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# Ten years of Kaesong Industrial Complex: a brief history of the last economic cooperation project of the Korean peninsula

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**Abstract:** After five months the special economic zone Kaesong Industrial Complex (KIC) in North Korea was reopened again on 16 September 2013. By this way, it is the last remaining centrepiece of North–South economic cooperation on the Korean peninsula. Established during the period of “Sunshine policy” (1998 – 2007) and opened in 2003 the project was controversial from the first beginning. This article will give an overview about the history of the project explaining its economic importance for both sides and the peaceful development in Korea. While KIC was assumed to strengthen inter-Korean relations, to improve knowledge of North Koreans about market economy, competition and democracy at all, it failed. What remains is a possibility for North Korea to earn money from the South – and for South Korea a possibility to use the cheap labour force of the North. In contrast, all political attempts grasped at nothing. Therefore, also the last remaining relict of this era should be closed down finally.

**Keywords:** Special Economic Zones, economic and political cooperation, North Korea, South Korea

## 1. Introduction

After five months of political confrontation on the Korean peninsula, the special economic zone Kaesong Industrial Complex (KIC) in North Korea was reopened again on 16 September 2013. By this way, it is the last remaining project of North–South economic cooperation in Korea. In the past decade, proponents of the project talked about an “ambitious experiment” (Kim Suk-hi, 2008), a “Mecca for inter-Korean business” or a “living organism that grows up every day” (Kim Dong-geun, 2006: 2-3). With taking up an area of 66 km<sup>2</sup> it was planned to become far bigger than any other industrial zone in either China or South Korea (Kim Young-

yoona, 2008: 4). In contrast, KIC can be seen as a growing source of foreign exchange for the communist government in Pyongyang supporting the survival of the regime (Nanto/Manyin, 2007: 2). Therefore, the project was controversial from the first beginning.

When South Korean “Sunshine-Policy” was replaced by a more demanding North-policy in 2008 all other cooperation projects on the Korean peninsula were interrupted. Since an incident in summer 2008 when a female tourist from South Korea was shot and killed by a North Korean soldier in Mount Kumgang, tourist tours to Mount Kumgang have been suspended. Until now this SEZ is closed. A new low-point was reached in spring 2010 when a South Korean warship was torpedoed by the North. While the South Korean government announced the cessation of inter-Korean exchanges and other sanctions against Pyongyang, the Kaesong Industrial Complex was maintained as the last inter-Korean cooperation project at work. When tensions between both Koreas rose in spring 2013 again, also the SEZ in Kaesong was closed by the North Korean government. That seemed to be the final deathblow for this last cooperation project on the Korean peninsula and the cooperation policy at all. Now, the project seems to be going on. But why it seems to be so important for both countries? This article will give an overview about the history of the project as well as an explanation of its economic importance for both sides and the peaceful development in Korea. Last but not least, it will show if there are chances to use the project to improve the North-South Korean relations in the future.

## **2. Economic Reforms in North Korea and Sunshine Policy**

Already in the early 1990s, when the breakdown of the socialist bloc led to economic difficulties in North Korea, attempts to attract FDIs were strengthened. The establishment of free economic areas was the most significant institutional innovation (Nam, 2005: 195). For instance, already in 1990, North Korea established a first SEZ in the Rajin-Sonbong area in the so called Golden Triangle between Korea, China and Russia. The proximity to China and Japan, the rich endowment with seafood and the ice-free harbour were main natural advantages of this area (Nam, 2005: 200). Favourable economic conditions like tax incentives, a guaranty for profit repatriation and the custom-free import and export of raw materials, intermediate products as

well as products related to the industrial production of the SEZ were also among the features of Rajin-Sonbong (Seliger, 2006: 98).

In 2000 and 2001 Kim Jong-il visited China various times and was reportedly impressed by the economic development in the Chinese SEZs (Seliger, 2006: 95). As a result, North Korea announced the opening of an additional SEZ at the Yalu River in Sinuiju opposite the Chinese town of Dandong in summer 2002. Like in Hong Kong the plan was for a fifty year special basic law, which among other things allowed private property of means of production, a separate monetary and customs system, an autonomous budget and unrestricted capital movements (Seliger, 2004: 74). By these regulations especially the inflow of hard currency from China to North Korea was intended. Additionally, in July 2002 North Korea initiated a series of economic reforms which have been heralded by some observers as important first steps into the establishment of a market economy in the country. These reforms have been characterised by the introduction of some basic monetisation into the economy and by the reduction of the role of the government in setting prices and controlling the distribution system (Wrobel, 2007: 488-496). But in the last years, most of these reforms have been withdrawn. Additionally, by a “currency reform” in November 2009 savings of private businessmen were devastated which caused some instability in North Korea (IFES, 2010a). But as the examples of Rajin-Sonbong and Sinuiju have shown, North Korea cannot adopt the Chinese strategy of opening by SEZs. Circumstances in North Korea are quite different from those in China. For instance, North Korea has only a small land area, scarce resources, a 60 year-old autocratic system of government, poor infrastructure (such as energy supply, harbours, roads etc.), and an uncompetitive labour force (Oh, 2002: 11). Additionally, from an investor’s perspective, North Korea with only 23 million people is an unattractive market. Therefore the country cannot achieve economic development like China (Nam, 2001: 74). As result, in both SEZs no lasting development took place.

