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## South Korea's aid to North Korea's transformation process: Social market perspective

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# Ordnungspolitische Diskurse

## Discourses in Social Market Economy



**Jang Tae-Seok**

**South Korea's Aid to  
North Korea's Transforma-  
tion Process  
- Social Market Perspective -**

**Diskurs 2007 – 6**

**Jang Tae-Seok**

# **South Korea's Aid to North Korea's Transformation Process: Social Market Perspective**

## **Abstract**

South Korea's aid to North Korea is deviated from the international trend in development aid. As a stylized fact, we find that South Korea's policy keeping economic relationship with North Korea was inconsistent and ineffective during the last decade. Since South Korea played a major role in promoting economic transformation process in North Korea, perspectives from social market economy, open economy, stabilization, and investment in infrastructure provide insights in dealing with development aid. Therefore the aid should be conditioned by projects promoting market system. And commercial activities should substitute government aid in a gradual way. Furthermore the evaluation process for policy rules should be designed to avoid rent-seeking in advance under the dictatorship in North Korea.

## **Keywords:**

North Korea, economic transformation, social market economy, development aid, rent-seeking

**Jang Tae-Seok**

# **South Korea's Aid to North Korea's Transformation Process: Social Market Perspective**

## **1. Introduction**

A way to understand North Korea from the outside is sometimes contrasted with the perspective of the Korean peninsula. North Korea's penchant for brinkmanship tactics aroused concerns over international relations while South Korea pursues implicitly unification policy. Since the former South Korean president Kim Dae-Jung's engagement policy culminated in the first summit of North-South Korea in the 15<sup>th</sup> June 2000, increase in economic relations as well as people exchange has initiated a new phase in Korea. The implementation of the "Sun-Shine Policy" has been evaluated as an institutionalization of economic cooperation between two Koreas. However, South Korea has been criticized over policy toward North Korea, because South Korea's aid neglected commercial activities characterized by the state involvement and interruption to the market process in North Korea.<sup>1</sup>

It is, therefore, worthwhile to note that discussion on South Korea's aid is stimulated to concretize process in economic relationship between two Koreas. An assessment to the institutional set-up in the economic cooperation can be deepened and widened with projects like special economic zones, industrial specializations, investment in infrastructure, etc. (see Cho, 2007 and Kim, 2007). Until now, the relationship between two Koreas is dominated by the top-bottom approach, because the political system of North Korea did not allow any negotiation beyond the control of its party. And more the nuclear crisis, which is frequently incurred by the North Korean regime, brought on negative effects for the external commercial relations.

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<sup>1</sup> It is also a contrast to the engagement of China, which is consistent with the market-conforming trade and investment. See Haggard and Norland (2007).

However the political impasse in North Korea and its losing control on people now reveals the reason why North Korea seeks the open economy. So we can pay attention to the recent development of foreign relationship of North Korea with China, Russia and Mongolia. The institutional set-up for economic convergence of North Korea will be undertaken for tasks in the social market economy.

In this paper we discuss possible ways to economic transformation of North Korea from the social market perspective. Firstly, we argue based on the recent statistics released by the Ministry of Unification that South Korea’s policy keeping economic relationship with North Korea was inconsistent and ineffective during the last decade, supposedly based on nationalism or other motivation from the domestic politics. Assuming that two Koreas continue to cooperate in the future, we introduce the concept for the proper scope of aid in North Korea. It follows that South Korea’s aid will have substantial effect on the way of economic transformation process in North Korea. Furthermore, rent-seeking under the North Korean regime will be discussed to assess social market system. With a strategy for social market economy, open economy, stabilization, and investment in infrastructure, the development aid to North Korea should be supported by the political decision and evaluation process. And it concludes.

