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Vital Venture

*Economic Engagement of North Korea
and the Kaesong Industrial Complex*

By Patrick M. Cronin



Center for a
New American
Security

Fifth Anniversary

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Cover Image

Orange-colored South Korean trucks carrying rice drive into the North via the road passing through the border town of Kaesong near the inter-Korean border in Paju, north of Seoul, July 20, 2007.

(KIM JAE-HWAN/AFP/Getty Images)

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VITAL VENTURE: ECONOMIC ENGAGEMENT OF NORTH KOREA AND THE KAESONG INDUSTRIAL COMPLEX

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I. INTRODUCTION

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South Korea – and, by extension, the United States – is losing what limited economic leverage it has over North Korea.¹ The tenuous North Korean regime is drifting further away from South Korea and increasingly depends on China for its economic sustainment. Indeed, only one avenue of economic cooperation between the two Koreas remains: a 1.25-square-mile industrial park, managed by South Korean businessmen, near the border city of Kaesong that employs 50,000 North Korean workers.

As envisioned in the late 1990s, the Kaesong Industrial Complex was part of a master plan to raise the North's standard of living and eventually pave the way to Korean unification. However, the partially built complex and sole remnant of inter-Korean commerce now symbolizes the fragile state of relations with the North.

While South Korean and U.S. leaders have focused on the vital, yet narrow, goal of eliminating the North's nuclear program, they have gradually ceded influence to China. Not all investment translates into political sway, but China's increasingly dominant role as North Korea's economic provider accords it a special status in Pyongyang. China has gained access to a reclusive transitional regime without forcing North Korea to sacrifice its nuclear ambitions. In contrast, South Korea and the United States lack channels of communication for dealing with North Korea's next generation of leaders. China remains the only outside country "with eyes on the ground."²

As North-South relations continue to deteriorate, the Kaesong Industrial Complex is left as the only conduit of daily contact between the two Koreas. The joint venture remains protected by the North and South for both financial and security reasons. North Korea receives a steady stream of revenue and benefits from the complex's modern infrastructure; South Korean manufacturers receive an ample supply of cheap labor. The industrial park also provides a safe haven for quiet North-South

dialogue and a symbol of the benefits of peace. In light of a shifting environment on and around the peninsula, the Kaesong Industrial Complex illuminates how economic engagement³ and competition may determine the future of South Korean and U.S. relations with North Korea. Some may reject the significance of a limited joint partnership driven more by politics than by market forces, but the complex is currently the only South Korean alternative to Chinese investment and assistance to North Korea. South Korea's belated attempt to reinvigorate Kaesong in early 2012 suggests that South Korea understands the unique significance of the industrial zone.⁴

The strategic dimensions of Korean economic policies have received far less scrutiny than North Korea's nuclear posture.⁵ This report attempts to help fill this gap. It begins by discussing the origins of Kaesong as a logical outgrowth of Kim Dae-jung's Sunshine policy to promote the gradual economic integration of the peninsula. Next, the report examines the impact of South Korea's first post-Sunshine policy president, Lee Myung-bak. South Korea's conditional policies have been sharply rebuffed by North Korea since his election, leaving the Kaesong Industrial Complex a solitary relic of earlier collaboration. North Korea's economic-security predicament is then analyzed, particularly the maturing economic links between China and North Korea. Finally, the report calls for U.S. leaders to adopt a different approach to North Korea. Increased engagement to determine the new regime's intentions makes sense during North Korea's leadership transition, and the United States should anticipate the likelihood that South Korea will seek a new engagement policy toward North Korea. The United States should review its policy on North Korea, taking into account economic issues as well as nuclear policy, the planned return of wartime operational control to South Korea at the end of 2015 and the possibility of initiating military-to-military contact with North Korea.⁶

II. THE KAESONG INDUSTRIAL COMPLEX

The Kaesong Industrial Complex is an 800-acre site located six miles north of the demilitarized zone (DMZ) dividing the Korean peninsula and represents the unfinished first component of a three-phased joint venture to link the North and South Korean economies. Currently, 123 South Korean companies employ some 50,000 North Korean laborers who make everything from clothing and electronics to chemicals and metals.⁷ The vast majority of the money invested in the complex has supported South Korean construction of a railroad, roads, utilities, medical and emergency service facilities, and the factories themselves.

Spearheaded by one of South Korea's leading industrialists, the idea of a Kaesong-like special industrial zone was embraced in 1998 by South Korean President Kim Dae-jung. It was advanced two years later when President Kim met North Korean leader Kim Jong-il at the first North-South summit meeting. The original master plan negotiated by Hyundai Asan and the North Korean government included a 10-square-mile industrial park incorporating residential housing and all of the commercial enterprises typically found in a town. The first phase was planned to encompass more than 800 acres, house some 300 companies with 70,000 workers and be completed by 2007. Phase two would add another 1,225 acres, 700 companies and 130,000 employees and was set to be finished by 2009. The third phase would add nearly 3,000 more acres, 1,000 more companies and 150,000 more workers, and would be finished in 2012.⁸ Fully occupied, the complex would occupy over 5,000 acres, include 2,000 South Korean businesses, employ more than 350,000 North Koreans and produce \$20 billion in annual revenue.⁹

Furthermore, the Kaesong Industrial Complex was to be surrounded by a larger joint special economic

and tourism region, knotting together the economies of the two Koreas.¹⁰ Only a fraction of the first phase has been completed, as inter-Korean tensions have slowed major new investment since 2008.¹¹

The complex was constructed in the pursuit of economic and political gain. North Korea wanted South Korean capital and high technology to flow into the country without undermining the authoritarian regime in Pyongyang. Having lost its main economic patrons with the demise of the Cold War, North Korea looked to South Korea and the United States for its future economic development. South Korean business and political leaders saw both the short-term benefit of cheap North Korean labor and the long-term benefit of easing eventual unification by reducing the sharp income disparity between the two Koreas. Making North Koreans more prosperous over time, it was thought, would prevent a colossal tax burden like that imposed on West Germans after sudden unification with East Germany. After all, expert estimates of Korean unification costs vary from hundreds of billions of dollars to more than \$2 trillion.¹² The Kaesong complex also appeared to make both a “soft landing” and unification more likely in the long run. Although many businesses in the complex struggle to make a profit, they are buoyed by the prospect that their commitment will eventually unite the two countries.

However, unity is not in sight, and the Kaesong Industrial Complex has not lived up to its transformative promise. Nonetheless, as the nexus of North-South economic convergence, the complex raises important questions regarding North Korea’s future path. Is the complex a harbinger of future inter-Korean economic integration or a relic of a failed Sunshine policy? Will North Korean economic dependence on China deepen, will North-South economic engagement be renewed, or both? At the extremes, two scenarios are possible.

Despite its difficult history, the Kaesong Industrial Complex could still hold promise as a springboard

for the next stage of North-South relations. It is possible that by the end of this decade, the complex could become the lynchpin of a modernizing North Korea. It remains a vital strategic investment that could still provide a gateway toward greater prosperity for the North Korean people and perhaps the ultimate confederation, if not unification, of the two Korean states. If Kaesong can be expanded to something close to its original planned capacity – 7 to 10 times its present size – it may also be possible for South Korea to build a modern highway connecting Kaesong with Pyongyang. Given the current road and railway connections between Seoul and Kaesong, such an artery could become the main transportation link between North Korea and South Korea.

Alternatively, the Kaesong Industrial Complex may never reach its potential or spur similar ventures, leaving it as a vestigial reminder of a failed attempt at inter-Korean engagement. Seeking to preserve its distinctive Korean identity, North Korea may continue to move further toward China’s gravitational pull. China has already become North Korea’s top economic partner, and it may wish to retain that role for strategic reasons related to its internal security and to avoid the emergence of a unified Korea allied with the United States. Special economic zones on the border between China and North Korea – and especially the buildup of a logistics and trading hub in Rason in far northeastern North Korea – may eclipse the Kaesong Industrial Complex. In addition, other Chinese economic transactions, from extracting resources to providing machinery, may make China a more reliable business partner for Pyongyang.

These two scenarios highlight competition, but some level of cooperation between China and South Korea could also be possible. In the past couple of years, China has shown little interest in jointly investing with South Korea in North Korea. South Korean officials have ascribed this to China’s surplus of capital, but China’s lack of interest

may also be explained by a pursuit of competitive advantage. Thus, it is interesting to see the first possible exception in the form of a Korean dockyard investment in the Hwanggumpyong Special Economic Zone.¹³ Although the industrial buildup on the island between China and North Korea was encouraged by Pyongyang to attract Chinese technology and industry, a joint venture by China and a South Korean company inside that zone would set a positive precedent.

Assuming as much or more competition than cooperation between China and South Korea, however, Seoul will look to the lessons and possibilities at the Kaesong Industrial Complex. Despite its trials and tribulations, the complex has become the last economic remnant of a *détente* policy launched in the 1990s and implemented in the past decade. Although Kaesong accounted for virtually 100 percent of South Korean economic exchange with North Korea in 2011, only a fraction of the original development plan has been realized to date.

A key question is whether the Kaesong special industrial zone can still become an economic catalyst for change – both the change that North Korea so desperately needs and the transformation in inter-Korean relations that President Lee and his predecessors have hoped for.¹⁴

The Kaesong Industrial Complex in Historical Context

In the past, strained relations between the two Koreas – which remained technically at war – had always scared away capital investment in North Korea. However, the end of the Cold War, German unification and the breakup of the Soviet Union provided an unprecedented window of opportunity in North-South relations and inspired hope inside and outside South Korea that the Cold War might also be extinguished on the Korean peninsula. Even so, the realization of a special industrial zone followed a tortuous path.

Economic engagement between North and South Korea, and the Kaesong Industrial Complex in particular, can be traced back to the late 1980s. In the waning days of the Cold War, Mikhail Gorbachev introduced *glasnost* and *perestroika* into the Soviet Union, and East-West engagement grew worldwide, including on the Korean peninsula. In mid-1988, South Korean President Roh Tae-woo proposed North-South cultural and economic exchanges. Although President Roh's proposal opened the avenue to further engagement, there was no particular economic strategy behind it. At the annual U.N. General Assembly meeting in New York, President Roh proposed that the two Koreas open a high-level security dialogue. Four months later, one of South Korea's most important industrialists, Hyundai Group founder Chung Ju-yung, visited North Korea. With a major investment in mind, the Hyundai scion surveyed Pyongyang and Wonsan in search of the ideal project.

Political engagement propelled discussions between North Korea and the Hyundai Group, which was then the largest of South Korea's family-owned industrial *chaebol*, or conglomerates. Practical considerations about logistics and a ready source of electricity argued in favor of a project site near the DMZ. Hyundai Asan, a subsidiary of the Hyundai Group, was later created and given the responsibility of designing and implementing an industrial park in North Korea.

The first political breakthrough between the Koreas resulted from high-level, inter-Korean diplomatic talks in 1990. An Agreement on Reconciliation, Nonaggression, Exchanges and Cooperation (known as the Basic Agreement) and a Declaration on the Denuclearization of the Korean Peninsula (the so-called Joint Declaration) were signed by the end of 1991. The Basic Agreement and the Joint Declaration were supplemented by America's unilateral withdrawal of tactical nuclear weapons from Korea and the publication of a Department of Defense Asian strategy that called for the staged

reduction of U.S. troops on the peninsula and a shift in U.S. policy from a leading security role to a supporting one. The accords and the improving security environment unlocked the first trial of inter-Korean commerce. In 1992, Daewoo pioneered South Korean business investment in the DPRK (the Democratic People's Republic of Korea, North Korea's official name) by signing a contract for clothing factories in the port city of Nampo outside Pyongyang, and Daewoo dominated the modest but growing North-South commerce for the next several years.¹⁵

A sudden breach in relations and a nuclear crisis interrupted this brief period of North-South cooperation. Although North Korea signed a nuclear safeguards accord with the International Atomic Energy Agency in January 1992, cooperation with the international nuclear watchdog quickly faltered. Subsequent attempts at inspecting various nuclear sites failed, and in 1993, North Korea announced its intention to withdraw from the Nuclear Non-Proliferation Treaty.

Relations generally deteriorated until mid-1994, when a visit to North Korea by former U.S. President Jimmy Carter surmounted the diplomatic impasse and set the stage for another round of diplomacy that would sustain the idea of North-South business cooperation. Kim Dae-jung, then a South Korean opposition politician, applauded President Carter's diplomatic intervention, admonishing that "America must be patient and stick to the 'sunshine policy' which proved to be the only effective way to deal with isolated countries like North Korea."¹⁶

The second catalyst of economic engagement was the bilateral, U.S.-DPRK diplomatic breakthrough to address North Korea's nuclear program. The October 1994 Geneva Agreed Framework was intended to safely close North Korea's Yongbyon plutonium reactor, which was suspected of being used to create fissile material for nuclear weapons.

In exchange, North Korea would receive alternative fuel supplies in the form of two graphite-powered, light-water nuclear reactors; these reactors would be far less susceptible to allowing fuel to be diverted and enriched to a level that supports nuclear weapons. In addition, during the decade-long interregnum before the reactors could be built, North Korea would receive a steady supply of 500,000 metric tons of heavy fuel per year. A nongovernmental entity – the Korean Peninsula Energy Development Organization – was set up by the United States, Japan and South Korea to spearhead execution of the Agreed Framework. South Korea played a central role in advancing this enterprise with both energy and economic components. If this project flourished, then other economic ventures, including an industrial park, could follow more easily.

Months after the U.S.-DPRK Agreed Framework was established, massive flooding created a humanitarian emergency in North Korea. The silver lining of this crisis was that it opened the way for the first significant economic exchange between the two Koreas. South Korea responded to the crisis by providing nearly \$200 million in wheat and other assistance, a record contribution for inter-Korean humanitarian aid that was not surpassed for a decade.¹⁷ Some smaller-scale relief assistance followed over the next three years, a peak period of North Korea's massive famine that, by 1998, had claimed an estimated 600,000 to 1 million lives.¹⁸ The famine further opened the door to cooperation, and this opening was seized by South Korea's new president, Kim Dae-jung.

Kim Dae-jung's Sunshine Policy

The next political catalyst for economic engagement was South Korea's election of Kim Dae-jung in December 1997, in the midst of the North Korean famine and an Asian financial crisis. Having earned a reputation as a staunch democracy advocate during his stints in jail and in exile abroad, President Kim entered the Blue House in 1998 determined

to usher in a North-South *détente*. Economic and cultural exchange played key roles as Kim Dae-jung sought to alter North-South relations through progressive stages of economic engagement. “I have been steadfast in advocating what I call a ‘sunshine policy,’ ” President Kim said shortly after taking office, “which seeks to lead North Korea down a path toward peace, reform and openness through reconciliation, interaction and cooperation with the South.”¹⁹

President Kim’s Sunshine policy featured a three-stage approach to Korean unification. The first stage was preparatory. A decade or so of open engagement, Kim Dae-jung hoped, would make North Korea far more receptive to serious reforms, including an open market system and a more pluralistic political system. After a period of years, the two sovereign states would then form an economic common market or confederation. In the final stage, the two Koreas would fully merge into one united Korean state.²⁰ Yet the policy never clearly articulated how North Korea would achieve this transformation. It was assumed that an increasingly prosperous and engaged regime in Pyongyang would wish to emulate South Korea once it came to understand it. The Sunshine policy made the nuclear issue a secondary priority, but it was implicit that better North-South relations would eventually produce sufficient strategic trust to eradicate North Korea’s nuclear weapons program.