But a new stimulus came from the South. Already in 1998 the South Korean president Kim Dae-Jung had articulated the new “Sunshine Policy” calling for a peaceful coexistence of the two nations, including prospect of aid and bilateral economic cooperation as well as a long-term unification proposal (Ahrens, 2003: 53). The historic summit between Kim Dae-jung and Kim Jong-il in June 2000 gave additional hope for a gradual and peaceful integration of both Koreas (Kim Won-bae, 2003: 118). Since then political contact between the two nations on the

Korean peninsula evolved and various cooperation projects were established. Already during the famine in the mid-1990s South Korea started to support its Northern neighbour with food, energy and fuel supply. The latter has been reactivated after the nuclear crisis in 2006. Additionally, since the inter-Korean summit in 2000 economic cooperation has been intensified on a higher level. Two Special Economic Zones (SEZs) were established in North Korea close to the borderline to the South: Kaesong Industrial Complex and the Mount Kumgang Tourism Zone. These SEZs became the core of the Korean economic cooperation. Thus the development of bilateral cooperation has accelerated in recent years, even in the face of the heightened tensions relating to the North Korean nuclear programme (Lim Sung-hoon/Lim Kang-taeg, 2006: 48-49). But they have to be distinguished from the two other SEZs. While the Rajin–Sonbong SEZ is a trade-oriented centre that includes China, Russia, and Japan, and Sinuiju SEZ has focused on the trade-oriented function in order to cooperate with countries in the Yellow Sea rim area, including China, Kaesong is envisaged as a production-centred SEZ, to attract small and medium-sized South Korean enterprises, as well as the Mount Kumgang project focused on tourism (Kim Suh, 2007: 7). While Mount Kumgang could be seen as a tourism project with a very special focus on South Korean hiking tourists, the Kaesong Industrial Complex was of wider interest.

### **3. Establishment of Kaesong Industrial Complex<sup>1</sup>**

#### **3.1 The Idea of a Western Coast Industrial Park**

Already in December 1998 during a visit of the founder of the South Korean Hyundai Group, Chung Ju-yung in Pyongyang, , the ambitious idea to establish a “West Coast Industrial Park” in North Korea developed (Park Suhk-sam, 2004b: 41). Because of a lack of electricity and high logistical costs in North Korea all production facilities should be concentrated near the Demilitarised Zone (DMZ). Ideally, South Korea would provide energy and build up an efficient logistical system. According to these criteria Hyundai had Haeju in the Hwanghae-do province as optimal location in mind. As second and third choices Nampo or Sinuiju were suggested (Lim Eul-chul, 2007b: 4-9).

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<sup>1</sup> This section bases on an article by Wrobel (2010).

In September 1999 a “Plan for Industrial Complex Development” was prepared by Hyundai explicitly stating Kangryoung-gun, Haeju-bay and Hwanghaenam-do as the prospective site for the new industrial complex. This plan stated the construction of the new complex requiring 6,400 ha of land. Additionally, it included a detailed plan to build the industrial complex in three phases within eight years. In autumn 1999, during a second meeting of Chung Ju-yung and North Korean leader Kim Jong-il they decided to develop an industrial complex, accepting a South Korean company’s support (Lim Eul-chul, 2007b: 9-10). But Kim Jong-il declared Sinuiju at the Yalu river as primary candidate for the complex. As the North Korean government pointed out different transportation routes for goods and people were guaranteed by the port of Sinuiju, and a road connection via Panmunjom. Furthermore, North Korea offered an airport with a 2.5 km runway. Sinuiju had a lot of advantages including access to the global markets, especially the Chinese one, abundant water resources by the Yalu river, abundant electricity by diverse North Korean power plants and an established communication system. But a visiting team of Hyundai was disappointed in Sinuiju. Hyundai’s aspirations were to establish an industrial complex that reached out to the world, not just to the market across the border. Additionally, Sinuiju was too far away from the South Korean consumer market. A lot of lacks in the infrastructure of the city completed Hyundai’s negative opinion about Sinuiju (Lim Eul-chul, 2007b: 11-12).

During summer 2000 Hyundai Asan and the North Korean government finalised Kaesong as the site for the new industrial complex. It is an open question why Kaesong has been chosen. While North Korea favoured Sinuiju, Hyundai Asan officials choose Haeju or Nampo as primary site for the complex. Lim Eul-chul (2007b: 22) assumes that the former Chinese President Jiang Zemin advised Kim Jong-il on the location already when Kim visited China in May 2000. This may be underpinned by the consideration that a new North Korean special economic zone at the Yalu river could be dangerous for the development of the Chinese SEZ in Dandong.

Additionally, Hyundai Asan recognised that there would be no possible success for such a project without a deeper political inter-Korean cooperation. Therefore the enterprise proposed a summit meeting of North Korean leader Kim Jong-il and the South Korean president Kim Dae-jung, which took place in June 2000. To secure its business rights in the new investment project Hyundai Asan paid as much as USD 500 million to North Korea before this summit. It can be

assumed that President Kim Dae-jung allowed the transfer because he could not openly offer monetary reward to North Korea in exchange for the summit meeting due to domestic constraints. At the June 2000 summit president Kim's administration pursued "Five Economic Cooperation Projects" with North Korea: the linking of roads and railroads between North and South Korea, developing Mount Kumgang in North Korea as tourist attraction, enabling travel to these mountains through land routes, and the Kaesong Industrial Complex (Lim Eul-chul, 2007b: 4-6).