	<b>Politics</b>	<b>Military</b>	<b>Economic</b>	<b>Humanitarian, Social, Cultural</b>	<b>Total</b>
<b>2000</b>	6	4	3	2	<b>15</b>
<b>2001</b>	2	2	3	1	<b>8</b>
<b>2002</b>	4	9	14	5	<b>32</b>
<b>2003</b>	5	6	17	8	<b>36</b>
<b>2004</b>	2	5	13	3	<b>23</b>
<b>2005</b>	10	3	11	10	<b>34</b>
<b>2006</b>	5	4	8	6	<b>23</b>
<b>2007</b>	3	5	10	6	<b>24</b>
<b>Total</b>	<b>37</b>	<b>38</b>	<b>79</b>	<b>41</b>	<b>195</b>

<Table 2.1> Official Meeting between South Korea and North Korea  
(Source: Ministry of Unification in South Korea, 2007)

## 2. South Korea's Aid to North Korea: Past and Present

It is interesting to see how the official meetings in Korean peninsula have been developed. (Table 2.1) According to the recent publication of the Ministry of Unification in South Korea (2007), we find that the official meeting between two Koreas has been drastically increased since the first summit in 2000. The humanitarian, cultural, and especially economic meetings peaked around 2003. These meetings are followed by humanitarian aid from South Korea to North Korea.

The increasing trend of aid from South Korea to North Korea is reflected in the official meetings for humanitarian, social, and cultural activities. In reality we can say without exaggeration that the first summit was supported by the promise of humanitarian aid to North Korea (Table 2.2). We pointed out that civilian sector also increased its contribution to humanitarian aid. It is contrasted by the trend in the aid of international organization. Since the nuclear crisis in the early 2000 influenced on the activities of the international organizations, there are now few activities in North Korea for economic development aid except for humanitarian aid.<sup>2</sup> In fact the South Korean policy of development aid to North Korea is deviated from the trend of international society, supposedly based on either nationalism or other motivations for domestic politics.

(Unit: million US \$)

Period	'95	'96	'97	'98	'99	2000	2001	2002	2003	2004	2005	2006	Total
Gov.	232	3.05	26.67	11	28.25	78.63	70.45	83.75	87.02	115.12	123.88	141.36	1001.2
Civil	0.25	1.55	20.56	20.85	18.63	35.13	64.94	51.17	70.61	141.08	88.66	44.57	558
Total	232.25	4.6	47.23	31.85	46.88	113.76	135.39	134.92	157.63	256.2	212.54	185.93	1559.2

<Table 2.2> Humanitarian Assistance from South Korea to North Korea

(Source: Ministry of Unification in South Korea, 2006 (On-line publication), See the website: <http://unikorea.go.kr/english/ENK/ENK0301R.jsp>)

<sup>2</sup> In 1993, representatives of 171 States adopted by consensus the Vienna Declaration and Programme of Action of the World Conference on Human Rights. This idea supports the necessary conditions of civil and political rights for the poor as well as food and water. It leads to the arguments that human rights should be conditioned by development aid, security, and other international issues beyond its basic moral. In other words, the inclusion, cooperation, and responsibility from the recipient countries are necessary conditions for the successful development aid. (World Bank, 2005)

The state's dominant economic cooperation has been associated with the recent increase in trade volume between two Koreas. (Table 2.3) Although the government and NGO's aids to North Korea increased for the last 5 years, the commercial activities remain standstill or slightly increasing compared to the total volume of trade in South Korea. The trends are heading in the opposite direction from the fact that the borderline commercial activities with China have been increased.<sup>3</sup> Since the economic cooperation between two Koreas is still regarded as a special relationship beyond the normal relations among nations, unification with a higher priority precedes the profits and rationality with a lower priority.

(Unit: 100 million US \$,%)

Period	2000	2001	2002	2003	2004	2005
<b>Inter-Korean trade volume</b>	4.2	4.1	6.4	7.2	7.0	10.6
<b>The ratio of inter-Korean trade to the entire South Korean trade</b>	0.13	0.14	0.20	0.19	0.15	0.19
<b>The total amount of the entire South Korean trade</b>	3,328	2,915	3,146	3,726	4,783	5,457