While President Kim Dae-jung’s administration was mapping out a blueprint for ending the Korean conflict, Hyundai founder Chung was meeting with Kim Jong-il in the hope of erecting an industrial park. The dictator and the industrialist met between October 27 and November 2, 1998, to renew the bidding on earlier plans for South Korean investment in North Korea.²¹ There, they to establish the Mount Kumgang Tourism Zone, where North Korea could earn hard currency in exchange for providing a scenic destination for foreign, especially South Korean, visitors.²²

Additional meetings followed, including a decisive one between September 27 and October 5, 1999, in which Kim Jong-il acceded to Hyundai’s proposal to build a special industrial park.²³ These three political catalysts during the 1990s collectively provided a window of opportunity. The moment for significant inter-Korean economic engagement was emerging.

From Mount Kumgang to Kaesong

In March 2000, South Korean President Kim Dae-jung delivered a speech in Berlin that linked his political vision with economic investment. Pledging to bring peace to the Korean peninsula, President Kim vowed to address “the last vestige of the Cold-War legacy.”²⁴ Peace, rather than unification, was the immediate aim of South Korea, and he called on North Korea to change its confrontational attitude toward South Korea. However, unlike South Korean policy since 2008, President Kim did not seek reciprocity or strategic patience – he intended to move forward with economic engagement despite the risks of leaving security issues behind. He pledged that South Korea would “help North Korea tide over its economic difficulties.” To do this, he promised to expand “the social infrastructure, including highways, harbors, railroads, and electric and communications facilities.”²⁵

The Mount Kumgang Tourist Zone was opened in 1998. Before South Korea halted visits in 2008 because of a shooting incident, nearly 2 million visitors trekked there.²⁶ The more durable economic jewel in the crown, however, proved to be the Kaesong Industrial Complex. At Kaesong, an increasing number of North Koreans, hand-picked by the regime in Pyongyang, went to work for South Korean businesses and their managers. Cheap but skilled North Korean labor bolstered scores of South Korean small and medium-sized manufacturing businesses, making everything from clothes to clocks, that were struggling to stay competitive in a globalized economy.

The location chosen for the industrial park carried historic significance. Kaesong was the home of the ancient capital of the Koryo Dynasty, which endured from AD 918 until 1392, a half century before Korea was divided.

In 2000, the business summitry of Hyundai founder Chung was finally matched by political summitry. When President Kim Dae-jung and North Korean leader Kim Jong-il met in June of that year, it marked the first *tête-à-tête* between the South and North Korean leaders. Hyundai secretly paid half a billion dollars to Kim Jong-il's regime in exchange for advancing a range of potential business projects that spanned industrial complexes not only in Kaesong but also in Sinuiju (on North Korea's border with China) and Tongchon (near Mount Kumgang), roads and railroads, access to the Imjin River to create hydro power, use of Tongchon Airport for logistical purposes, water resource management at Mount Kumgang and the development of tourism sites.²⁷ This ambitious set of business ventures was captured in a formal agreement and signed in Beijing on August 22 by representatives of Hyundai and North Korea.²⁸ In effect, Hyundai became North Korea's sole-source contractor overseeing infrastructure projects and economic reform in the country.²⁹

The location chosen for the industrial park carried historic significance. Kaesong was the home of the ancient capital of the Koryo Dynasty, which endured from AD 918 until 1392, a half century before Korea was divided.³⁰ The initial concept

was to take 16,000 acres of land for development near Kaesong and expand over time, transforming the city of Kaesong as a showcase for North Korean modernization.³¹ Working gingerly around the 2002 revelation that North Korea appeared to be pursuing a uranium enrichment program, Hyundai managed to break ground on the industrial park in June 2003, although many details, including basic legal arrangements, were unsettled. A breakthrough on how to regulate North-South passage, both for Kaesong and Mount Kumgang, was struck in January 2004.³²

A Complex Evolves

During the early years of the past decade, North and South Korean economic cooperation gained momentum. While South Korea wished to avoid a repeat of the earlier failed experiment with the Chinese at Rajin-Sonbong, the United States was more concerned about indirectly subsidizing North Korea's military programs.³³ However, these hurdles were brushed aside by the South Korean government. By the time of the 2003 groundbreaking and 2005 opening of the Kaesong Industrial Complex, Kim Dae-jung had succeeded in expanding economic ties with North Korea.

If all came to fruition, the Kaesong Industrial Complex was to be filled with hundreds of South Korean companies employing from 350,000 to 500,000 North Koreans and producing \$20 billion in products.³⁴ North Korea, meanwhile, would benefit from an influx of nearly \$10 billion over 10 years.³⁵ The size of the industrial park might eventually expand from 16,000 acres to a much larger region, both to accommodate more factories and also to provide housing for employees as the complex's demands far outstripped the supply of both workers and housing in the city of Kaesong. In one early design, even a casino would be erected in the special economic zone.³⁶

In 2005, its first year of operation, Kaesong employed about 6,000 North Koreans. That number nearly

**TABLE 1: KAESONG INDUSTRIAL COMPLEX AND OVERALL INTER-KOREAN TRADE, 2004-2011
 (IN MILLIONS OF DOLLARS)**

YEAR	TRADE THROUGH KAESONG INDUSTRIAL COMPLEX	OVERALL TRADE BETWEEN NORTH AND SOUTH KOREA	KAESONG TRADE AS A PERCENTAGE OF OVERALL TRADE
2004	\$42	\$697	6%
2005	\$177	\$1,055	17%
2006	\$299	\$1,350	22%
2007	\$441	\$1,798	25%
2008	\$808	\$1,820	44%
2009	\$941	\$1,679	56%
2010	\$1,443	\$1,912	75%
2011	~\$1,683*	\$1,714*	~98%

* According to the Ministry of Unification, South Korean trade with North Korea in 2011 was \$1.714 billion. See Kim Kyung-ho, "Concerns Mount over China's Grip on N.K. Economy," *Korea Herald*, January 31, 2012. Estimates for trade at Kaesong for 2011 are based on the latest figures released from South Korea in January 2012 and the official comment that the Kaesong Industrial Complex accounted for 99 percent of all trade. See "Inter-Korean Trade Drops 10 Percent Last Year," Yonhap News Agency, January 14, 2012, <http://english.yonhapnews.co.kr/national/2012/01/14/95/0301000000AEN20120114001500315F.HTML>.

Sources: Kaesong numbers are from the ROK Ministry of Unification, "Trends of Inter-Korean Trade," published in Cho Bong-hyun, "Kaesong Industrial Complex Development and Inter-Korean Relations," *Korea Focus*, January 2012, http://www.koreafocus.or.kr/design3/essays/view.asp?volume_id=117&content_id=103858&category=G. The Kaesong Industrial Complex accounted for \$826 million in trade between the two Koreas in the first six months of 2011; see "Kaesong Firms Worry as N. Korea Seizes Mount Kumgang Assets," *Chosun Ilbo*, August 24, 2011, http://english.chosun.com/site/data/html_dir/2011/08/24/2011082401039.html. For overall trade numbers, see "Major Statistics in Inter-Korean Relations," Republic of Korea Ministry of Unification, accessed February 27, 2012, <http://eng.unikorea.go.kr/CmsWeb/viewPage.req?id=PG0000000541>; and Bank of Korea, "News Release: Gross Domestic Product Estimates for North Korea in 2010," November 3, 2011, http://www.nkeconwatch.com/nk-uploads/GDP_of_North_Korea_in_2010.pdf.

doubled in each of the next two years to about 11,000 in 2006 and 22,500 in 2007. A second inter-Korean summit, between Kim Jong-il and President Roh Moo-hyun on October 2-4, 2007, focused on finding a Korean solution to unification and expanding economic and security cooperation. In a far-reaching joint declaration, the two leaders pledged to complete the first phase of construction of the Kaesong Industrial Complex and immediately begin the second phase. They also agreed to repair the

Kaesong-Sinuiju railroad, open freight rail services between Munsan and Bongdong, expedite customs procedures and establish cooperative complexes for shipbuilding in Anbyeon and Nampo.³⁷ Of particular interest was the desire to complete a 170-kilometer expressway between Pyongyang and Kaesong; coupled with the existing road from Kaesong to Seoul, this would create a major thoroughfare for transportation that would help join the two Koreas.³⁸ The second inter-Korean summit accords attempted

to effectively plan the infrastructure that could bring the two Koreas closer together, leveling the playing field between China and South Korea.

In the South Korean political transition year of 2008, Kaesong employed nearly 39,000 North Koreans. These workers were dexterous and productive, adding significant value in manufacturing clothing, chemicals, metals and machinery, and electrical and electronic products. The initial value of all goods produced in the complex in 2005 was a modest \$15 million; however, by 2008, that value had jumped to more than \$250 million (see Table 4). More important than the value of the goods produced, however, was the infrastructure and total exchange of goods related to Kaesong and the Mount Kumgang Tourism Zone. In 2011, the industrial park accounted for virtually all inter-Korean commerce, which amounted to about \$1.7 billion (see Table 1). Yet the impact of that commerce differed vastly between the two countries: \$1.7 billion represented about 6 percent of North Korea's economy but a mere 0.2 percent of South Korea's economy.

The Sunshine policy effectively severed a tight linkage between security and economics. Although the policy aimed to bolster the long-term goal of North-South peace, it emphasized economic assistance over a strict focus on eliminating the North's nuclear program. The faltering attempts at denuclearization and the election of a more conservative South Korean president in December 2007 radically tilted North Korea's economy toward growing dependence on China. The resulting policy of making economic engagement conditional on denuclearization stalled but did not terminate the Kaesong Industrial Complex. It simultaneously curbed what one analyst called South Korea's longstanding "bet that North Korea wants to reform but is waiting for the right international environment to embark on grand reforms or at least greater openness to the international community..."³⁹

III. KAESONG AFTER THE SUNSHINE POLICY

North-South economic relations plunged after the December 2007 election of South Korean President Lee Myung-bak. He had been a harsh critic of the lenient Sunshine policy, which appeared to reward North Korea for cheating on its own commitment to eliminate its nuclear program and abide by the 1953 Armistice Agreement. The new South Korean president believed that ending the Sunshine policy was the best means of gaining bargaining leverage and restoring a principle of reciprocity in inter-Korean relations.

Like his predecessors, President Lee was interested in finding a breakthrough in North-South relations. With his "Vision 3000" plan, President Lee offered North Korea massive economic assistance: investing \$40 billion in infrastructure, training hundreds of thousands of North Koreans and raising North Korean per capita yearly income from about \$500 to more than \$3,000 within a decade.⁴⁰ However, he was willing to do so only if North Korea verifiably and irreversibly gave up its nuclear program. Later, he eased up somewhat, withholding economic benefits from North Korea until it started to take definitive steps toward reducing its nuclear program.

Only weeks after taking up the presidency, President Lee was welcomed with North Korean short-range missile tests. It was the modest beginning of a series of increasingly aggressive steps, including a second nuclear test in May of 2009, the sinking of the South Korean corvette *Cheonan* in March 2010, the revealing of an advanced uranium-enrichment nuclear facility in November 2010 and the shelling of the South Korean-administered Yeongpyeon Island a few days later.

Each time the Lee administration thought it might be on the cusp of a diplomatic breakthrough, North Korea had a crisis that prevented its realization.

This happened in early 2010 after back-channel progress at the end of 2009, in April of 2011 and in December 2011 after the death of Kim Jong-il. By the time South Korea penalized North Korea with the so-called May 24th measures in 2010, following the international report confirming that North Korea was responsible for sinking the *Cheonan* and killing 48 of its sailors, two-way trade outside of the Kaesong Industrial Complex had already been in decline. After May 24, 2010, all commerce outside of Kaesong was shut down completely.⁴¹

After the sinking of the *Cheonan*, South Korea established a new precondition for even returning to nuclear talks: North Korea would have to apologize and take responsibility for its actions. In the absence of progress on winning a North Korean apology or eliminating North Korea's nuclear program, the United States and South Korea held back humanitarian assistance as well as economic investment (see Table 2). The United States and South Korea were once the largest providers of humanitarian assistance to North Korea, but the allies significantly slowed the flow of food and other assistance, at least partly in the hope of first extracting concessions over nuclear issues. A U.N. World Food Programme appeal in April 2011⁴² went unanswered by the allies. Despite an independent assessment by the U.S. Agency for International Development that corroborated the humanitarian need, the United States reportedly was only prepared to offer nutritional assistance in exchange for an interim freeze on North Korea's nuclear and missile programs.⁴³

Kaesong Endures

In its fewer than eight years of operation, the Kaesong complex has withstood harsh geopolitical tests. It remained open after North Korea's second nuclear test in May 2009 and even in the wake of the North Korean torpedo that sank the *Cheonan*. Nor did the complex curtail operations after North Korea's surprise 2010 artillery attack on Yeonpyeong Island near the disputed Northern

TABLE 2: SOUTH KOREAN HUMANITARIAN ASSISTANCE TO NORTH KOREA, 1995-2010 (IN MILLIONS OF WON)

YEAR	GOVT.	PRIVATE	TOTAL
1995	1,854	2	1,856
1996	24	12	36
1997	240	182	422
1998	154	275	429
1999	339	223	562
2000	2,035	387	2,422
2001	975	782	1,757
2002	2,650	576	3,226
2003	2,607	766	3,373
2004	2,672	1,558	4,230
2005	3,147	779	3,926
2006	2,273	709	2,982
2007	3,488	909	4,397
2008	438	725	1,163
2009	461	376	837
2010	22	112	135

Note: The value of the Korean won during this period fluctuated between about \$1 and \$1.50.

Source: "Major Statistics in Inter-Korean Relations," Republic of Korea Ministry of Unification, accessed February 27, 2012, <http://eng.unikorea.go.kr/CmsWeb/viewPage.req?id=PG0000000541>.