Backed by the South Korean president on 22 August 2000, Hyundai initiated the Kaesong Industrial Complex project by signing an agreement with the North Korean Chosun Asia Pacific Peace Committee (APPC) on the KIC encompassing more than 6,400 ha. (Lim Eul-chul, 2007b: 6-7) Coincidentally, an agreement on exclusive business rights for large-scale social overhead capital (SOC) projects in North Korea was signed. It included business in electric power, telecommunication, tourism, etc. (Hyundai Asan, 2007). Both sides came to an agreement giving Hyundai exclusive rights in constructing and operating the KIC as a "Special Economic Zone". As it was determined the complex's size should be gradually expanded, as needed in the future. Land routes would promptly be provided for the transport of labour and goods. Railroads would also be utilised. Additionally, a development of the city of Kaesong was included in the agreement (Lim Eul-chul, 2007b: 17-18).

Later, because of subsequent financial difficulties, Hyundai Asan handed over some of its rights to the Korean Land Corporation (KLC), a state-invested business concern in South Korea. On 26 December 2002, Hyundai Asan and KLC signed an "Agreement on Constructing Kaesong Industrial Complex" (Park Suhk-sam, 2004a: 90). By this way, the South Korean government became directly involved into the former private project. During a three year preparation period, both sides worked on ensuring free coming and going across the border, as well as on establishing basic rules and regulations on tax, accounting, banking and labour institutions to be applied in the KIC (Kim Dong-geun, 2006: 2) Then, after a visit of Hyundai Asan officials, the ground-breaking ceremony of the Kaesong Industrial Park took place in summer 2003. The construction work began in April 2004 (Park Suhk-sam, 2004a: 89).

### **3.2 Investment Environment**

The Kaesong Industrial Complex is physically and legally separated from the rest of North Korea. General North Korean laws do not apply. Under the guidance of market principles it is provided with economic autonomy. (Kim Youn-suk, 2006: 63) The KIC is governed by a special set of laws, since it was officially inaugurated in June 2003. The Basic Law allows individuals to own private property. It articulates the development implications for a “one country – two systems” strategy. It is composed of five articles and forty-six sections, including investors’ rights, development methods, durations of land leases, labour utilisation, and commercial dispute-settlement procedures. Because the KIC is established to induce direct investment from South Korea the law articulates specific provisions for South Korean investors, such as special immigration procedures or residential status. It guarantees the unrestricted usage of inter-Korean postal and communication services as well as free movement within designated routes between South Korea and the business complex. Additionally to the Basic Law, the North Korean government enacted several supplementary guidelines, including for instance the Development and Investment Provision and the Taxation and Labour Provision in 2003 (Lee Jong-woon, 2004: 125-126). Additionally, South Korea enacted “The Kaesong Industrial Zone Support Act” in May 2007 as well as corresponding decrees in September 2007. Based on this law and those decrees, South Korean companies and workers receive legal protection. That is commensurate with that of SEZs located on the territory of South Korea (Ministry of Unification, 2008).

At a first glance investment conditions are very good. Income tax of 14 % in case of general business and 10 % in case of the sphere of encouragement (e.g. light industry or ultramodern science) as well as an exemption for the first 5 years since generating profits and a 50 % deduction for another 3 years are great advantages (Lee Chang-won, 2005: 97). The basic wages of North Korean workers were initially \$57.5 per month (social insurance and pension included), while the wage increase is limited to a maximum of 5 % a year. 48 working hours per week are standard (Park Suhk-sam, 2004b: 42). The land use term is 50 years but is extendable. It is allowed to acquire, transfer, lease and inherit the certification of land use. Additionally, there are no restrictions on communication such as internet or phone. Foreign currency and credit cards

are free to use. For entry and departure no visa is necessary. The whole complex is a duty free zone (Hyundai-Asan, 2007).

In a way the North Korean SEZ Kaesong provided better economic conditions for investors from abroad than China. There foreign enterprises were given tax exemptions for only two years, followed by tax reduction for the ensuing three years. Also monthly minimum wages for workers were lower than comparable rates in China (USD 100 – 200) or Vietnam (USD 60). Of course, also the wage differential between both Koreas is substantial. Also transportation cost advantages and a lack of language barriers are reasons for South Korean investments in the KIC (Kim Youn-suk, 2006: 65). As table 1 shows the formal investment environment was very good in the Kaesong Industrial Complex, compared with China and South Korea from the beginning.

**Table 1: Selective Economic Data in the KIC, China and South Korea (2004)**

	<b>Kaesong Industrial Complex</b>	<b>China</b>	<b>South Korea</b>
Monthly wage	USD 57.50	USD 100 - 200	USD 423
Weekly working hours	48	44	44
Corporate income tax	10 – 14 %	15%	23 – 28%
Lease per pyong*	Won 150,000	Won 50,000	Won 407,550

\* One pyong = 3.3 square meters.

