Kumchangri and its incipient uranium enrichment program.²⁵

At the end of 2000, the U.S. and North Korea appeared very close to concluding a missile deal and moving toward full normalization,²⁶ but the Bush administration adopted a completely different approach in March 2001—more than a year before the emergence of conclusive evidence on North Korea's attempt to construct a uranium enrichment program. In October 2002, the Bush administration used this evidence to press North Korea to come clean and subsequently stopped heavy fuel oil deliveries, essentially scrapping the Agreed Framework. Predictably, North Korea responded by restarting its plutonium program.

As the Bush administration put more emphasis on regime change than arms control as the central objective of its North Korea policy, the division of labor between the U.S. and South Korea began to break down. When the second nuclear crisis erupted in October 2002, South Korea made serious efforts to contribute to the resolution of the crisis instead of severely reducing economic exchanges with North Korea. Unlike in 1993-4, Seoul sent special envoys to Pyongyang to persuade North Korea to come to the negotiating table and secure Kim Jong Il's commitment to denuclearization in exchange for North Korea's improved relations with the outside world. In fact, a visit by South Korea's special envoy to Pyongyang in June 2005 helped to lay the groundwork for the September 19 joint statement of principles. However, with the six-party talks in a holding pattern and tension on the Korean peninsula on the rise since September 2005, South Korea's parallel-track strategy has been increasingly coming under attack.

²⁵ On this point, see Robert Carlin, "Wabbit in Free Fall," *Nautilus Policy Forum Online* 06-78A, September 21, 2006, accessible at: <http://www.nautilus.org/fora/security/0678carlin.html>.

²⁶ See Michael R. Gordon, "How Politics Sank Accord on Missiles with North Korea," *The New York Times*, March 6, 2001. See also Wendy R. Sherman, "Talking to the North Koreans," *The New York Times*, March 7, 2001.

(3) Economic Engagement and Human Rights

The connection between economic engagement and human rights is an old issue. Perhaps the best known example is the debate in the 1980s on whether to divest from South Africa for its racist practices known as apartheid. The Sullivan principles, a set of ethical principles guiding business practices in South Africa, may be regarded as an attempt to address this dilemma regarding economic engagement and human rights.

In the Korean case, this issue has received increasing attention in recent years in part because the South Korean government mishandled the North Korean human rights issue by giving the impression that it was putting “peace” before human rights. It is almost the same as someone like Henry Kissinger saying he does not care about human rights in Maoist China because confronting Beijing about its human rights practices would jeopardize the possibility of using “the China card” against the Soviet Union. However, one could have defended the U.S. engagement with Maoist China as a policy designed to promote both human rights *and* peace, as it indeed turned out to be. The South Korean government can make a similar case. In fact, South Korea should make clear that it is resorting to the policy combination of “peaceful coexistence” and “change through rapprochement” because that is likely to promote human rights *and* peace, much more so than the policy of “naming and shaming.” Economic engagement is an important component of this strategy. In the human rights debate, the emphasis should be placed on which policy would be more effective in improving human rights in North Korea.

4. Conclusion

Inter-Korean economic relations have come a long way since South Korea’s unilateral declaration to promote economic engagement with North Korea on July 7, 1988. Inter-Korean trade volume exceeded \$1 billion for the first time in 2005, and major cooperation projects such as the Mt. Kumgang tour and the Kaesong Industrial Complex are now more commercially viable than ever before. Economic cooperation would not only facilitate North Korea’s market-oriented reform and South Korea’s industrial restructuring, but also promote Korean reunification.

Despite these positive developments in recent years, the political foundation of inter-Korean economic relations has considerably weakened since September 2005. In particular, North Korea’s missile launch and nuclear test has prompted serious questions about the possible

transfer of proceeds from cooperation projects to North Korea's weapons programs.²⁷ Although a parallel-track strategy, separating politics from commerce, has been an essential component of South Korea's engagement policy, it is increasingly coming under attack.

For a parallel-track strategy to be successful, it is imperative that comparable progress be made on parallel tracks. In 1998-2000, South Korea was able to make a great deal of progress in inter-Korean relations by taking advantage of the synergy between economic cooperation and political reconciliation. During the same period, the U.S. and South Korea also developed an effective division of labor in dealing with North Korea, by which the U.S. would contain North Korea's nuclear and missile programs through arms control negotiations and South Korea would promote internal changes in North Korea through economic engagement. This division of labor broke down when the Bush administration dropped arms control negotiations with North Korea. With the U.S. and North Korea making little progress in security areas, it has become increasingly difficult to defend inter-Korean economic cooperation. Yet, anyone who has followed North Korea's nuclear crisis closely would know better than blame South Korea's parallel-track strategy or engagement policy for North Korea's nuclear breakout.²⁸

This was evident in South Korean opinion polls after North Korea's nuclear test on October 9, 2006. South Koreans initially expressed anger at the Kim Jong Il regime for escalating tension, but after having a few days to think about the crisis, many showed frustration with the Bush administration for refusing to engage in serious negotiations. South Koreans harbor deep resentment at being caught right in the middle of the game of chicken that North Korea and the United States are playing. In fact, when asked about who bears the greatest responsibility for the current crisis, South Koreans blamed the U.S. as much as North Korea. Moreover, only a small minority wanted to scrap engagement policy. According to a poll conducted on Oct. 14 and 15, only 15.2 percent of the respondents were in favor of discontinuing engagement policy. 73.0 percent wanted to maintain the overall direction of engagement policy with some modification, and 9.9 percent gave unconditional support to engagement policy. More than three-fifths of South Koreans—61.8 percent—were in favor of continuing inter-Korean economic cooperation projects.²⁹

²⁷ Of course, because money is fungible, there is no way to address this "diversion" problem in a satisfactory manner unless North Korea's external trade is reduced to zero. Even if proceeds from cooperation projects are made to go to non-weapons programs, the very infusion of these payments would free up North Korea's resources for weapons programs.

²⁸ See, for instance, Nicholas D. Kristof, "Send in the Fat Guys," *The New York Times*, October 22, 2006.

²⁹ See "'Continue Kaesong Industrial Complex and Mt. Kumgang Tour'—62 Percent," *Naeil Sinmun*, October 17, 2006, based on an opinion poll of 800 adults, conducted by Han Gil Research (HGR). This

Just as it is not appeasement to talk to North Korea or any other potential adversary, it is not appeasement to hire North Korean workers and pay their wages. Instead of blaming economic engagement that promotes internal changes in North Korea, it would be far better to contain and reduce potential military threats through arms control negotiations and re-establish the policy synergy the United States and South Korea enjoyed in dealing with North Korea.

was in contrast to the result of an earlier poll conducted by *Joong Ang Ilbo* the day after North Korea's nuclear test, although the different structure of the polling question makes direct comparison difficult. In that poll, 78 percent of the respondents said South Korea's policy toward North Korea should be changed. Only 17 percent supported continuing with engagement policy.