Limit Line (although Seoul started to reduce the number of South Korean supervisors and employees working at Kaesong from around 1,000 to fewer than 800).⁴⁴ President Lee, the former CEO of Hyundai Engineering and Construction, preserved the Kaesong Industrial Complex. He understood its symbolic value, representing what could be the beginning of his “Vision 3000” plan for peace. He also understood the practical issues of keeping some contact with even a truculent North Korean regime, and realized that shutting down the industrial park, unlike shutting down Mount Kumgang, would set back scores of South Korean businesses. President Lee was criticized by some members of his own Grand National Party (or *Hannara* in Korean) who argued that the program provided a disproportionate advantage to North Korea. Not only had Kaesong been an initiative of the opposition party, but it was also providing Kim Jong-il with \$30-50 million per month in U.S. currency that could be spent on programs antithetical to South Korean interests.⁴⁵

For South Korea, the Kaesong experiment has had mixed economic results, at best, with many companies struggling even as overall North-South trade reached new heights. Most companies at the complex have yet to turn a profit.⁴⁶ Two have lost everything. Kim Suk-chul, one of the original investors in Kaesong in 2004, set up a kitchenware factory employing 350 North Koreans; his cooking pots were among the first goods produced in the Kaesong Industrial Complex and were sold to South Korea and later exported to Mexico and Germany. However, around Christmas of 2010, North Korean workers forgot to turn off an electric heater, and fire broke out. Even though there was a fire house 300 meters away, it took fire fighters 40 minutes to respond, and the water truck carried far too little water. The entire \$1.7 million factory was lost.⁴⁷ A year later, the South Korean Ministry of Unification announced that Hyundai Asan would build a new fire station in 2012.⁴⁸

Even while left to languish, the Kaesong Industrial Complex emerged as the exclusive positive connection between North and South Korea. As one analyst observes, “The Kaesong Industrial Complex has served as a locomotive for inter-Korean economic cooperation.”⁴⁹ During the past seven years, the complex has been responsible for close to \$6 billion in trade between the two Koreas (see Table 3). Yet the human dimension is also important. South Korea remains highly polarized in its view of North Korea, but seeing pictures of North Korean workers beginning their morning routine with exercise, even a game of volleyball, made conflict seem highly improbable to many South Koreans.⁵⁰ Although the 2010 killing of South Korean military personnel and even two civilians renewed patriotic fervor in South Korea, the effect appeared to be relatively short lived. After Kim Jong-il’s death in December 2011, almost half of South Koreans polled thought that North Korea would become more open to engagement.⁵¹

Ironically, South Korea adopted a less market-oriented approach to North Korea than China.⁵² Stephen Haggard and Marcus Noland write that “the transformative effects of engagement on the North Korean economy are more likely to hold with respect to Chinese trade and investment with North Korea, which appears to occur on largely market-conforming terms, than they are with South Korea’s, which contain a very substantial noncommercial component.”⁵³ Haggard and Noland claim that South Korea’s Mount Kumgang Tourism Zone and the Kaesong Industrial Complex lack the “socializing” effect of Chinese investment.

A More Flexible Policy

In the wake of regime change in North Korea, South Korea appears to be adopting an increasingly flexible approach to North Korea. Indeed, before Kim Jong-il’s death, President Lee had already started to recalibrate his policy. Despite the military provocations of 2010, President Lee tacked

**TABLE 3: SOUTH KOREA-NORTH KOREA TRADE BY YEAR, 1990-2011
 (IN MILLIONS OF DOLLARS)**

YEAR	SOUTH KOREA'S EXPORTS TO NORTH KOREA	SOUTH KOREA'S IMPORTS FROM NORTH KOREA	TOTAL TRADE
1990	\$12	\$1	\$13
1991	\$106	\$6	\$112
1992	\$163	\$11	\$174
1993	\$178	\$8	\$186
1994	\$176	\$18	\$194
1995	\$223	\$64	\$287
1996	\$182	\$70	\$252
1997	\$193	\$115	\$308
1998	\$92	\$130	\$222
1999	\$122	\$212	\$334
2000	\$152	\$273	\$425
2001	\$176	\$227	\$403
2002	\$272	\$370	\$642
2003	\$289	\$435	\$724
2004	\$258	\$439	\$697
2005	\$340	\$715	\$1,055
2006	\$520	\$830	\$1,350
2007	\$765	\$1,033	\$1,798
2008	\$932	\$888	\$1,820
2009	\$934	\$745	\$1,679
2010	\$1,044	\$868	\$1,912
2011	n/a	n/a	\$1,710

Sources: "Major Statistics in Inter-Korean Relations," Republic of Korea Ministry of Unification, accessed February 27, 2012, <http://eng.unikorea.go.kr/CmsWeb/viewPage.req?idx=PG0000000541>; and Bank of Korea, "News Release: Gross Domestic Product Estimates for North Korea in 2010," November 3, 2011, http://www.nkeconwatch.com/nk-uploads/GDP_of_North_Korea_in_2010.pdf.

back to a softer line in North-South relations during the last four months of 2011. Among other reasons for this change was Lee's apparent realization that the conditional approach and demand for an apology was losing domestic political support.

In early September 2010, he appointed a new Minister of Unification, Ambassador Yu Woo-ik, to carry out the vague promise of flexibility. Minister Yu announced that South Korea would provide nearly \$6 million in medicine and nutritional supplements for North Korean children through the U.N. Children's Fund, UNICEF. He also announced the South would spend more on infrastructure at Kaesong, building a medical clinic and a new fire station, and expanding employee bus service from 20 to 40 kilometers.⁵⁴ In late September, the Chairman of President Lee's Grand National Party, Representative Hong Joon-pyo, visited the industrial park, suggesting that a higher level of economic activity was possible.

A South Korean policy promoting more economic engagement is possible in 2012 but even more probable in 2013. Public and political sentiment in South Korea appears to be swinging back in favor of engagement. The ruling party's loss to a left-wing political novice in the race for the mayor of Seoul in October 2011 was interpreted as a rejection of President Lee's policies, including his handling of North Korea. Experts urged President Lee to soften his approach.⁵⁵ For instance, according to one major survey, 81 percent of 117 North Korean experts surveyed support the Ministry of Unification's policy of "flexibility" as an "inevitable choice to ease the danger to national security."⁵⁶

While the North's initial reaction to President Lee's policy of flexibility has fluctuated between skeptical and hostile, North-South relations may again improve in the future. After Kim Jong-il's death, the North issued an official statement saying that it would never cooperate with the government of President Lee Myung-bak.⁵⁷ However, despite

such propaganda, both capitals have an interest in making modest progress even during 2012. Such progress could lead to a moratorium on provocations in exchange for more economic assistance.

Although the modest humanitarian aid and cultural contacts offered by Minister Yu were readily dismissed by Pyongyang, the passing of Kim Jong-il has breathed some life into further cooperation. In his 2012 New Year's speech, President Lee Myung-bak ended preconditions for dialogue. The President insisted that South Korea wanted a "new era" of relations with North Korea and that he would seek to make progress during the present "window of opportunity."⁵⁸ Minister Yu has said that South Korea is now prepared to offer large-scale humanitarian aid and discuss further cooperation with North Korea, even without receiving an apology over the naval or artillery incidents two years ago.⁵⁹ In January 2012, an aide close to Minister Yu visited the Kaesong Industrial Complex in order "to figure out how to revitalize" it. The aide, Cha Se-hyeon, also announced that the number of North Korean laborers had topped 50,000.⁶⁰ Most significantly, in mid-February 2012, the Lee administration announced an easing of the May 24, 2010 sanctions on North Korea, thereby opening up the prospect of new investment in the Kaesong Industrial Complex.⁶¹

Yet despite President Lee's open-door policy, the collective leadership of North Korea is likely to wait until after the December 2012 presidential election in South Korea before seeking an economic bargain with Seoul.

Conditionality on Trial

As President Lee's term winds down in 2012, his policy of conditionality in North-South relations may also be on the ballot. South Korean presidents are elected for only a single five-year term. Although Lee Myung-bak has earned trust from President Barack Obama in handling South Korea's alliance with the United States, he and

his policies are viewed with considerable dismay – or at least seen as a political liability – in the ROK (the Republic of Korea, South Korea’s official name).⁶²

South Korea has continued to debate the specific objectives of its dialogue and engagement with North Korea. Strategic issues necessarily trump more narrow issues of economic development, and yet the vast inequality between North and South Korea has been both an incentive for and obstacle to economic engagement. As with development assistance programs in other low-income countries, there are problems with basic infrastructure, the absorptive capacity of the developing country and the limited understanding of economic management and systems.⁶³ Nonetheless, South Korean businesses were drawn to Kaesong not only because of a ready source of cheap, Korean-speaking labor but also for reasons of national pride.⁶⁴ Under Kim Dae-jung and Roh Moo-hyun, economic investments were seen as a way to lubricate the possibility of better relations. Conservatives branded the Sunshine policy as a lost decade, and under Lee Myung-bak, the North Koreans had to realize that they would not reap the benefits of progress without first abandoning their truculent military posture.

Without the Kaesong Industrial Complex, the two Koreas would lose a channel of daily conversation as well as a vital symbol for a unified Korea. Even when tensions reached trigger-ready levels in 2010, the Kaesong Industrial Complex remained what one journalist called a “conspicuous exception.”⁶⁵ Indeed, the number of employees even grew modestly because the special measures taken by Seoul in May 2010 precluded only new investment and did not halt business expansion already in the pipeline.

Regardless of the merits of South Korea’s decision to move away from the Sunshine policy, that policy had a profound impact on economic

The South Korean decision to constrict investment in North Korea had two chief effects. First, it accelerated China’s rise as North Korea’s dominant economic partner... Second, it relegated North-South economic linkages to a single endeavor, the business park Hyundai had built just north of the DMZ.

relations with North Korea. Although investments in the Kaesong Industrial Complex sustained two-way trade in 2010, the amount of South Korean money and goods flowing to North Korea has continued to decline over the past several years, and humanitarian assistance has been virtually cut off. The contraction in North-South economic activity, and the concomitant rise in China-DPRK trade, has stirred unease within South Korea, despite the fact that North Korea’s repeated provocations – from a second nuclear test in 2009 to two uses of lethal military force in 2010 – are chiefly responsible for the breakdown in the North-South dialogue.

The South Korean decision to constrict investment in North Korea had two chief effects. First, it accelerated China’s rise as North Korea’s dominant economic partner. By 2010, Pyongyang actively sought Chinese trade and investment.⁶⁶ Second, it relegated North-South economic linkages to a single endeavor, the business park Hyundai had

built just north of the DMZ. The South Korean determination not to give North Korea something for nothing also resulted in a more assertive push back from Pyongyang. Kim Jong-il, and whomever was making decisions for him after his stroke in August 2008, appeared determined to ratchet up pressure on South Korea in response to the post-Sunshine policy. According to the South Korean official who was in charge of Kaesong at the time, North Korea pleaded with the South Korean government to keep the Kaesong Industrial Complex open and to “please build the road” from Seoul to Kaesong to Pyongyang.⁶⁷ That highway, which would be far easier to build than a major highway down the rugged and under-developed east coast of North Korea, has been a longstanding proposal dating back to seminal talks between Hyundai and Kim Jong-il.

While Chinese-North Korean economic relations waxed, South-North relations waned. Inter-Korean trade dropped by 10 percent between 2010 and 2011 (see Table 3). At the same time, however, cooperation at the Kaesong Industrial Complex continued to grow in spite of the sanctions (see Table 4).⁶⁸ Most of the South’s investment in North Korea took the form of money spent on the complex. The total value of goods produced at Kaesong grew by an estimated 25 percent between 2010 and 2011. From January through November 2011, goods produced at Kaesong were valued at \$369.9 million, and the estimated total for all of 2011 was likely close to \$400 million, despite disruptions related to the death of Kim Jong-il. Total production for 2010 was \$323.3 million. The number of North Koreans working at the complex reached 48,708 in November 2011 and reportedly topped 50,000 in January 2012.⁶⁹

What these statistics both hint at and conceal is that South Korean conservatives and liberals seek similar objectives but wish to employ different means. According to Kim Dae-jung and his successor Roh Moo-hyun, North Korea needed

to open up gradually, and economic means like the Kaesong Industrial Complex were the best ways to bring about needed reform. The fact that Kaesong provided new life for some endangered, labor-intensive light-manufacturing industries in wealthy South Korea was an added practical benefit on top of the larger strategic goal of ending the Cold War with North Korea. When Lee took over as president, he understood that the Kaesong Industrial Complex could not be closed without losing political support for shutting down inter-Korean ties and dampening the potential profits for some South Korean businesses. He also appreciated the idea that economic contact with tens of thousands of North Koreans could plant the seeds of creative destruction that would be required to bring about a peaceful and prosperous North Korea.⁷⁰ Kaesong was a “Trojan Horse,” according to a senior official inside President Lee’s administration.⁷¹

Kim Jong-il had long been wise to the theory of “poisoned carrots,” that an economic hand-out could carry with it a political contagion that might endanger a closed system of government determined to resist the 21st century. Even today, there is no Internet at the Kaesong Industrial Complex, for example, a shortcoming that seriously limits business but protects North Koreans from learning too much about the outside world.

South Koreans still see North Koreans being influenced by indirect means, including unlimited showers and baths at the facility, hot meals, unlimited coffee and tea, and the large distribution of a special South Korean cookie – the Choco Pie – as a substitute for cash that is also useful for barter within North Korea. In fact, the distribution of Choco Pies has become so prominent that, in late 2011, the North Korean government cracked down on them.⁷² Even as North Korean employees sometimes missed work without notice, presumably to attend mandatory political training, the South Korean managers

TABLE 4: KAESONG INDUSTRIAL COMPLEX EMPLOYEES, BUSINESSES AND PRODUCTION VALUE

YEAR	SOUTH KOREAN BUSINESSES	NORTH KOREAN EMPLOYEES	PRODUCTION VALUE (IN MILLIONS OF DOLLARS)
2005	18	6,013	\$15
2006	30	11,160	\$74
2007	65	22,538	\$185
2008	93	38,931	\$250
2009	117	42,561	\$256
2010	121	46,135	\$323
2011	123	48,708	~\$400*

* The 2011 numbers are based on the press report below. The number of workers was that for November 2011, and the real number may be a bit higher, given that in early January 2012, the South Korean government announced that the number of employees had reached 50,000. The \$400 million estimate is based on an official figure of \$370 million for production from January through November 2011, plus a December estimate based on the year's average of \$30 million per month. Production may have been a bit lower than average in December 2011, given the disruption following the announcement of Kim Jong-il's death and the subsequent mourning period. "Production at Joint Industrial Kaesong Park Expands 14.4 Percent in 2011," Yonhap News Agency, January 23, 2012, <http://www.koreaherald.com/national/Detail.jsp?newsMLId=20120123000059>.