Source: Park Suhk-sam, 2004a: 92; Kim Youn-suk, 2006: 65

Additionally, infrastructure, such as electricity, phone, and internet (since 2007) is constructed and guaranteed by South Korea. The Complex management committee is an administrative body headed and managed from South Korea by an unprecedented symbolic concession. The South is also in charge of developing land for manufacturing, as well as renting that space out to South Korean enterprises (Kim Youn-suk, 2006: 66). As North Korea mentioned itself the Kaesong Industrial Complex offers a “favourable investment environment for South Korean enterprises” (Korea Today, 2006: 38). But on the other hand, as the closure in 2013 has shown the political risks of an investment in the KIC are not calculable. Therefore the development of the KIC is depending mainly on the engagement of the South Korean

government as well as the development of the political cooperation process on the Korean peninsula.

### 3.3 Master Plan and Development of the KIC project

Hyundai Asan and the South Korean public Korea Land Corporation have been given the right to engage in all activities of funding, blueprints, and sale in order to carry out the first stage of the Kaesong Industrial Complex (Kim Youn-suk, 2006: 64). They planned to carry out the complex in three stages over eight years. In a first phase one million pyong (ca. 330 ha) were planned for mostly labour intensive manufacturing sites, comprised of textile and leather production as well as simple general manufacturing goods. In a second phase more than 1.3 million pyong (ca. 430 ha) were designated for manufacturing and service industries as well as in a third phase 6.2 million pyong (ca. 2,050 ha) for high tech and chemical industries. By this way technology-intensive industries are expected to establish a presence only in the third phase. This phase was designed to construct an IT industrial complex on an area of one million pyong (ca. 330 ha). Then industries like electricity and electronics, software, printing and publishing, as well as textile and leather should be settled down in the KIC (Kim Youn-suk, 2006: 64).

**Table 2: Master Plan of Kaesong Industrial Complex (as of 2006)**

Classification	Development Zone		Companies	Employees (workers)	Development Schedule
	Industrial zone	Supporting zone			
<b>1st phase</b>	330 ha	1,635 ha (Urban Kaesong Area)	300	70,000	2002 - 2007
<b>2nd phase</b>	490 ha	330 ha	700	130,000	2006 - 2009
<b>3rd phase</b>	1,145 ha	655 ha	1,000	150,000	2008 - 2012
<b>Expansion zone</b>	655 ha	1,635 ha			
<b>Total</b>	<b>2,620 ha</b>	<b>4,255 ha</b>	<b>2,000</b>	<b>350,000</b>	

Source: Ministry of Unification 2006: 11, own calculations.

In the first years the development of the Kaesong industrial Complex seemed to be fast and successful. After the preparatory stage the erection of first industrial plants began in

December 2004. (Ministry of Unification 2008) And the first product “Made in Kaesong”, a cooking pot (!), has been sold in April 2005. In the same year, nearly 6,000 North Koreans and several hundred South Koreans were employed in the KIC. Already in August 2006 were fifteen companies in operation, fourteen of them in a model complex and one in the main complex. At that time workers of the complex are composed of about 10,000 from the North and 800 from the South (Cho, 2006: 28).

In the past, products from Kaesong have been shipped mainly to the South Korean market, but with the fast development of the project by South Korean industrial concerns, exports to other countries were on the rise. The export produced in the KIC was worth USD 866,000 in 2005, produced and exported during April and December of that year. In 2006 the figure increases already to more than USD 19 million worth of products shipped to overseas markets (Bae, 2007: 52). In 2007 a level of production worth has reached more than USD 184 million, but this was far away from the expected worth of production a year in the first phase of development by USD 3,000 million it has been scheduled in the Hyundai-Asan master plan. Equally, the development of the number of enterprises as well as workers in Kaesong fell behind the schedule of the master plan. As one can imagine all development goals were very optimistic and also Hyundai-Asan Corporation itself acknowledged in the meantime that the appointed time of project completion could not be adhered. (Auer, 2006: 159) Nevertheless, at that time outlooks for the development of the KIC project were absolutely positive.

Through a Summit Declaration (October 4 Declaration) and inter-Korean prime minister talks at the end of 2007, the two Koreas confirmed details for how they will work together to facilitate inter-Korean economic cooperation. For instance, both sides agreed to work on institutional measures as well as infrastructure related problems like transit systems or communication (Ministry of Unification, 2007). Consequently necessary infrastructure for the KIC completed in December 2007. Facilities for water treatment, waste water and waste disposal have been built. In May 2007, a transmission substation with the capacity of 100,000 KW began to supply electricity in the KIC (Nanto/Manyin, 2007: 5). While telecommunications service started with 303 lines in December 2005, more than 650 telephone and fax lines were available a few years later. Additionally, in the Declaration of 4 October 2007 both Koreas agreed to build accommodation to make it easier to house the needed North Korean workforce. Moreover they

agreed to simplify the inspection process of entering and leaving the complex and to improve the system of customs clearance. Also a railway transportation link between Moonsan and Bongdong started operating on a regular basis since 11 December 2007 (Kim Young-yoon, 2008: 4 – 6). Additionally, in June 2007 also the second phase of the Master Plan started officially. This phase was scheduled to be completed in June 2012 (Kim Young-yoon, 2008: 4-5).

At the end of 2007 some optimism was justified. 72 South Korean Companies were working in the KIC. Additional 195 companies were in the design phase. So officials of the KIC estimated that some 150 to 200 enterprises are producing in the zone by the end of 2008 (Flake, 2007). Additionally, the 2007 annual output of the KIC amounted for USD 184.78 million, a 2.5-fold increase and more than a tenfold increase compared to 2006 respective 2005 (Kim Young-yoon, 2008: 5).

**Table 3: Enterprises on Operation and Production in Kaesong**

Year	2005	2006	2007	2008	2009	aggregated as of May 2010
Enterprises on Operation	11	30	65	93 (+38 under construction)	109	109
Production (USD)	1,491,000	73,730,000	184,780,000	242,609,000	114,590,000	617,200,000
Amount of Export (USD)	866,000	19,830,000	39,670,000	33,964,000	11,030,000	105,360,000
Share of Exports	58,08%	26,89%	21,47%	14,00%	9,63%	17,07%

Source: Ministry of Unification, 2008 and 2010; Hyundai-Asan, 2009; Lim Eul-chul, 2009; own calculations.

#### 4. Further Development

Since the beginning of 2008 the political situation on the Korean peninsula has changed dramatically. The new conservative South Korean government of Lee Myung-bak had a far different North Korea policy than the previous one. President Lee's new approach towards North Korea, which was formulated during his election campaign, was called "Vision 3000". Relative to economic terms it was designed to provide conditional economic assistance to North Korea

over the next decade. The purpose was to help North Korea to boost its annual per capita national income from estimated current USD 1,800 to USD 3,000 during this decade. No doubt, this would turn North Korea's economy into an export-driven one. However, there existed the conditionality. The plan was built on the premise that the Joint Statement adopted at the Fourth Round of the Six-Party Talks on 19 September 2005 in Beijing had to be completely implemented before any developmental and financial aid would be offered to North Korea. In this way the issue of denuclearisation turned into the primary policy goal which dominated the speed and direction of the inter-Korean cooperation (Petrov, 2008). President Lee's proposal to create a man-made island "Na-deul" at the estuary of the Han-river and to build a joint economic complex thereby combining North Korean labour and South Korean capital caused additional irritations. Also, the new administration in Seoul divided all inter-Korean cooperation projects into three categories relative to their importance and cost. While humanitarian aid (first category) should be continued commercially viable ventures directly benefiting South Korea like cooperation in transport and communication (second category) were saved but regulated by the new Inter-Korean Cooperation Fund. In contrast all projects requiring significant financial investment, among them reconstruction of the dilapidated North Korean infrastructure and the creation of special "peace and cooperation zones" in the Yellow Sea (third category) were suspended. At the inter-Korean summit in October 2007 almost everything what Kim Jong-Il and the former South Korean president Roh Moo-Hyun agreed had been cancelled by the new South Korean presidential administration (Petrov, 2008, Lim Eul-chul, 2009).

The North Korean regime answered in an expectedly way by mistrust and pride. Pyongyang suspended bilateral talks, expelled most of the South Korean officials from the inter-Korean office in the KIC on 27 March 2008, and fired Styx ship-to-ship missiles into the West Sea one day later. In summer 2008, tours to Mount Kumgang were halted after one female tourist from South Korea was shot to dead (Kim Young-yoon, 2008: 6). The worsening in inter-Korean relations during 2008 slowed down also the development of the KIC. At the end of November 2008 the North Korean government announced to limit the South Korean work force in the KIC. According to the announcement the normal South Korean work force was limited to 880 workers. Additionally, North Korea restricted the land crossing between the two Koreas by the 1 December 2008. If South Korean newspapers, magazines or other banned materials were found,

the result would be immediate expulsion from the KIC (ICNK, 2008). The South Korean government reacted on these disturbances by supporting the KIC project explicitly. It worked continuously actively to ensure smooth operations in the factories located within the KIC. Already in November 2008 it released the “Kaesong Industrial Complex Activation Measures Plan”. According to the budget for the cooperation fund for 2009 which would reflect projects such as expansion of basic facilities in the complex, construction of a dormitory, repair of roads, establishment of a fire department etc. Additionally, the plan included an agreement between authorities for the construction of further dormitories that could begin as soon as early 2009, of course, in accordance with the necessity of nuclear disablement (Lim Eul-chul, 2009).

In spring 2009, the nuclear crisis on the Korean peninsula reached a new point of culmination by Pyongyang’s missiles test in April and the nuclear test in May. Additionally, the Kaesong Industrial Complex became more and more involved in the centre of the conflict. In April 2009, a South Korean staff member of the KIC was imprisoned in North Korea, because he “criticised the noble dignity of the Republic’s political system” and “tried to convince a female North Korean worker to defect” as the North Korean government announced. According to the South Korean accusation, this was a violation of the inter-Korean agreement on entrance and sojourn procedures in the KIC. Additionally, the denied access of South Korean officials to the detainee was a violation of human rights (IFES, 2009a). Having threatened the South already in April, the North Korean government announced on 15 May that agreements on land rent, wages and other issues regarding the KIC were no longer recognised and that South Korean businesses not willing to accept the new demands of the North Korean government were free to leave the complex (IFES, 2009b). Confusion exceeded this, when the North stated it would continue to support the complex’ development only two weeks later (IFES, 2009c). Fortunately, all restrictions of December 2008 were already abolished in the summer of 2009 after a meeting of Kim Jong-il and Hyunday chairwoman Hyun Jung-eun. Passages across the DMZ were restored, travel restrictions were eased, and limitations of number and length of visits by South Korean workers were suspended (IFES, 2009d and 2009e).