Source: "Major Statistics in Inter-Korean Relations," Republic of Korea Ministry of Unification, accessed February 27, 2012, <http://eng.unikorea.go.kr/CmsWeb/viewPage.req?idx=PG0000000541>.

at Kaesong could not help but notice how North Korean female employees (the vast majority of workers at Kaesong) soon began using cosmetics and ignoring political propaganda sessions.⁷³ For South Korean officials, the human dimension of the Kaesong Industrial Complex seemed to be living proof of the transformative potential of joint economic ventures.⁷⁴ Although President Lee ended the Sunshine policy, South Korean influence continued to be felt in North Korea, at least at Kaesong.⁷⁵

IV. THE NORTH KOREA DILEMMA: HOW TO ADAPT AND SURVIVE

North Korea rests on a precarious economic foundation. Although collapse does not appear imminent, Kim Jong-il's death underscores the question of how long North Korea can survive in its present incarnation. The combination of economic duress, sudden leadership transition and external pressure to shut down any nuclear program may well destabilize North Korea. The cumulative weight of international sanctions has squeezed North Korea's illicit trade.⁷⁶ Even Kim Jong-il had to quash his own currency reform when it threatened to trigger civil unrest.

The untested new leader – Kim Jong-eun, believed to be in his late 20s – will have to make some hard economic decisions to avert potential instability. He was catapulted to power after Kim Jong-il, the son of Kim Il-sung, died of a heart attack on or just before December 17, 2011. By the end of the official 10-day funeral period, he received an empowering 21-gun salute, and the North Korean media went to extra lengths to make him look like he was cut from the same cloth as Kim Il-sung and Kim Jong-il.⁷⁷ The DPRK is now on its third leader, and the third-generation Kim is easily the least prepared among them.⁷⁸ Even with experienced regents at his side as part of a collective leadership, Kim Jong-eun must steer a country of some 25 million people away from the economic abyss. He must do so without losing the support of either the Korean Workers' Party or, especially, the dominant Korean People's Army on which his regime's survival depends.⁷⁹

Sooner, rather than later, North Korea will have to start to demonstrate that it has a plan for turning around its moribund economy. Although the nation has persisted a long time without doing so, the widening economic disparity with its neighbors and increased access to information make loyalty to the Kim dynasty more problematic over

time. The North Korean government must adapt or face the prospect of its downfall.

Economic reform thus seems compelling, although evidence is currently scant that Kim Jong-eun is seeking economic reform. There are, however, signs of economic concern within the new regime: Special economic zone activity has been encouraged rather than disrupted by the transition, and his regime has asked for food aid reportedly promised to his father's government in connection with the restoration of nuclear disarmament talks.⁸⁰ It is my judgment that time is not on North Korea's side, at least not without an economic course correction. Kim Jong-il reversed a crackdown on foreign currency in 2009-2010 after the confiscation of people's meager savings threatened civil unrest.⁸¹ Kim Jong-eun is likely to be faced with similar tough choices. If survival is North Korea's highest priority, then the fear of possible upheaval will influence its future behavior.

The abrupt reversal of fortunes of several entrenched strongmen around the world (including Libya's Colonel Moammar Gadhafi and Egyptian President Hosni Mubarak) has probably been noted in Pyongyang. Unlike those Middle Eastern leaders, Kim Jong-eun heads an authoritarian state juxtaposed against a region of rich and rapidly developing economies. This circumstance raises a question: How long can one of the world's weakest economies (ranked no better than 99th) prop up one of the world's largest militaries (ranked 4th)?⁸² North Korean defense spending is greater than that of every other country in the world as a percentage of gross national product (as much as 25 percent).⁸³

Of course, North Korea has managed to muddle through – and build nuclear weapons – despite having been in economic decline since the 1970s. North Korea appears to have enough assistance from China and enough internal repression to resist implosion for the foreseeable future.⁸⁴

Beyond Juche

North Korea's chief dilemma is how to survive despite significant internal and external pressure. The country has a torpid economy, a leadership lacking experience and legitimacy and reluctant external investors.

For two decades following the 1950-1953 Korean war, North and South Korea were equally poor. Today, South Korea is one of the world's leading economies and a member of the Group of 20, while North Korea is one of the world's pariah kleptocracies. Per capita annual income in South Korea has reached \$23,000, versus only \$1,800 in North Korea.⁸⁵ Only 3 percent of North Korea's roads are paved, and a loss of arable land and other problems have condemned North Korea to chronic food shortages.⁸⁶ Its anachronistic central planning and broken public distribution system produced a nominal gross national income of about \$27 billion in 2010.⁸⁷ North Korea's constricting economy contrasts sharply with South Korea's vibrant, trillion-dollar economy.⁸⁸ South Korea attained a higher gross domestic product 35 years ago.⁸⁹ North Korea's poor economy already demonstrates that self-reliance – the DPRK ideology of *juche* – cannot suffice as an economic model. The continued rise of North Korea's neighbors has meant that a shrinking North Korean economy is falling even further behind the energetic economies of the region.

North Korea needs to stem its ailing economy, keep the military in check, attract foreign investment and keep a lid on dissent. A basic problem, however, is that its political system is built on the premise of self-sufficiency, yet the economic system, including its central public distribution system, is dysfunctional. There is no easy way for Pyongyang to permit outside assistance without calling into question the regime's monopoly of political authority. Explaining why he believes the new North Korean regime will not survive for long, Kim Jong-nam, the older half-brother of Kim

Jong-eun, offered this grim catch-22: “Without reforms, North Korea will collapse, and when such changes take place, the regime will collapse.”⁹⁰

In North Korea, economics are inextricably entangled with national security. Because of the need to minimize the political and social impact of economic investment, North Korea has sought to attract investment on its borders rather than in the heart of the country. North Korea has designated special economic zones to attract foreign investment and revenue in a controllable environment. Only South Korea invests in Kaesong, but other zones have been opened particularly to attract Chinese investment. North Korean security forces maintain strict control of these border areas, but foreign investors are allowed access and varying degrees of autonomy within them to conduct business or tourism.

North Korea's initial inability to attract much revenue led the special economic zones to waste away until a few years ago, when Kim Jong-il wooed China. Although Kim Jong-il is often blamed for blocking the success of economic zones in the 1990s, he appears to have had a change of heart around 2009, the same period when the North was attempting currency reform.⁹¹ In the past two years, China has agreed to invest more than \$3 billion in new infrastructure, power plants and oil-refining facilities in the Rason Free Trade Zone – an area China views as an essential hub for transportation and trade.⁹² China also pledged major investment on the western end of the China-North Korea frontier, on the island of Hwanggumpyong, which would be converted into a logistics and manufacturing center and accessed by improved bridges and roads.⁹³

Whether or not North Korea ever wanted a closer relationship with the United States, it may now be content with moving closer to a Chinese government interested in stability above all else. Two leading experts on North Korea, Robert Carlin and

John Lewis, judge the pivot toward Beijing to be “no routine oscillation” on the part of Pyongyang. They write that “the drive to normalize relations with the United States from 1991 to 2009 has been real, sustained and rooted in Kim Il-sung’s deep concern about the regime’s future in the aftermath of the collapse of the Soviet Union.”⁹⁴ The authors cite as one data point a meeting on October 25, 2000 – the 50th anniversary of the entry of Chinese soldiers into the Korean war – between the U.S. secretary of state and Kim Jong-il, during which the Chinese defense minister was left waiting.⁹⁵ However, Carlin and Lewis conclude that reliance on China, rather than the United States, almost surely means that the North will use Chinese largesse to further develop its nuclear weapons program, commenting that “the North Koreans have long assumed that given enough time, the world would resign itself to their nuclear weapons, as happened with India and Pakistan.”⁹⁶

North Korea remains interested in attracting money from various sources. Prior to his death, Kim Jong-il spent considerable effort trying to entice Russian investment. Russia repaired the railroad into Rason, which enabled Russia to access a warm-water port for shipping coal and other resources even when Vladivostok was frozen. In addition, an oil pipeline that would link Russia and North Korea remains under negotiation, a scheme promised to bring North Korea \$100 million a year in transit fees.⁹⁷ However, the time needed to complete the deal, not to mention to construct the pipeline, means that additional Russian investment is years away from coming to fruition. In the meantime, North-South economic engagement has fallen off, and the Rason free economic and trade zone is the only current collaborative venture with Russia.

North Korea’s Options

Looking ahead, North Korea’s leadership can traverse one of two paths to pull the country out of its economic rut. A northern route leads toward greater dependence on China, the world’s

second-largest economy and a country with which the DPRK maintains close political relations.⁹⁸ A southern path heads toward South Korea and greater economic integration with 50 million fellow Korean speakers in one of the world’s top 15 economies.⁹⁹

Although South Korea has started to show renewed interest in North Korea, China has thus far been the most interested party in increasing economic engagement with North Korea. China’s increased investment appears designed to secure resources and preserve stability, even when confronted with North Korean provocations. Because South Korea made initiating the denuclearization process a prerequisite to improved relations, economic investments begun under the Sunshine policy have stalled.¹⁰⁰ Meanwhile, North Korea has accepted Chinese investment and managed to keep its nuclear program intact.

In the future, North Korea may attempt to rebalance its growing dependence on China by increasing ties to others, especially South Korea. A joint venture between Daewoo and a Chinese company to build a dockyard on the North Korean island of Hwanggumpyong may be a harbinger of joint ventures to come.¹⁰¹ Having both China and South Korea as suitors could increase North Korea’s profits and bargaining leverage and help balance the influence of outsiders. North Korea fears that excessive dependence on China will jeopardize its autonomy. South Korea and China share a common interest in preventing North Korean collapse. However, the two suitors are likely to remain wary of each other’s intentions with respect to North Korea, and this mutual suspicion will probably limit the scope of joint ventures.

A handful of Chinese and South Korean special economic zones lie at the heart of the struggle for the economic future of North Korea. Although China is increasing trade outside of North Korea’s special economic zones, particularly to extract

coal, steel and other minerals, most infrastructure investment is confined to these special development zones on the border. The extent to which China and North Korea develop these zones may not be clear for several years, as North Korea consolidates and deliberates during this year of remarkable political transition. Certainly, Kim Jong-eun must strengthen his legitimacy as China installs a new leadership, the United States conducts its quadrennial presidential election and South Korea votes for a new president. However, the perilous state of North Korea suggests that decisions cannot be put off indefinitely, and economic policy choices made in Pyongyang during the next few years may well seal the fate of North Korea.

China and South Korea are rivals when it comes to the future of North Korea. South Korea assumes that one day the peninsula will be reunited and reflect South Korean values. China's leaders have little interest in unification and, at a minimum, would prefer a more pro-China Korean peninsula. A recent survey of Korea experts in China found that nearly a third flatly oppose Korean unification and half see a unified Korea as posing a threat to China.¹⁰² China appears to be supporting the transition to Kim Jong-eun as a means of maintaining stability. However, some wonder whether China has a "plan B" for installing a new, pro-China regime should Kim Jong-eun suddenly lose power. One possible alternative is Kim Jong-eun's half-brother, Kim Jong-nam, who has been living in Macau since 2003, presumably with Chinese support.¹⁰³

Even if inter-Korean military tensions were reduced – and that is admittedly no small if – China and South Korea would still compete for influence over the future military, political and economic disposition of the Korean peninsula. After all, China and Korea still debate historical sovereignty claims over parts of North Korea.¹⁰⁴ Although other, mostly more distant investors

– from the United States and Russia to Japan and the European Union – would be beneficial, none of these would-be suitors have demonstrated financial interest at the level that North Korea appears to demand.¹⁰⁵

In the past decade, China and South Korea have swapped places as North Korea's main economic partner. After a decade of steadily growing economic relations between South and North Korea, economic and humanitarian assistance have been sharply reduced under President Lee Myung-bak. Seeking to curb North Korea's imperious negotiating behavior aimed at gaining as much as possible for doing as little as possible, the South Korean president proposed his variant of a grand bargain. To transform inter-Korean relations, President Lee called on North Korea to dismantle its nuclear weapons program in exchange for security assurances and economic assistance.¹⁰⁶ This hard-line approach to North Korea found ready approval in Washington. With Seoul firmly behind America's principal goal of eliminating the North's nuclear threat, the United States was comfortable with supporting South Korea's leading role in dealing with North Korea.

Without quenching the North's thirst for nuclear weapons, South Korea's "principled approach" to dealing with North Korea has accelerated Beijing's economic influence in Pyongyang. Chinese capital has been flowing at increasing rates into special economic zones on the northwest border in the Rason region, as well as on the westernmost Chinese-North Korean maritime frontier near Sinuiju and on Hwanggumpyong and Wihwa islands in the Amnok (or Yalu) River, near the Chinese border city of Dandong. Tellingly, some 80 recent defectors from North Korea with connections to the party or armed forces almost unanimously credited their relative prosperity to China, either through direct business dealings or indirect benefits.¹⁰⁷

V. CHINA'S ECONOMIC INROADS

In the past decade, China-DPRK trade has climbed tenfold, from around \$500 million in 2000 to about \$5.6 billion in 2011 (see Table 5). Whereas China accounted for just over half of North Korea's commerce in 2005, it accounted for 57 percent in 2010 (and for 83 percent of North Korea's trade excluding inter-Korean commerce).¹⁰⁸ China's trade with North Korea climbed to about \$3.47 billion in 2010, about a 30 percent increase over 2009. That jump was then surpassed in 2011, as two-way trade reached \$5.6 billion, a 60 percent increase over 2010.¹⁰⁹ These numbers underplay the real extent of the economic links between China and North Korea because the publicly available numbers regarding merchandise trade exclude private cash flows, military and clandestine money transfers, remittances, smuggling and illicit trade, and barter.¹¹⁰ Key members of the ROK Ministry of Unification are not clear on the full extent of Chinese economic involvement in North Korea.¹¹¹

Beijing's Sunshine Policy

China's government is now offering North Korea its own version of the Sunshine policy.¹¹² China's economic lifeline to North Korea is increasingly taking the form of joint ventures, particularly those focused on the exploitation of natural resources and manufacturing. According to Drew Thompson, China established 138 joint ventures with North Korea between 1997 and August 2010, with about 40 percent of them focused on each of those two business sectors.¹¹³

Perhaps most significant is the influx of Chinese provincial investment. That economic investment is emerging from the provinces neighboring North Korea, especially Jilin and Liaoning. As Thompson observes, the "silent partners" of "Jilin and Liaoning share a 1,400 kilometer border with North Korea and are increasingly focused on foreign trade and on achieving competitive economic

TABLE 5: CHINA-NORTH KOREA TRADE BY YEAR, 1995-2011 (IN MILLIONS OF DOLLARS)

YEAR	CHINESE IMPORTS	CHINESE EXPORTS	TOTAL TRADE
1995	\$63.6	\$486.0	\$549.6
1996	\$68.6	\$497.0	\$565.7
1997	\$121.6	\$534.4	\$656.0
1998	\$51.1	\$356.6	\$407.8
1999	\$41.7	\$328.6	\$370.4
2000	\$37.2	\$450.8	\$488.1
2001	\$166.8	\$570.7	\$737.5
2002	\$270.9	\$467.3	\$738.2
2003	\$395.5	\$628.0	\$1,023.5
2004	\$582.2	\$794.5	\$1,376.7
2005	\$496.5	\$1,084.7	\$1,581.2
2006	\$467.7	\$1,231.9	\$1,699.6
2007	\$581.5	\$1,392.5	\$1,974.0
2008	\$754.0	\$2,033.2	\$2,787.3
2009	\$793.0	\$1,887.7	\$2,680.8
2010	\$1,200.0	\$2,300.0	\$3,500.0
2011	\$2,460.0	\$3,170.0	\$5,630.0

Source: Dick K. Nanto and Mark E. Manyin, *China-North Korea Relations* (Washington: Congressional Research Service, December 28, 2010); "GPI Launching November DPRK Business Delegation," *North Korean Economy Watch*, October 12, 2011; and ROK Ministry of Unification statistics. The total for 2011 also comes from the Ministry of Unification; see Kim Kyung-ho, "Concerns Mount over China's Grip on N.K. Economy," *Korea Herald*, January 31, 2012, <http://www.koreaherald.com/national/Detail.jsp?newsMLId=20120131001012>. Figures for 2010 and 2011 are rounded; see "North Korea Economy," *Economic World*, January 16, 2012, <http://worldseconomy.blogspot.com/>; and "North Korea-China Trade Jumps 62 Percent in 2011: Data," *Yonhap News*, January 31, 2012, <http://english.yonhapnews.co.kr/northkorea/2012/01/31/0401000000AEN20120131003300315.HTML>.

China and North Korea's Special Economic Zones

China's investments have been concentrated in three special economic zones (separate from Kaesong) created by North Korea. These zones, although not originally intended solely for Chinese capital and infrastructure, have attracted little other economic activity (see map).

The first zone was created in 1991 as a North Korean pilot project begun by Kim Il-sung to introduce market reforms into North Korea.¹¹⁴ Rajin-Sonbong, now known as the Rason Free Trade Zone, is located in the very northeastern portion of North Korea, just west of the Tumen River, a location selected in part to limit contact between the North's autarkic system and the outside world. The area was also selected because of its geography: It is home to the northern-most ice-free port and thus has long been seen by Chinese and Russian officials as a hub for regional transportation.

The port facility did not attract much foreign capital until recently. In the past couple of years, Chinese authorities from Beijing and from the adjacent Jilin Province have invested in the notion of a vital seaport.¹¹⁵ As one analyst has noted, in 2009 there emerged a convergence of interest between a North Korean desire for investment and an ambitious Chinese plan for provincial development in the Changchun-Julín-Tumen corridor (a regional development plan known as 'Changjitu').¹¹⁶ China signed a 10-year lease on a pier at Rason and agreed in 2010 to spend \$2 billion on rebuilding the port there,

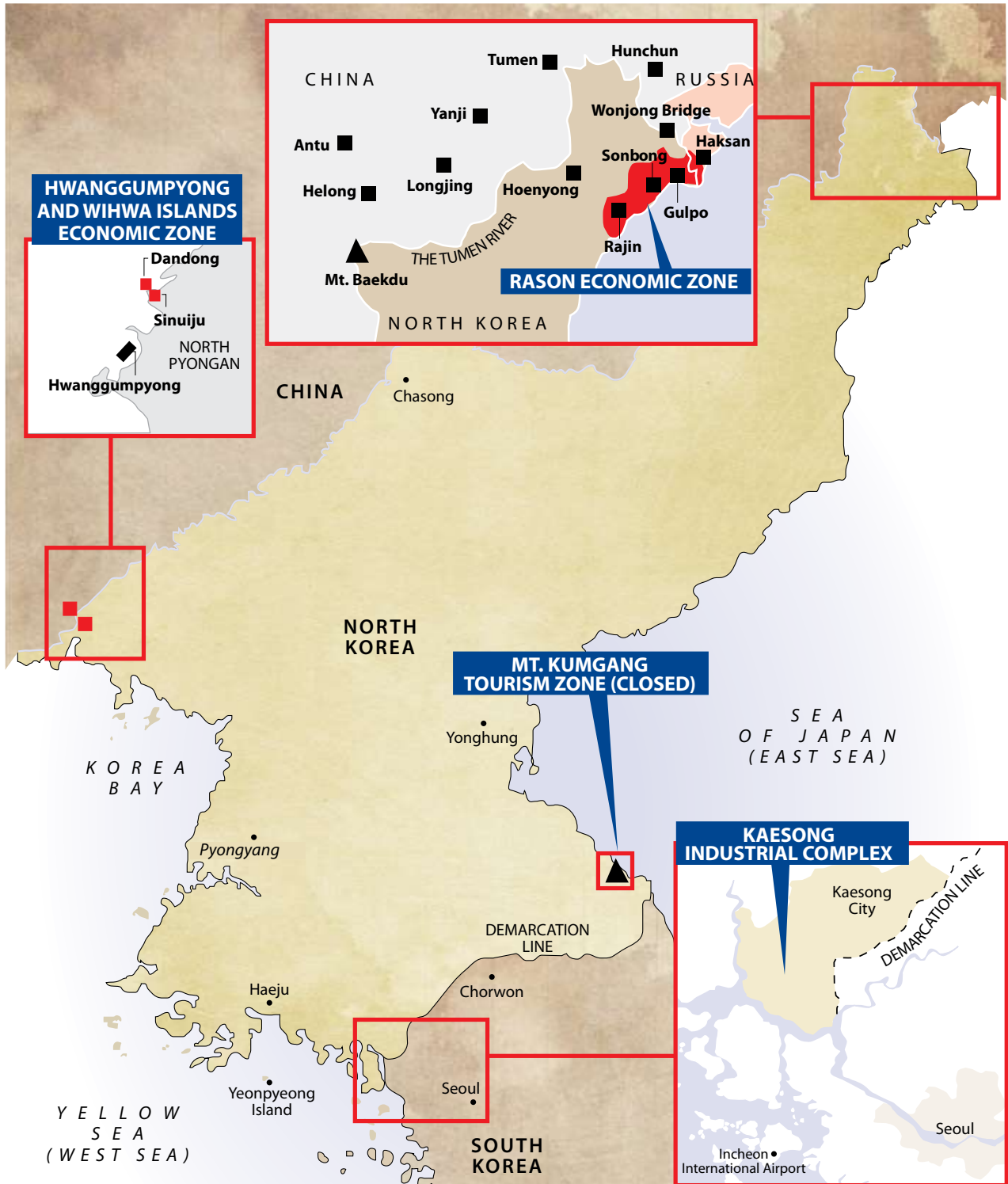
a major construction project led by the Shangdi Guanqun Investment Company of China.¹¹⁷ Recent reports suggest China has increased its investment into refurbishing piers from \$2 to \$3 billion, with the duration of the lease spanning perhaps 50 years. Other reports suggest that a new company, Taepung International Investment Group, was set up with \$10 billion to galvanize infrastructure development in Rason.¹¹⁸ Although there is reason to believe that China does not believe denuclearization is a useful near-term goal, there is strong potential for China to use this type of investment as leverage over North Korea, including over its nuclear program.

The second special economic zone was created in 2002 at the opposite end of the China-North Korea border in Sinuiju, opposite Dandong City across the Yalu River. It has since been left behind for a third zone nearby described below, but its rise and fall provide insights into Chinese wariness about North Korean offers. Kim Jong-il announced the establishment of this special administrative region in September 2002, when the two Koreas were haggling over how to govern the future industrial park at Kaesong. The timing of the new economic zone also coincided with a sharp downturn in U.S.-North Korea relations. Earlier that year, President George W. Bush had referred to North Korea as part of an "axis of evil," and North Korea appeared to confirm allegations that it was secretly harboring a uranium enrichment facility. In this environment, North

Korea invited China's second-richest man, 39-year-old Yang Bin, to set up and govern an economic zone with 200,000 North Korean technicians, something one North Korean official dubbed a "new historical miracle."¹¹⁹ Yet only months later, China arrested the Chinese-Dutch national on charges of fraud and sentenced the orchid tycoon to 18 years in prison. He was never given a chance to assume leadership over the special administrative region of Sinuiju. In effect, China undercut the zone before it ever got off the ground.¹²⁰

The third special economic zone, closer to the Yalu/Amnok River estuary, is a more recent site of Chinese investment. The Yalu/Amnok River separating China and the western-most tip of North Korea is populated with a number of small islands and land features. Hwanggumpyeong and Wihwa Islands have been selected by North Korea as part of a special economic zone, and China has agreed to invest about \$260 million to build a highway and bridge from Dandong across the river in order to support the project.¹²¹ Not long after Kim Jong-il's funeral, the road from Dandong to Pyongyang was congested with trucks and construction vehicles. It was not clear whether this represented an upswing in Chinese assistance or simply the backlog of deliveries that had been delayed by the 10-day funeral period.¹²²

NORTH KOREAN SPECIAL ECONOMIC ZONES



advantages through their proximity to North Korea.” As Chinese investors “position themselves for a future opening of the DPRK,” these joint ventures become the potential springboard for North Korea’s economic revival and closer integration with China.¹²³

Although Chinese investors do encounter hurdles and suspicions from North Korea, Pyongyang appears to prefer economic integration with a country that does not threaten its authoritarian system. China thus offers its Beijing consensus model of development, one which supports authoritarian political order with free-market elements.¹²⁴

China’s Interests

What does China want from North Korea? Natural resources are a key Chinese interest, and some 43 percent of Chinese-North Korean joint ventures listed publicly are related to natural resource production.¹²⁵ Anthracite coal and metal extraction are of particular interest to China.¹²⁶ While China received coal, steel and other minerals, North Korea imported fuel and machinery.¹²⁷

However, China provides an economic lifeline to North Korea mostly out of an abiding interest in stability on its border. In effect, it rents stability to ensure that the fragile state of North Korea does not collapse. As one China expert and Obama administration defense official put it, “Kim Jong Il would lack the means to secure the allegiance of elites that support his rule, making trade and investment with China particularly important for ensuring the regime’s survival.”¹²⁸

Beyond resources and stability, China also may be starting to view North Korea as an indispensable, long-term buffer state. Rather than risk the presence of U.S. military forces on China’s border, the historic goal of preserving a buffer state may gain greater prominence in China’s strategic calculus. So although many Chinese goals may clash – from teaching the United States a lesson about stability,

to renting stability at all costs, to competing with the ROK and the United States for influence – growing Chinese economic investment is presenting China with new options regarding North Korea’s future.

The recent elevation of Asia as a strategic priority for the United States may reinforce any Chinese interest in creating a long-term buffer state. Many Chinese appear to think that America’s newfound interest in Asia is aimed at encircling China.¹²⁹ Moves to strengthen the U.S. military posture in East Asia may increase China’s interest in limiting U.S. influence in Asia, especially on the Asian mainland.

China has hardly coerced North Korea to improve its compliance with the international community, including U.N. resolutions. Although China has officially supported some sanctions on North Korea, it has, by many accounts, not enforced those sanctions. A 2010 U.N. Panel of Experts not only concluded that China was failing to enforce sanctions but also that it was allowing North Korea to transfer even military-related technology.¹³⁰ Moreover, loopholes in the international sanctions against North Korea have enhanced China’s stature as a provider of high-technology and luxury goods to Pyongyang. Meanwhile, although the U.N. Security Council agreed on sanctions after North Korea’s first nuclear test in 2006 and then sought to tighten those sanctions further after the second test in 2009, it let member states decide which goods they deemed to be luxury products. As a consequence, the more international sanctions that are slapped on North Korea, the greater China’s potential hold over North Korea. In the past five years, North Korea’s imports of automobiles, laptop computers, cell phones and air conditioners have skyrocketed.¹³¹ Although some observers see the North Korean demand for luxury items as indicating “the emergence of a new entrepreneurial class in North Korea,” another aspect of this recent trend is China’s growing influence on North Korea’s elite.¹³²

Whatever China's ultimate intentions are with respect to North Korea, from preserving stability to controlling North Korea as a long-term buffer state, Beijing's public support for the DPRK has remained firm. According to one senior official from China's Foreign Ministry, "it is the unwavering policy of the Communist Party of China and the Chinese government to continuously consolidate and develop relations of friendship and cooperation with the Democratic People's Republic of Korea..."¹³³ Although the vague diplomatic language leaves the statement open to different interpretations, the foreign ministry makes clear that it is focused on "stability and development, for the Korean Peninsula to stay peaceful and stable, and for Northeast Asia to realize long-term peace and order."¹³⁴ China's best ties to North Korea remain the regular contacts between their respective political parties, and thus, it is not surprising that the foreign ministry thinks that North Korea's ruling party will be as important as Kim Jong-eun: "China believes that under the leadership of the Workers' Party of Korea and comrade Kim Jong Un, the people of the DPRK will turn grief into strength and carry forward the DPRK's cause of socialism."¹³⁵

VI. POLICY IMPLICATIONS

Kim Jong-eun's ascension to power presents both a need and an opportunity for North Korea to arrest its economic decline.¹³⁶ Thus far, North Korea has increasingly aligned with a rising China. Some analysts view this shift as not what North Korea regime preferred but what it decided was in its best interest after failing to win more support from South Korea and the United States. In particular, after years of looking for a thaw in relations with the United States – the one country that might provide North Koreans with the "the cash, technology, and know-how that they seek" – North Korea settled on China as its only available business partner.¹³⁷

However, although Kim Jong-il appears to have decided toward the end of his life to seek Chinese investment to prop up North Korea's economy, the new regime may well be concerned about becoming over-dependent on China or find Chinese investment to be insufficient. In either case, Kim Jong-eun may choose to return to the notion of finishing the Kaesong Industrial Complex. Indeed, with a more progressive political change in Seoul in 2012, the North may wish to rekindle not only the industrial park but also the 2007 plan to finish the expressway that would link the two capitals via a vital artery of transportation. Extensive interviews with South Korean officials and experts over the past year indicate that such progress may come sooner than many suspect.¹³⁸

Asia's only other economic pariah state, Burma (also known as Myanmar), has recently undergone a radical change in direction. Since the 2010 rise of Prime Minister Thein Sein as a nominal civilian leader, that country has moved gradually away from self-isolation by undertaking reforms (though it has not yet instituted real democracy). The release of hundreds of political prisoners; the reinstatement of the main opposition party and its leader, Aung San Suu Kyi; and the agreement to swap ambassadors with the United States have all

been viewed as affirmations that the country is on a new path.¹³⁹ If Burma stays on its current trajectory, it may well go from being largely dependent on China to relying on a far more balanced set of economic relations with China, India, and other nations, including the United States.¹⁴⁰ Similarly, if North Korea were to repair ties with South Korea, then the United States could support a growing economic relationship between North Korea and more for the outside world. If Burma appears to benefit from reform, then perhaps North Korea could be persuaded to follow a new path as well.