But Inter-Korean relations escalated again in the spring of 2010 when a South Korean warship was torpedoed by the North. Already in March after the dumping of the Cheonan (PCC-772), the South Korean government blamed the North for the aggression while the North denied

any involvement. Coincidentally, in April 2010 the North Korean government announced to nationalise the South's real estate in the Mount Kumgang SEZ and to start tours for tourists in collaboration with another operator (KCNA, 2010). In May, an international Joint Civilian-Military Investigation Group was able to definitely state that the warship was torpedoed by North Korea. Therefore, on 24 May, the South announced the cessation of inter-Korean exchanges and other sanctions against Pyongyang. First of all North Korean exports of sand and seafood to the South were affected, both which provided financial income for the North's military. Additionally, North Korean ships were prevented from entering South Korean waters. By these sanctions North Korea stood to lose at least USD 200 million as well as up to 40,000 jobs in related industries. In contrast, all business related to the Kaesong Industrial Complex was exempted from these measures (IFES, 2010b). Only a few days later North Korea threatened the South by banning all South Koreans from the KIC. Until then several hundreds of South Korean managers and engineers were allowed to cross the border and go to work. Now, the North Korean government said it wants to keep the complex going (Yonhap 2010). In this way, the political risks of investment in the KIC became obvious again as well as the political character of the whole project.

In the beginning of 2013 political tensions began escalating rapidly between Seoul and Pyongyang again after a nuclear test in the North and an escalation of rhetoric on both sides. On 3 April 2013, North Korea began to deny South Korean employees access to the Kaesong Industrial region and five days later the North Korean government recalled all 53,000 North Korean workers from the KIC, fully suspending its operations. On 17 April, North Korea barred a delegation of ten South Korean businessmen from delivering food and supplies to the approximately 200 South Koreans who remained in the industrial zone. Therefore a few days later, South Korea decided it would withdraw all remaining staff. In the beginning of May, the last seven South Koreans left the KIC, which thus was completely shut down by this way. This seemed to be the final end of the SEZ in Kaesong and the inter-Korean cooperation at all. But the condemned live longer. On 4 July, both countries agreed in principle that the Kaesong Industrial Park should be reopened, while six rounds of talks were held without reaching a concrete agreement. Therefore, an official agreement to reopen the complex was reached and signed only on 15 August. On 16 September 2013 a test mode started in Kaesong. South Korean staff entered

the SEZ again and North Korean workers were requested to return into the KIC (Deutsche Welle, 2013).

## **5. Importance of the Project for Both Koreas<sup>2</sup>**

### **5.1 Economic Effects on South Korea**

Because of the successful economic development in South Korea, domestic wages greatly increased in the last years. Additionally, the South Korean economy was suffering from labour management disputes, unstable political conditions, poor performance in attracting investment due to militant labour unions, a widespread dualism between domestic and export enterprises, as well as a decline in manufacturing industries for a long time. (Kim Young-yoon, 2008: 5) The KIC satisfies urgent labour demands of different South Korean companies. During the establishment of the first stage it became an operation side for the South's labour intensive industry sector. Especially, small and medium-sized companies were forced to either hire foreign labour from China or Southeast Asia or transfer their manufacturing plants to those countries. The KIC offers an alternative: hiring North Korean inexpensive workers who share a common language with the investors (Lee Chang-won, 2005: 97). An estimated 40 % of the small and medium-sized South Korean enterprises in the KIC that established operations in China before have not been successful there. Therefore, the KIC is viewed as essential for survival to some of these companies (Nanto/Manyin, 2007: 7).

Therefore, main investors in the KIC are small and medium sized companies from South Korea, manufacturing goods in a labour-intensive way. For instance in 2005 and 2006, 35 % of production in the KIC pertained to the textiles and clothing sector, 13 % to chemicals (e.g. synthetic leather, container for cosmetics), 26 % to machines and metal-working (e.g. car pumps), and 15 % to electronics (e.g. LCD components) (Hyundai Asan, 2007). In contrast, larger South Korean Chaebols (family-based conglomerates) were definitely underrepresented in the KIC from the first beginning. (Kim Youn-suk, 2006: 66) It seems that big companies from

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<sup>2</sup> This section bases on an article by Wrobel (2010).

South Korea are evading investment in the KIC because they recognise the political uncertainty as still being too high, especially due to internationalisation of their business.

But the South Korean small and medium enterprises invested in the KIC are not able to independently finance dormitories and other facilities. Therefore, economic success of their investments in Kaesong is so deeply dependent on the South Korean government's ability and willingness to subsidise the project that all economic activity can be indicated as not competitive (Flake, 2007). Additionally, the South Korean government offers companies establishing operations in the KIC loans with low interest rates equal to those applied to public works projects and covers financial losses up to 90 % by providing political risk insurance. In this way, it is quite clear that the companies in the KIC would not be economically viable without support of the South Korean government (Nanto/Mayin, 2007: 3-7). Therefore, it must be pointed out that economic advantages of the KIC are small for the South Korean side. In contrast, the whole project must be indicated as politically-driven by the South Korean government.