If North Korea has felt spurned by the United States and South Korea, both democratic powers have been equally convinced of North Korea's insincerity, if not perfidy. Neither side has been willing to offer sufficient incentives to change the cost-benefit calculus of the other. Even if they had been willing to consider doing more a few years ago, the lethal provocations and nuclear tests of the past few years have raised the barriers to doing business. Several years ago, two respected analysts proposed a grand bargain in which North Korea would receive \$2 billion a year, of which the United States would make an annual contribution of \$300 million, in exchange for full denuclearization and verification.¹⁴¹ However, North Korea has found a better bargain by working closely with China, which has provided more than that amount of money per year, suggesting perhaps both North Korea's desire to keep raising the price on doing business and China's willingness to rent stability. For the United States and South Korea, this seems to suggest that the price of admission is not simply the half-billion-dollar down payment originally made for a summit meeting in 2000, but a far steeper economic package to begin closing the gap between the 99th and 13th largest economies in the world.

South Korea's Lessons Learned

President Lee Myung-bak entered office convinced that the main lesson from 10 years of the Sunshine

policy was the need for disciplining North Korea to understand that the price of prosperity would be denuclearization and that there would be no free handouts. However, the lesson that South Koreans have drawn from President Lee's conditional and "principled" approach is that it has pushed North Korea into China's ambit. The force driving South Korean sentiment is less a benign view of North Korea than a suspicion of China. If the ruling conservative Grand National Party loses its legislative majority in April and loses the Blue House in December, South Korea's approach to North Korea may undergo a 180-degree shift by February 2013.

Neither sunshine policies nor coercion has yet produced significant progress toward denuclearization. Some analysts can dispute whether a slow-down, or even a temporary freeze, represents progress, but there is no evidence to support the claim that either policy has reversed North Korean nuclear ambitions. Thus, many South Koreans may conclude that if nuclear weapons are a long-term problem, then the focus in the near-to-mid term should be on ensuring that North Korea does not slide too close to China and away from a path toward unification. There is a serious chance that South Korea will try to restore inter-Korean economic relations to the primary position, rather than watching China-DPRK ties grow to the point that they could have decisive implications for the future of Korean unification.¹⁴² Whatever South Koreans think about the regime in North Korea, they do not want to see North Korea become a *de facto* province of China.

As politics shift in South Korea, which they may given the upcoming elections, North-South policy and relations may shift accordingly.¹⁴³ South Korea has been interested to learn lessons from other divided states and reunification experiences.¹⁴⁴ However, South Korea still appears to need a consistent, long-term strategy that accords greater weight to North Korea's trade balance.¹⁴⁵

A leading proposal being discussed in Seoul is a return to the idea of building a highway from Seoul to Pyongyang, via Kaesong. In addition, some influential South Koreans are thinking that after President Lee completes his term, Seoul should not only build Kaesong to its full capacity but also build a second industrial park outside Pyongyang in the port city of Nampo. This infrastructure would truly advance North-South economic integration by building up the relatively wealthier and more geographically hospitable southwestern portion of North Korea.¹⁴⁶ The next South Korean government will go a long way to determining whether this vision is fanciful or prescient.

Implications for U.S. Policy

Given recent developments on the Korean peninsula, the United States must undertake a systematic strategic review of North Korea policy. The United States and its allies should revisit fundamental questions: What is the United States striving to achieve on the peninsula? What means will be used? What are the prospects for success? A review of the situation should incorporate economics with other vital issues, especially nuclear policy, the planned 2015 transfer of wartime operational control to South Korea and military-to-military contacts. Taken together, such a comprehensive review may provide new policy options for the way ahead.

At the same time, the United States needs to adopt a short-term policy of engagement and information collection, including food assistance to the North.

This policy is needed for three reasons.

1. The short-term need for engagement, information and probing is more urgent than the longer-term goal of denuclearization and may ultimately better serve that outcome.

Fixating on denuclearization as the sole driver of U.S. policy precludes the kind of probing and information gathering that should dominate

alliance policy. Holding everything else hostage to Six Party Talks (the diplomatic framework involving the two Koreas plus China, Japan, Russia and the United States, set up in 2003 to grapple with North Korea's nuclear programs) has not delivered positive results.

The United States must still attempt to stem the North's nuclear program. Seeking to rekindle those talks and at least freeze the North's nuclear program remains an important objective. Officials in the United States and South Korea were convinced that prior to Kim Jong-il's death, North Korea was on the verge of returning to Six Party Talks. The North appeared willing to freeze its Yongbyon nuclear reactor and refrain from a third nuclear test and long-range missile launches, while respecting the Armistice agreement to maintain a truce with the South. At the same time, the United States was ready to provide significant nutritional assistance. However, in the new context, it is not worthwhile to withhold other types of engagement and assistance; it is more important to increase contact with the fledgling leadership, determine who now has power in North Korea, buy some time to probe for new opportunities and possibly reduce the likelihood of provocations.¹⁴⁷ This is a unique window of opportunity.

U.S. policy has become hostage to a variety of shibboleths, from the notion that North Korea would easily be coerced to give up its main insurance policy of nuclear weapons to the belief that China would prioritize denuclearization over stability. Both ideas were pipe dreams. Waiting for China to use its economic weight to coerce North Korea regarding nuclear weapons ignores all the evidence: China did not rein in North Korea's nuclear ambitions after lethal uses of force in 2010, and China has been careful to structure its resource extraction and infrastructure investments in special economic zones to match Chinese interests. China spends money to preserve stability and,

increasingly perhaps, to ensure a permanent buffer state. The United States, along with South Korea and other allies, must face the possibility that China is settling in to support permanent division and secure a buffer state.

2. Engagement and probing are urgently needed to better understand North Korea's new leadership and to have even a chance of establishing a new chapter in U.S.-DPRK relations.

Although North Korean behavior defies easy prediction, it is generally true that the country eschews provocation when it is actively engaged.¹⁴⁸ Logically, North Korea has every incentive to observe a mourning period and avoid provocation before the April 15, 2012 centenary of North Korean founder Kim Il-sung. Yet some provocations may be pursued, especially if they do not result in fatalities. For example, North Korea's new leadership, keen to demonstrate military strength without completely alienating either China or South Korea, may decide to conduct missile tests. A third nuclear test may or may not cross a line with China, and the effect of such an action on democratic elections in South Korea is uncertain.

The United States needs a comprehensive policy. North Korea's burgeoning economic dependence on China – and the potential backlash that this may engender in South Korea – could expose U.S. interests to new risks for which there is currently no effective policy. A root-and-branch policy reassessment is necessary if the United States is to forge a new, comprehensive and coherent policy for dealing with economic developments in North Korea. Meanwhile, the United States should be seeking to open as many channels of dialogue and contact with the North as possible. Whereas South Korea opposed such engagement before Kim Jong-il's death, even President Lee understands the need to change tack in light of the new situation in the North.

U.S. policy currently discounts the most plausible economic trends – the North's growing dependence on China and the possibility of a South Korean about-face on economic engagement – and their military and political implications. Without preparing for a possible resurgence of North-South economic engagement, the United States could face both a wedge in the U.S.-South Korean alliance and a further erosion of leverage vis-à-vis the DPRK.¹⁴⁹

Engagement does not imply that Kim Jong-eun will be a more enlightened leader than his father. There is no reform movement in North Korea, and the need for the young leader to demonstrate authority undoubtedly gives the military an advantage. Yet taking the long view, who, besides China, will have strong relationships and economic ties with leaders inside North Korea? Contact with the United States and South Korea could forge new ties with the next generation of North Korean leaders during an era when information is pervasive and borders are permeable. It is a risk that Kim Jong-eun might be willing to take. At worst, engagement may yield a clearer picture of a secretive regime during a crucial period of transition.

In January 2012, the Assistant Secretary of State for East Asia and the Pacific, Kurt Campbell, stated that the United States preferred to seek “a new chapter” in relations with North Korea.¹⁵⁰ However, the offer was still predicated on North Korea returning to a clear roadmap to denuclearization. Officials in Seoul and Washington thought that such a deal had been outlined in Geneva in late October 2011. This type of deal would be desirable, but after the death of Kim Jong-il, the notion of holding up food assistance until the North returns to nuclear talks short-changes engagement exactly when it is most needed.¹⁵¹ Direct talks in Beijing in February offered the first public hint that North Korea might be persuaded to pick up discussions where they had been left off before Kim Jong-il's death.¹⁵²

If linking nutritional assistance to denuclearization made sense as a bargaining position prior to Kim Jong-il's death, it makes little sense afterward. Such talks are not likely to produce more than an unverifiable freeze. Meanwhile, the sudden rise of an uncertain leadership with an unknown decisionmaking process makes it imperative to open as many channels of communication and dialogue with North Korea as possible. Without dialogue, contact and people on the ground, the United States and South Korea are shut out of most opportunities for contact with North Korea.

A short-term policy of active engagement would include providing North Korea with generous humanitarian assistance. The United States has been slow to understand the benefits of providing significant humanitarian assistance to North Korea not only as a means of helping malnourished children, pregnant women and the elderly but also as a means of putting Americans and other relief specialists on the ground to see firsthand what is happening in North Korea. For instance, the delivery of 240,000 metric tons of food aid reportedly offered to North Korea in late 2011 would place some 45 aid workers in North Korea.¹⁵³

3. The U.S.-ROK agreement to prioritize denuclearization in North Korea policy may unravel following South Korean elections in 2012.

While opening channels of communication with the North, the U.S. policy review should also focus on preempting a possible crisis in the U.S.-South Korea alliance. The trend of the past decade will reach a turning point by next year. The April 2012 National Assembly election in South Korea is likely to result in the loss of the conservative ruling party's legislative majority. Whether the Grand National Party, the main opposition Democratic United Party or even an independent third party prevails in the December presidential election, the winning candidate is almost certain to press for reinvigorating economic ties with the North. South

Koreans are unlikely to countenance watching North Korea slip further into China's ambit. Such movement probably stirs anxiety in Pyongyang as well as Seoul.

If inter-Korean economic ties are revitalized, however, the United States will be faced with a potential alliance crisis. U.S. policy has been predicated on a tight alignment with South Korea, which has recently hewed closely to the principal U.S. objective of dealing with the North's nuclear program. South Korean President Lee Myung-bak has single-mindedly focused on the North's nuclear threat. In exchange for embracing America's major goal, Seoul has received Washington's complete political backing. However, this unprecedented degree of alliance cohesion has come at the price of being ill-prepared to engage with North Korea during its historic power transition. Economic development has been held back as an incentive for cooperation on denuclearization.

If the next government in Seoul decouples disarmament and economic cooperation, Washington policymakers could find themselves working at cross purposes with their ally. The Kaesong Industrial Complex – and through it, greater North-South commerce – could drive a wedge in the U.S.-ROK alliance. The bilateral alliance has enjoyed great success in recent years, but the pendulum may be about to swing back in the other direction. South Korea may soon experience a backlash from the recent tight alignment with U.S. policy. There is no doubt that South Korea has paid a certain price for tightly aligning with U.S. policy, especially its priority on denuclearization. As a result, South Korea has watched China pick up the economic partnership with North Korea.

VII. CONCLUSION

The Kaesong Industrial Complex could be reignited, vastly expanded and then joined by other major investments, such as the long-awaited expressway to Pyongyang. It could even be replicated in the North Korean port city of Nampo, the site of the very first South Korean industrial investment in the North.

Renewed economic engagement between North and South Korea would be an important precursor to preventing conflict on the peninsula. It should take place in the context of a bottom-up policy review that holistically evaluates economic trends, nuclear issues, the 2015 transfer of operational control from the United States to South Korea and the need to establish regular military-to-military contacts with North Korea during its time of transition. Predicting the future of North Korea is a perilous task. Yet by mixing engagement with a serious review of national and alliance policy options for 2013 and beyond, the United States can minimize friction in its alliance with South Korea and retain leverage for shaping the future regional security environment.

ENDNOTES

1. North Korea is formally known as the Democratic People's Republic of Korea, DPRK. South Korea is formally known as the Republic of Korea, ROK.
2. Victor Cha, "What Not to Do about North Korea," *The Diplomat*, January 13, 2012, <http://the-diplomat.com/2012/01/13/what-not-to-do-about-north-korea/>.
3. Although there are clear differences between economic investments and humanitarian assistance, this paper is interested in all economic engagement, even while appreciating different purposes, types, and levels of activity.
4. See GI Korea, "South Korean Government to Revitalize Operations at the Kaesong Industrial Complex," ROK Drop, February 15, 2012, http://www.nktoday.com/index.php/contents/view_content/8011/south-korean-government-to-revitalize-operations-at-the-kaesong-industrial-complex; and "Seoul to Partially Lift Restrictions on Biz Complex in N. Korea," *The Dong-a Ilbo*, February 16, 2012, <http://english.donga.com/srv/service.php3?biid=2012021611808>.
5. There are some notable exceptions, including extensive writing by Stephan Haggard and Marcus Noland. Their most recent works include: "Engaging North Korea: The Role of Economic Statecraft," Policy Studies 59 (East-West Center, 2011); "Sanctioning North Korea: The Political Economy of Denuclearization and Proliferation," *Asian Survey*, 50 no. 3 (May/June 2010), 539-568; and "North Korea in 2008: Twilight of the God?," *Asian Survey*, 49 no. 1 (January/February 2009), 98-106. Bernhard Seliger and Werner Pascha have edited a useful recent volume on the North Korean political economy, *Towards a Northeast Asian Security Community: Implications for Korea's Growth and Economic Development* (New York: Springer, 2011). Semoon Chang and Hwa-Kyung Kim have written an excellent essay, "Inter-Korean Economic Cooperation," in *The Survival of North Korea: Essays on Strategy, Economics and International Relations*, ed. Suk Hi Kim, Terence Roehrig and Bernhard Seliger (Jefferson, NC and London: McFarland & Company, Inc., 2011), 86-96. Scott Snyder puts China-North Korean economic issues within a broader context in *China's Rise and the Two Koreas: Politics, Economics, Security* (Boulder, CO: Lynne Rienner Publishers, 2009). For analysis of earlier North Korean economic reforms, see: Richard Tait, "Playing the Rules in Korea: Lessons Learned in North-South Economic Engagement," *Asian Survey*, 43 no. 2 (March/April 2003), 305-328; Christopher D. Hale, "Real Reform in North Korea? The Aftermath of the July 2002 Economic Measures," *Asian Survey*, 45 no. 6 (November/December 2005), 823-842; and Robert L. Carlin and Joel S. Wit, *North Korean Reform*, International Institute for Strategic Studies Adelphi Paper 382 (London: Taylor and Francis, 2006).
6. A brief word on the research for this paper: I have been fortunate to make frequent trips to South Korea in the past 18 months, thanks in large measure to a grant from the Korea Foundation. I have benefitted from access to senior officials in both countries, including Minister of Unification Yu Woo-ik and his predecessor, Hyun In-taek. I have conducted dozens of interviews with other officials and leading experts involved in North Korea policy and the Kaesong Industrial Complex. These interviews, combined with extensive research of available books, journal articles and press stories, gave me a rich, detailed view of issues vital to this report. The North-South tensions that prevailed after the military provocations of 2010 made it impossible for me to make a personal visit to the Kaesong Industrial Complex. However, I was given a VIP tour of the joint customs area located at the DMZ, as well as direct access to senior South Korean officials responsible for the industrial zone and North Korean policy. Fortunately, Mark Manyin of the Congressional Research Service had been able to visit Kaesong prior the clampdown on foreign visitors; he was very helpful in the formative stages of my research, and I benefitted greatly from his excellent research. I have not tried to replicate his effort at outlining the specific details of the Kaesong Industrial Complex, but instead have aimed to explain the implications of recent South Korean and Chinese economic relations with North Korea and why Kaesong could be a solution. Professor Lim Eul-chul of Kyungnam University was generous with his time and expertise; not only is he one of South Korea's leading experts on the North Korean economy, he has also written the only comprehensive book on the Kaesong Industrial Complex.
7. Kim Yong Hun, "Kaesong Still Growing," NK Net, December 2, 2011.
8. Ralph Michael Wrobel, "Inter-Korean Cooperation in Special Economic Zones: Developments and Perspectives," in Seliger and Pascha, eds., *Towards a Northeast Asian Security Community: Implications for Korea's Growth and Economic Development*, 178. In addition to the acres indicated for the facilities, another 19,000 or so acres would be used for a regional support zone in the Kaesong urban area.
9. Although the original Memorandum of Understanding called for 350,000 North Korean workers, South Korean officials managing the Kaesong Industrial Complex said they could accommodate 500,000. This is based in part on an interview with Moon Moo-hong in Seoul on June 14, 2011. Moon Moo-hong served as President and Chairman of the Kaesong Industrial District Foundation and Kaesong Industrial District Management Committee, the institutions established for inter-Korean governance of the industrial park and its neighboring region. He stepped down from those positions in late 2011.
10. Ibid.
11. Ibid.
12. See table of estimates of unification costs in Deok Ryong Yoon, "Toward a Northeast Asian Security Community: Implications for South Korea's Economic Growth," in Seliger and Pascha, eds., *Towards a Northeast Asian Security Community: Implications for Korea's Growth and Economic Development*, 201.
13. "Daewoo Shipbuilding to Enter Economic District in N. Korea," *The Dong-a Ilbo*, February 11, 2012, <http://english.donga.com/srv/service.php3?biid=2012021134658>.
14. One recent analysis strongly advocates making the Kaesong Industrial Complex the catalyst for future North-South economic cooperation. See Cho Bong-hyun, "Kaesong Industrial Complex Development and Inter-Korean Relations," *Korea Focus*, January 2012, http://www.koreafocus.or.kr/design3/essays/view.asp?volume_id=117&content_id=103858&category=G.
15. Selig S. Harrison, *Korean Endgame: A Strategy for Reunification and U.S. Disengagement* (Princeton, N.J.: Princeton University Press for the Century Foundation, 2002), 44.

16. Quoted in Chung-in Moon, "Understanding the DJ Doctrine: The Sunshine Policy and the Korean Peninsula," in *Kim Dae-jung Government and Sunshine Policy: Promises and Challenges*, ed. Chung-in Moon and David I. Steinberg (Seoul: Yonsei University Press, 1999), 36-37.
17. "South Korea's Aid to North Korea Reaches New Record," Korean Information Service Report, December 4, 2006, <http://reliefweb.int/node/220144>.
18. This is the estimate of Stephan Haggard and Marcus Noland, *Famine in North Korea: Markets, Aid, and Reform* (New York: Columbia University Press, 2007). Although these figures are lower than the estimate of up to two million deaths from the famine posited by Andrew S. Natsios in *The Great North Korean Famine* (Washington: United States Institute of Peace Press, 2001), Haggard and Noland benefitted from better empirical information for their later study. Even so, some analysts do not rule out the higher casualty rate put forth by Natsios, in part because North Korea could hardly report death by starvation. On this last point, see Barbara Demick, *Nothing to Envy: Ordinary Lives in North Korea* (New York: Spiegel & Grau Trade Paperbacks, 2010), 145.
19. Chung-in Moon, "Understanding the DJ Doctrine: The Sunshine Policy and the Korean Peninsula," 37.
20. *Ibid.*, 43-44.
21. Lim Eul-chul, *Kaesong Industrial Complex: History, Pending Issues, and Outlook* (Seoul: Haenam Publishing Co., 2007), 7.
22. Sung Chul Kim and David C. Kang, eds., *Engagement with North Korea: A Viable Alternative* (Albany, N.Y.: State University of New York Press, 2009), footnote 28, 169.
23. Lim Eul-chul, *Kaesong Industrial Complex*, 8.
24. "Address by President Kim Dae-jung of the Republic of Korea, Lessons of German Reunification and the Korean Peninsula," *Le Monde*, March 9, 2000, <http://www.monde-diplomatique.fr/dossiers/coree/A/coree2000>.
25. *Ibid.*
26. Some 1.93 million visitors paid to go to the resort between 1998 and 2008; South Koreans accounted for all but 12,817, or less than 1 percent, of the visitors. See "North Korea Shoots Itself in the Foot Again," *Chosun Ilbo*, August 23, 2011, http://english.chosun.com/site/data/html_dir/2011/08/23/2011082301021.html.
27. Lim Eul-chul, *Kaesong Industrial Complex*, 16-17.
28. *Ibid.*
29. Kim Jong-il reportedly made this explicit in explaining to one interlocutor why he turned down a request from Samsung to create an industrial park of its own. See Lim Eul-chul, *Kaesong Industrial Complex*, 22.
30. For a synopsis of the historical importance of Kaesong, see Lim Eul-chul, *Kaesong Industrial Complex*, 20.
31. *Ibid.*, 42-43.
32. *Ibid.*, 42-43.
33. See Victor Cha, "DPRK Briefing Book: North Korea's Economic Reforms and Security Intentions," Testimony for the Foreign Relations Committee of the United States Senate, March 2, 2004.
34. See Mark E. Manyin and Dick K. Nanto, *The Kaesong North-South Korean Industrial Complex* (Washington: Congressional Research Service, April 18, 2011).
35. *Ibid.*
36. Interviews with ROK Ministry of Unification officials in June, September and December 2011.
37. "Declaration on the Advancement of South-North Korean Relations, Peace and Prosperity," October 4, 2007, http://www.ncnk.org/resources/publications/North-South%20Declaration.doc/file_view.
38. Interview with Moon Moo-hong, Seoul, December 10, 2011.
39. Scott Rembrandt, "'Peace in our Time' at What Cost? Possible Financial and Legal Implications of Denuclearizing North Korea," in *Toward Sustainable Economic and Security Relations in East Asia: U.S. and ROK Policy Options*, Joint U.S.-Korea Academic Studies 18 (Korea Economic Institute, 2008), 118.
40. Nam Seong-uk, "Lee Myung-bak's North Korean Policy Initiatives," *The Hankyoreh*, August 28, 2007, http://english.hani.co.kr/arti/english_edition/e_opinion/232017.html.
41. Um Jong-sik, "No More Provocations in West Sea," *Korea Times*, May 23, 2011, http://www.koreatimes.co.kr/www/news/opinion/2012/02/198_87497.html.
42. See World Food Programme website on Korea, Democratic People's Republic (DPRK), <http://www.wfp.org/countries/korea-democratic-peoples-republic-dprk>.
43. "North Korea Keeps Door Open to Food-Nuke Deal with U.S.," *USA Today*, January 11, 2012, <http://www.usatoday.com/news/world/story/2012-01-11/North-Korea-food-aid-nuke/52492872/1>.
44. Manyin and Nanto, *The Kaesong North-South Korean Industrial Complex*.
45. Interview with Moon Moo-hong, June 14, 2011. Interestingly, North Korea insisted that South Korea transfer all payments, including all wages, to Pyongyang in U.S. dollars, from which workers are paid up to half of their earnings in North Korean currency and in-kind goods.
46. Perhaps 30 to 40 percent of South Korean businesses are making a profit in the Kaesong Industrial Complex, although fewer businesses report that they are doing so. This is according to Moon Moo-hong, who until the fall of 2011 was the top South Korean official in charge of administering the complex. Interview with Moon Moo-hong in Seoul, December 10, 2011.
47. "Fire-Ruined South Korean Investor in Kaesong Appeals to Government for Help," *Yonhap News Agency*, January 16, 2012, <http://english.yonhapnews.co.kr/national/2012/01/16/90/0301000000AEN20120116003000315F.HTML>.

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49. Cho Bong-hyun, "Kaesong Industrial Complex Development and Inter-Korean Relations."
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52. Stephen Haggard and Marcus Noland, "North Korea's External Economic Relations," Working Paper 07-7 (Peterson Institute for International Economics, August 2007).
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54. Choe Sang-hun, "South Korea to Send \$5.7 Million in Aid to North Korea," *The New York Times*, December 5, 2011, http://www.nytimes.com/2011/12/06/world/asia/seoul-to-send-5-7-million-in-aid-to-north-korea.html?_r=1. Also see Cho Bong-hyun, "Kaesong Industrial Complex Development and Inter-Korean Relations."
55. Donald Kirk, "Leftist Wins Mayor Race: How It Could Alter South Korea's Ties with North Korea," *Christian Science Monitor*, October 26, 2011, <http://www.csmonitor.com/World/Asia-Pacific/2011/10/26/Leftist-wins-Seoul-mayoral-race-How-it-could-alter-South-Korea-s-ties-with-North-Korea>.
56. See Heo Seoni, "Survey Shows Experts Back Ryu," *Daily NK*, December 13, 2011, <http://www.dailynk.com/english/read.php?catald=nk00100&num=8526>.
57. "North Korea 'Never to Deal' with Lee MB Administration," *The Dong-a Ilbo*, December 31, 2011, <http://english.donga.com/srv/service.php3?bicode=050000&biid=2012010164948>. It is also noteworthy that the only senior South Korean delegation to visit North Korea during its official memorial period was led by the former first lady Lee Hee-ho (Kim Dae-jung's widow) and Hyun Jeong-eun, chairman of the Hyundai Group. See Evan Ramstad, "North Korea Paints a Picture of Stability," *The Wall Street Journal*, December 27, 2011, <http://online.wsj.com/article/SB10001424052970203391104577121440190983520.html>.
58. Jiyeon Lee, "South Korea Ready for 'New Era' of Relations with North, President Says," *CNN*, January 1, 2012, http://articles.cnn.com/2012-01-01/asia/world_asia_south-korea-president-speech_1_pyongyang-national-defense-commission-lee-myung-bak?_s=PM:ASIA.
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68. "Inter-Korean Trade Drops 10 Percent Last Year," Yonhap News Agency, January 14, 2012, <http://english.yonhapnews.co.kr/national/2012/01/14/95/0301000000AEN20120114001500315F.HTML>.
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70. Interviews with South Korean officials in June, September and December 2011.
71. Interview in Seoul, June 2011.
72. "N. Korea Appears to Crackdown on Choco Pies in Kaesong," *Chosun Ilbo*, October 20, 2011, http://english.chosun.com/site/data/html_dir/2011/10/20/2011102000862.html.
73. Interviews with South Korean officials in Seoul, June and September 2011.
74. *Ibid.*
75. Although it is interesting to note that in the immediate aftermath of Kim Jong-il's death, there were no reported instances of disrespect for the departed leader or the regime.
76. See David L. Asher, Victor D. Comras and Patrick M. Cronin, *Pressure: Coercive Economic Statecraft and U.S. National Security* (Washington: Center for a New American Security, January 2011); and Haggard and Noland, "North Korea's External Economic Relations."

77. This is both figuratively and literally the case, according to an off-the-record discussion with one Western ambassador to North Korea that took place on January 23, 2012. According to the ambassador, Kim Jong-eun's wardrobe and poses were meant to evoke both his grandfather and his father.

78. Kim Jong-il had 20 years of grooming to take over and was involved in nuclear and other sensitive policies. Some surmise that Kim Jong-eun was not tapped as successor recently but as early as 2001, when the eldest son, Kim Jong-nam, was arrested trying to visit Tokyo Disneyland (an indication that Kim Jong-nam was no longer in the running to succeed his father). Even so, Kim Jong-eun's younger age kept him away from serious posts until recently.

79. A senior U.S. official reports that a Chinese official described North Korea in this way: It will be run by Kim and the Party, with the military's influence unspoken, perhaps because of China's hope to ensure that political control can be maintained over the armed forces in North Korea (and perhaps even in China). Interview with senior U.S. official, January 2012.

80. The apparent resumption of talks between the United States and North Korea, which had been slated to occur in December 2011 until Kim Jong-il's death forced their cancellation, may be the first public sign that Kim Jong-eun plans to carry on his father's plan to return to limited engagement. See "U.S., DPRK Envoys to Hold Talks in Beijing," *Xinhua*, February 14, 2012, http://www.moody.com/research/Moodys-adjusts-ratings-of-9-European-sovereigns-to-capture-downside--PR_237716.

81. Blaine Harden, "North Korean Currency Crackdown Fuels Inflation, Food Shortages," *The Washington Post*, January 7, 2010.

82. Based on gross domestic product (GDP) purchasing power parity in 2010, *The World Factbook* ranked North Korea 99th in the world. North Korea's economy further contracted in 2010, which probably knocked North Korea from the world's top 100 economies. See Central Intelligence Agency, *The World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html>. Regarding the size of global armies, see the International Institute for Strategic Studies' annual volume, *The Military Balance* (London: Routledge). Only China, the United States and India have more men and women in military uniform than North Korea.

83. The U.S. State Department says that perhaps a quarter of North Korea's gross national income is spent on its armed forces; see U.S. Department of State, "Background Note: North Korea," October 31, 2011, <http://www.state.gov/r/pa/ei/bgn/2792.htm>. Among 172 countries ranked in *The World Factbook*, the highest percentage of GDP spent on the military is Oman at 11.4 percent; North Korea is not ranked. See *The World Factbook* at <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2034rank.html>.

84. Views differ on this, and some respected experts see problems emerging within two years. Certainly, immediate reporting after the funeral of Kim Jong-il has reinforced continuity in North Korea. For instance, see "North Korean Military Shows No Abnormality after Kim's Death: Official," *Yonhap News Agency*, January 24, 2012, <http://english.yonhapnews.co.kr/national/2012/01/24/60/0301000000AEN20120124002000315F.HTML>.

85. See Elaine Kurtenbach, "Leader's Death Puts North Korea Economic Reforms on Hold," *USA Today*, December 22, 2011, <http://www.usatoday.com/money/world/story/2011-12-22/north-korea-economy/52157060/1>.