## **5.2 Political Confidence Building and Reunification**

Evaluation of the Kaesong project and especially its political effects are various in the world. While most of South Korean officials are zealous in their support of the Kaesong Industrial Complex a range of American and other South Korean voices were equally passionate in their criticism (Flake, 2007). For instance, in a publication supported financially by Hyundai-Asan (Lim Eul-chul, 2007a) the KIC was praised as "mini-unification" with a "vital role" for inter-Korean relations etc. In contrast, already Flake (2007) pointed out: "Like many others, after the October 2006 North Korean nuclear test, I was somewhat frustrated with the South Korean government's unwillingness to abandon what I viewed as a symbolic, but insignificant, clustering of marginal South Korean firms in Kaesong." Therefore, the political effects of the KIC must be analysed in detail.

First, the KIC is important for keeping inner Korean cooperation active preventing North Korea from a collapse which may induce a "big-bang-reunification" with higher costs than in the German case. The development of the KIC as well as the other SEZs can promote modernisation of the North Korean economy and overcome long-term stagnation. Additionally, it can contribute

to co-prosperity and balanced development of both North and South Korea. During such a process reunification costs would be reduced enormously. Secondly, in this way cooperation projects like Kaesong Industrial Complex or also Mount Kumgang SEZ are useful to improve the political situation on the Korean peninsula as well as the institutional economic development in North Korea. Both Koreas have turned former battle grounds into “peace zones”. Especially they opened peace corridors in the West as well as in the East of the demilitarised Zone. Mines have been removed and roads as well as railroads between North and South of the peninsula have been reconnected across the Military Demarcation Line to transport persons, materials and final products between the Kumgang Mountains respective Kaesong Industrial Complex and the South. To achieve this result, military talks were decided building up simultaneously confidence between both sides. Thirdly, in the case of the KIC both Koreas are cooperating in a form of a joint participation. In the long run, such kind of economic cooperation should certainly contribute to favourable inter-Korean relationships as well as to a more peaceful situation on the Korean peninsula. But as we can see during all crises since 2008, beside that the Kaesong Industrial Park can also become a focus of the North – South conflict, an “apple of discord!” In this way, joint projects like the KIC have two effects. While they can bring North and South Koreans together negotiating and discussing their differences they can also induce new differences between both sides. If positive aspects of cooperation may exceed negative ones is questionable.

### **5.3 Economic Effects on North Korea**

In contrast to the South Korean side economic effects of the KIC on North Korea are manifold. First of all, the Kaesong Industrial Complex helps North Korea facilitates trade with other countries worldwide relieving North Korea’s severe external imbalance. The KIC also induces foreign direct investment. By this way, North Korea benefits from an expansion of its industrial infrastructure and capital equipment, an increase in factory opening rates as well as by growth in both production and export volumes. Especially by the latter one, which also increases revenues received from foreign currency has to be mentioned. In 2002, the Construction Economic Research Institute of Korea estimated the economic effects of the Kaesong project of USD billion annually with 60,000 new jobs and production of around 16.7 % of North Korea’s

GDP (Seliger, 2006: 101). Of course, taking the slow development of the project into account this is an overestimation.

Till its closure in April 2013, the main financial benefits for North Korea were the wages of workers. In line with the KIC labour law North Korean workers had to be paid a minimum of USD 50 per month (USD 57.50 including the cost of social insurance) (Nanto/Manyin, 2007: 8). While article 32 of the KIC Labour Law stipulated that South Korean firms have to pay wages to North Korean workers directly in cash, on North Korean demand, the companies remit worker's salaries to the North Korean government, which paid the workers an average 6.300 North Korean Won per month, or USD 42 using the official exchange rate of 150 Won for one US dollar (Human Rights Watch, 2006: 7). As reason the North Korean government mentioned a lack of foreign exchange centres in the KIC (Nanto/Manyin, 2007: 9). Therefore it can be argued that the North Korean regime exploits its workers in Kaesong. Because the North Korean regime retains a large share of the USD 57.50 per month paid to each North Korean worker, in fact the workers net less than USD 3 per month (Kim Suh, 2007).

However, additionally must be stipulated that working conditions in the KIC are advantageous in contrast to the rest of North Korea. Of course, workers at the KIC have to work eight hours per day and 48 hours per week, not including overtime (Nanto/Manyin, 2007: 7). Additionally, North Korean workers are committed to use eight hours a day for studies in Socialism and the North Korean ideology. But by article 22 of KIC Labour Law workers are guaranteed one day off per week, North Korean national holidays and 14 days of paid leave per year (Human Rights Watch, 2006: 7). By this way, it must be pointed out that working conditions in the KIC are the best in North Korea (Kim Suh, 2007). The KIC Labour Law contains important protections like paid leave and holidays, limiting conditions under which employers can fire workers, and those clarifying employer's responsibilities for protecting workers from dangerous or hazardous work conditions. According to the KIC Management Council, the health condition of North Korean workers had visibly improved as they had access to better nutrition (Nanto/Manyin, 2007: 10). On the other hand, KIC Labour Law fails to protect worker's rights to freedom of association and to bargain collectively at the KIC (Human Rights Watch, 2006: 10 - 11). But at all, it can be pointed out that the KIC offered advantageous working conditions to more than 50,000 North Korean workers in April 2013.

Additionally, the sum as well as the effects of foreign currency inflows from the KIC is worthy of discussion. Calculating only 40,000 workers in 2009, an average income of USD 57.50 a month and costs of USD 3 to pay the workers in North Korean Won, an annual inflow of a little more than USD 26 million to the North Korean government could be estimated. In addition, there are land lease fees and other payments to the North Korean government. For instance, Hyundai Asan paid USD 12 million for a 50-year lease on the entire Kaesong site when the project was initiated. Additionally, companies in the KIC have to pay North Korea's job reference agency a commission of USD 17 per employee (Nanto/Manyin, 2007: 11-12).