86. Ibid.

87. This is the estimate of the Bank of Korea. See In-Soo Nam, "BOK: NK's Economy Shrank Again in 2010," *The Wall Street Journal*, November 3, 2011, <http://blogs.wsj.com/korearealtime/2011/11/03/bok-nks-economy-shrank-again-in-2010/>.

88. These are based on 2010 data as estimated by the Central Intelligence Agency. See *The World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html>.

89. See "South Korea GDP," Trading Economics.com, <http://www.tradingeconomics.com/south-korea/gdp>.

90. Quoted in Jonathan Watts and Tania Branigan, "North Korea's Leader Will Not Last Long, Says Kim Jong-un's Brother," *The Guardian*, January 17, 2012, <http://www.guardian.co.uk/world/2012/jan/17/north-korea-leader-not-long>.

91. For instance, see Andray Abrahamian, "A Convergence of Interests: Prospects for Rason Special Economic Zone" (Korea Economic Institute Academic Paper, February 24, 2012).

92. "Report: China Agrees to Invest \$3b in N.K. Zone," *Korea Herald*, February 15, 2012, <http://www.koreaherald.com/national/Detail.jsp?newsMLId=20120215001117>.

93. Ibid.

94. Robert Carlin and John W. Lewis, "North Korea's New Course," *Los Angeles Times*, December 8, 2011, <http://articles.latimes.com/2011/dec/08/opinion/la-oe-carlin-nkorea-20111208>.

95. Ibid.

96. Ibid.

97. Ibid.; and "Russia-Rajin (Rason) Railway Compendium," *North Korean Economy Watch*, KCNA, October 13, 2011, <http://www.nkeconwatch.com/2011/10/13/russian-delegation-in-nkorea-to-discuss-rail-project/>.

98. Based on 2010 data, China is ranked 2nd in world GDP (purchasing power parity), behind only the United States. I exclude the number one ranking of the European Union, because it is not one country. See *The World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html>.

99. Based on 2010 data, the ROK is ranked 12th in world GDP (purchasing power parity) when excluding the European Union as a single entity. Ibid.

100. In the wake of the sinking of *Cheonan* and the shelling of Yeonpyeong Island in 2010, South Korea added the additional precondition that North Korea must take responsibility for its provocations to re-initiate a healthy North-South dialogue.

101. "Daewoo Shipbuilding to Enter Economic District in N. Korea," *The Dong-a Ilbo*, February 11, 2012, <http://english.donga.com/srv/service.php3?biid=2012021134658>.

102. Sunny Lee, "Chinese Perspectives on North Korea and Korean Unification" (Korea Economic Institute, January 24, 2012).
103. For instance, see Scott A. Snyder, "Kim Jong-un's Dangerous Brother," *CNN*, January 22, 2012, <http://globalpublicsquare.blogs.cnn.com/2012/01/22/kim-jong-uns-dangerous-brother/>. It's not clear what Kim's plans are, given reports in mid-February 2012 that he had been kicked out his hotel suite in Macau. See "Kim Jong Il's Eldest Son Kicked out of Macau Hotel," *Daily Telegraph*, February 19, 2012, <http://www.todayonline.com/Hotnews/EDC120219-0000010/Kim-Jong-Ils-eldest-son-kicked-out-of-Macau-hotel>.
104. See "China Set to Distort Korean History via Completion of Project," *The Dong-a Ilbo*, January 12, 2012, <http://english.donga.com/srv/service.php3?biid=2012011261288>.
105. Indeed, Robert Carlin and John Lewis argue that North Korea has given up on the idea that the United States would ever be a reliable economic partner. See Carlin and Lewis, "North Korea's New Course."
106. For instance, see President Lee Myung-bak "Keynote Speech at the 64th UN General Assembly" (United Nations, New York, September 2009), <http://news.mofat.go.kr/enewspaper/articleview.php?master=&aid=2346&ssid=23&mvid=701%20>.
107. Interview with Lim Eul-chul, December 2011.
108. See Bomi Lim, "North Korean Dependence on China Trade Rises as Sanctions Worsen Isolation," *Bloomberg News*, May 27, 2011, <http://www.bloomberg.com/news/2011-05-27/north-korean-dependence-on-china-trade-rises-as-sanctions-worsen-isolation.html>; and Kim Kyung-ho, "Concerns Mount over China's Grip on N.K. Economy," *Korea Herald*, January 31, 2012, <http://www.koreaherald.com/national/Detail.jsp?newsMLId=20120131001012>.
109. Chinese trade with North Korea reached nearly \$3 billion in the first six months of 2011. See Jim Trippon, "China Faces Uncertainty with North Korea" (Trippon Financial Research, Inc., December 26, 2011), <http://www.globalprofitsalert.com/china-stock-digest/china-faces-uncertainty-with-north-korea-119638>.
110. Nathaniel Aden, "North Korean Trade with China as Reported in Chinese Customs Statistics: 1995-2009 Energy and Minerals Trends and Implications" (Nautilus Institute, June 8, 2011), http://www.nautilus.org/publications/essays/napsnet/reports/summaries/2011/DPRK_PRC_Trade_Aden.
111. Interview with ROK Ministry of Unification intelligence officials, December 2011.
112. John S. Park, "How China Can Bring Sunshine to Korea," *Far Eastern Economic Review*, 169 no. 5 (June 2006), 29-31.
113. Drew Thompson, *Silent Partners: Chinese Joint Ventures in North Korea* (Washington: U.S.-Korea Institute, February 2011), 4, http://uskoreainstitute.org/wp-content/ploads/2011/02/USKI_Report_SilentPartners_DrewThompson_ExecSum3.pdf.
114. An earlier effort to create a Tumen River Area Development Project, which had significant backing from the United Nations Development Program, failed to lure investment. See, for instance, Christopher W. Hughes, "Tumen River Area Development Programme: Frustrated Micro-Regionalism as a Microcosm of Political Rivalries," Working Paper No. 57/00 (Centre for the Study of Globalisation and Regionalisation, August 2000), <http://www2.warwick.ac.uk/fac/soc/csg/research/workingpapers/2000/wp5700.pdf>.
115. Scott Snyder, "Rajin-Sonbong: A Strategic Choice for China in Its Relations with Pyongyang," *China Brief*, 10 no. 7, April 1, 2010, [http://www.jamestown.org/programs/chinabrief/single/?tx_ttnews\[tt_news\]=36215&cHash=b8c79b916c](http://www.jamestown.org/programs/chinabrief/single/?tx_ttnews[tt_news]=36215&cHash=b8c79b916c). Also see "Exogenous Zones: An Opening for Chinese Investment in a Benighted Country," *The Economist*, June 16, 2011, <http://www.economist.com/node/18836790/print>.
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117. Jeremy Page, "Trade Binds North Korea to China," *The Wall Street Journal*, December 24, 2011, <http://online.wsj.com/article/SB10001424052970203686204577116162967853258.html>. See also U.S.-China Economic and Security Review Commission, *2011 Report to Congress*, November 2011, 247-248.
118. Scott A. Snyder, "Rajin-Sonbong: North Korea's (New?) Strategy to Attract Foreign Investment," Council on Foreign Relations, December 3, 2010, <http://blogs.cfr.org/asia/2010/03/11/rajin-sonbong-north-korea%E2%80%99s-new-strategy-to-attract-foreign-investment/>.
119. Michael Schuman, "The Hermit Kingdom's Bizarre SAR," *Time*, September 30, 2002, <http://www.time.com/time/magazine/article/0,9171,356131,00.html>.
120. Jeremy Page, "Trade Binds North Korea to China," *The Wall Street Journal*, December 24, 2011, <http://online.wsj.com/article/SB10001424052970203686204577116162967853258.html>.
121. U.S.-China Economic and Security Review Commission, *2011 Report to Congress*, November 2011, 248.
122. Interview with Western ambassador to North Korea, Washington, January 23, 2012.
123. Thompson, *Silent Partners: Chinese Joint Ventures in North Korea*, 4. I am indebted to Scott Snyder for underscoring this observation.
124. *Ibid.*, 4-8.
125. U.S.-China Economic and Security Review Commission, *2011 Report to Congress*, November 2011, 247.
126. *Ibid.*, 248.
127. Bomi Lim, "North Korean Dependence on China Trade Rises as Sanctions Worsen Isolation."
128. Drew Thompson quoted in U.S.-China Economic and Security Review Commission, *2011 Report to Congress*, November 2011, 246.
129. Hilary Clinton, "America's Pacific Century," *Foreign Policy*, October 11, 2011, <http://www.state.gov/secretary/rm/2011/10/175215.htm>. Regarding

China's push back, including possibly over North Korea, see Patrick M. Cronin, "Power Play," *Foreign Policy*, January 5, 2012, http://www.foreignpolicy.com/articles/2012/01/05/power_play.

130. For one analysis of the U.N. Panel of Experts, see Mary Beth Nikitin, Emma Chanlett-Avery, Mark Manyin, Dick K. Nanto, Dianne Rennack and Mi Ae Taylor, "Implementation of U.N. Security Council Resolution 1874" (Congressional Research Service Memorandum, October 8, 2010), <http://lugar.senate.gov/issues/foreign/reports/NKoreaCRSReport.pdf>.

131. Jeremy Page, "Luxuries Flow into North Korea," *The Wall Street Journal*, January 7, 2012, <http://online.wsj.com/article/SB10001424052970204331304577142372171328622.html>.

132. Ibid.

133. Assistant Foreign Minister Liu Zhenmin quoted in "Continuously Developing Ties with DPRK Unwavering Policy of China: Diplomat," Xinhua, January 8, 2011, http://eng.chinamil.com.cn/news-channels/today-headlines/2012-01/09/content_4762947.htm.

134. Ibid.

135. Ibid.

136. Clearly, some analysts judge the political transition in North Korea as an opportunity for prudent exploration of new openings. See Victor Hsu, "The DPRK Interregnum: Window of Opportunity for the International Community" (Nautilus Institute, January 10, 2012), <http://www.nautilus.org/publications/essays/napsnet/forum/1201HSU>.

137. This is the view of Dr. Antonio Betancourt, Director, Universal Peace Federation Office of Peace and Security Affairs; see "Summary of Proceedings: Regional Perspectives of the Korean Peninsula after the November Asian Summits," December 14, 2011.

138. These conclusions are based largely on my interviews with both officials and North Korean experts in South Korea throughout the past year.

139. "Myanmar Wins Plaudits for Long-Awaited Release of Prominent Political Prisoners," *The Washington Post*, January 14, 2012, http://www.washingtonpost.com/world/asia-pacific/myanmar-wins-plaudits-for-long-awaited-release-of-prominent-political-prisoners/2012/01/14/gIQAuGuxP_story.html.

140. Furthermore, if Burma were to become an active member of the international community in good standing, then it would largely have to desist from befriending North Korea.

141. This proposal was made by Michael O'Hanlon and Mike M. Mochizuki in *Crisis on the Korean Peninsula: How to Deal with a Nuclear North Korea* (New York: McGraw-Hill, 2003); see the review by Selig S. Harrison, "The North Korean Conundrum," *The Nation*, May 20, 2004, <http://www.thenation.com/article/north-korean-conundrum?page=0,4>.

142. This view is shared by many people interviewed, including Park In-kook, President of the Korea Foundation Advanced Studies, whom I interviewed in Washington on December 5, 2011.

143. Even the heralded Korea-U.S. Free Trade Agreement could be reexamined by a more left-wing Korean government. This would be ironic, given the tough scrutiny some members of Congress gave the trade accord because of concern that trading goods produced in Kaesong could subsidize North Korea's nuclear program. From the first production in December 1994 through March 2011, only 9 percent of the total production has been exported, leaving 91 percent of the more than \$1.2 billion in goods consumed domestically on the Korean peninsula. The \$110 million value of the exported goods included mostly textiles headed to Australia, Russia and Europe. To ease passage of the free trade agreement, President Obama signed an executive order banning the direct and indirect entry of goods made in North Korea, including the Kaesong complex. Lee Chi-dong, "Obama's Executive Order Aims to Ban Imports of Kaesong Products: CRS Official," Yonhap News Agency, June 16, 2011, <http://english.yonhapnews.co.kr/national/2011/06/16/13/0301000000AEN20110616000100315F.HTML>.

144. For instance, the ROK Ministry of Unification has studied the example of Hong Kong and its gradual integration and yet autonomous governments. See Greg Torode, "One Step Closer to a Single Korea?," *South China Morning Post*, January 17, 2012.

145. This view appears to be shared by Jean-Jacques Grauhar, Secretary General of the European Union Chamber of Commerce in Korea. See Kim Young-jin, "Seoul Needs Long-Term North Korea Plan," *Korea Times*, January 19, 2012, http://www.koreatimes.co.kr/www/news/nation/2012/01/116_103210.html.

146. Based on interviews with officials and experts in Seoul in June, September and December 2011.

147. For instance, see Mark E. Manyin, *Kim Jong-il's Death: Implications for North Korea's Stability and U.S. Policy* (Congressional Research Service, December 22, 2011), especially pages 7-8.

148. Victor Cha's research on when North Korea commits provocations shows a strong tendency of the North not to provoke when it is heavily engaged in negotiation and contact. For instance, see Shaun Tandon, "U.S. Shakes Up North Korea Team for New Talks," *Defense News*, October 19, 2011, <http://www.defensenews.com/article/20111019/DEFSECT04/110190305/U-S-Shakes-Up-North-Korea-Team-New-Talks>.

149. A South Korean government think tank broached the subject of recognizing North Korea as a de facto nuclear power, hinting at the kind of debate that exists within South Korea. Many South Koreans, notwithstanding the provocations of 2010, are interested in pursuing economic ties with North Korea. See "Think Tank Upsets Gov't with Thoughts on Nuclear N. Korea," *Chosun Ilbo*, February 3, 2012, http://english.chosun.com/site/data/html_dir/2012/02/02/2012020201534.html.

150. Kim Hee-jin, "U.S. Diplomat Tells North Korea a 'New Chapter' is Possible," *Korea Joongahn Daily*, January 21, 2012, <http://koreajoongangdaily.joinsmsn.com/news/article/article.aspx?aid=2947372&cloc=rss%7Cnews%7Cjoongangdaily>.

151. South Korea belatedly offered modest humanitarian assistance toward the end of 2011 in its quest to show some greater flexibility. Meanwhile, the United States held back on offering serious food assistance, despite both U.N.

and USAID confirmation in 2011 that millions of North Koreans were at risk of malnutrition. The sole U.S. aid link that remained open was for discussing the return of the remains of those killed during the Korean War. Interview with senior U.S. government official, February 2012.

152. Brian Spegele and Alastair Gale, "U.S., North Korea Extend Discussions," *The Wall Street Journal*, February 24, 2012, <http://online.wsj.com/article/SB10001424052970204778604577240882501367456.html?KEYWORDS=us+north+korea+extend+discussions>.

153. Interviews with senior representative of the U.S. government and international relief agencies, February 2012.

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