On the one hand, already in 2003 it was argued that such inflows stabilise the Kim-regime in Pyongyang and hinder institutional change in North Korea. But on the other hand it must be mentioned that an abrupt breakdown of the DPRK would have immense negative impacts on South Korea, like mass migration, famines, etc. But all these problems are to be solved by a South Korean government. Additionally, a slow but continuous improvement of the economic development in North Korean would ease a future reunification of both Koreas. This can be learned e.g. from the German example, too. In this way, the financial support of the regime in Pyongyang by the KIC has also positive effects for South Korea.

#### **5.4 Institutional Learning in North Korea**

Originally, the opening of all SEZs in North Korea was evaluated positively by analysts. As e.g. Lim Kang-taeg/Lim Sung-hoon (2005: 9) mentioned: "The North Korean government wants to show its willingness to open itself up in order to induce foreign investment and bring in foreign capital and technology, leading to national economic growth as well as using these zones as the learning and testing ground of economic reform." By this way, the implementation of all four SEZs in North Korea (Rason, Sinuiju, Mount Kumgang and Kaesong) was seen as a first step into direction of an economic transformation. It was assumed that all kind of economic exchange would make North Korea moving forward "marketisation" of its totally planned economy (Lee Dalgon, 2007: 280-281). Especially through the Kaesong project North Korea should get a chance to learn foreign technology and management skills and, as result, should take the path of openness and reform in the long run. If these hopes can be maintained after the steps

back in inter-Korean relations as well as in economic reforms seem to be highly questionable at the moment. But the regression in reforms of the North Korean government in the last years can also be interpreted as an indication of first success of this strategy. It may be argued that the steps back to centralization became only necessary because of an obvious first beginning of a spontaneous transformation in North Korea.

Continued contact between North and South Koreans in Kaesong can stimulate some more change in North Korea over the long term. For instance, North Korean workers are enabled to experience modernised equipment and efficient plant management systems, which they have never seen before. Additionally, they can start to understand the principles of a market economy. As it is reported from the KIC workers ask for details of the market system like “What is a stock?” or “Why does the exchange rate keep changing?” (Kim Dong-geun, 2006: 5). Presently, workers from different regions of North Korea are employed in the KIC experiencing cooperation with workers from the South and diffusing this knowledge into the rest of the country. By this way, the KIC is assumed as a mediating influence on the Korean peninsula. Of course, to get a significant effect the number of North Korean workers must be expanded as envisioned in the Hyundai master plan. Additionally, 50,000 workers employed in the KIC are too few to establish something like a North Korean middle class. As result, spillover-effects of the learning process in North Korea and a social development are limited at the moment.

Additionally, all North Korean SEZs have the advantage that they can absorb foreign investment without affecting the domestic economy while they can support learning processes in North Korea and allow time to build up foreign economic relations with the neighbouring countries without the need to engage in a major economic transformation programme at the moment. In the North Korean bureaucracy, there are both who agree with the usefulness of the KIC and those who do not. Supporters in the regime see the regime supporting effects of the KIC but also its effects on inter-Korean relations as well as its economical usefulness. Additionally, the complex can be seen as a test case for a range of market-economic functions that can be applied later in other regions of the country in attempts to revive the ailing economy. If North Korea establishes its economic linkage with South Korea it will be easier for this country to adapt to global economic cooperation, too.

On the other hand, taking into account criticism and scepticism on the KIC in the North Korean regime, it must be mentioned that the Kaesong Industrial complex is only part of the North Korean strategy of limited opening. According to this strategy, only limited areas of the country should be opened up, while blocking any unwanted outside influence on the regime. Therefore, the following requirements had to be met for all SEZs in North Korea, also the KIC: The areas to be opened had to be far away from Pyongyang as well as from military bases. They had to be located nearby a coastal city with a port which can serve as gateway for international trade. The area had to be equipped with industrial infrastructure and had to have easy access to labour force (Nam, 2001: 80). Additionally, if the North Korean government believes economic cooperation threatens its own socialist system, it may take measures to protect the system as we can observe now. Therefore, all investment projects in North Korea – including the KIC – proceed in an environment of mutual tension.

## **6. Outlook**

Sunshine Policy is at the end and inter-Korean relations remain on a low level. Only the economic advantages of the Kaesong Industrial Complex for both sides hinder a final closure. While KIC was assumed to strengthen inter-Korean relations, to improve knowledge of North Koreans about market economy, competition and democracy at all, it leaves ambiguous. What remains is a possibility for North Korea to earn money from the South – and for South Korea a possibility to use the cheap labour force of the North. In contrast, all political attempts grasped at nothing. The idea to open KIC for international investors will fail in the long run, too. The Kaesong Industrial Complex is a Korean project. But it does not fit anymore in the time. Less than German “Ostpolitik” in the 1970s also the Korean “Sunshine-Policy” cannot be called success. Therefore, also the last remaining relict of this era should be closed down finally. The project does not fulfil any more positive purpose for the inter-Korean relations. On the contrary, it will be source of new conflicts on the Korean peninsula in the future, only.

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