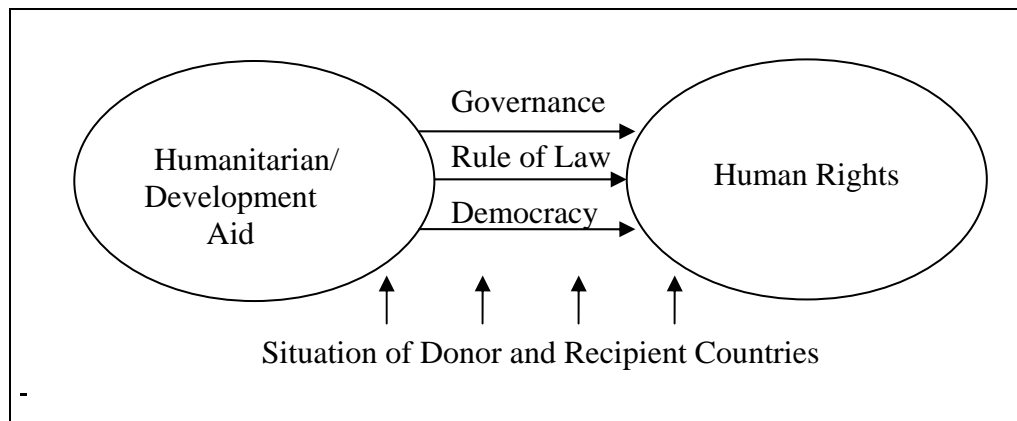
<Table 2.3> Ratio of inter-Korean trade to the entire South Korean trade

(Source: Ministry of Unification in South Korea, 2006)

### 3. Scope of Economic Aid for Economic Transformation in North Korea

South Korea's development aid to North Korea is considered to be incompatible with international norms. Also, China sometimes emphasizes the unconditional aid to North Korea, assuming that sudden eruption of North Korean regime might bring about disastrous side effects. In fact, however, South Korean government intends to introduce market economy in North Korea through the gradual reforms. The sun shine policy also has a great goal to introduce self-sufficient economic growth in North Korea through reform and market opening, which eventually contributes to unification in Korean peninsula. (Lankov, 2005)

<sup>3</sup> Its impact of market activities with North Korea will be discussed in the next section. The possible explanation of increasing trade only with China will be as follows. Firstly, Chinese companies keep product prices cheaper than that of South Korean companies. Secondly, the borderline activities are authorized by the Chinese government, which makes it difficult for Korean companies to gain profits. See KOTRA (2007).



<Figure 3.1> Relationship between Human Rights, Aid and Situation of Donor and Recipient Countries

Then the criticism over economic aid which is different from the market economic process in a transition country should be reconsidered. Its explanation is visualized in <Figure 3.1>. In practice for principles of governance, rule of law and democracy in the recipient countries, donor countries tended to link the aid with human rights issues. The failure of effective development aid has been attributed to the absence of favorable interactions with domestic situations.

However it should not be detracted from the necessity of Korean government aid to North Korea, because initial conditions for suitable economic development in North Korea are still desirable. Only the scope of economic aid to North Korea then remains controversial. The critical point here is related to the type of aid, condition, and the political situation in North Korea. Furthermore North Korea is reluctant to reveal its basic economic data, which makes it difficult for donor countries to understand properly macroeconomic situation. (Eberstadt, 2000) Taking it into account, we have to find some alternatives to enhance policy implementation in dealing with the aid to North Korea.

Firstly, the influence of state supervision should remain intact or decreased to some extent for the balance with the private sector. South Korean government also promotes the trade-friendly environment in cooperation with North Korea. It should be a long-term commitment because North Korea takes time to learn market economy system. We can consider market enhancing model as a possible strategy (Ahrens, 2006). An assessment to the quality of institutions for market oriented policies and private-sector coordination is important. So, it can allow North Korea to unfold its way



to market economy if proper transitional institutions are maintained with educated public officials in North Korea.

Secondly, South Korea's aid to North Korea should be aimed at the market-friendly environment. Since transition countries from the Soviet Union experienced corruptions and malfunction of public institutions, South Korea's transfer of institutional rules to North Korea can be enacted either in people exchange or in projects. In practice political decisions and supports are critical for its implementation.

And the economic development model for North Korea can be adjusted according to the perspectives from social market system. If policy for the market economy system is adopted gradually throughout North Korea, South Korea's aid which is conditioned by market-friendly projects will contribute to promote market activities. And the aid from the government's side could slowly be crowded out. Now the special economic zones made good starting points, but scope and conditions are still limited. Several other projects are to be planned. For example, the interest of North Korea on international financial system shows good reasons why North Korea tries to reform by itself as the cooperation with international organization like IMF or World. Even though the political system in North Korea added restrictions to the economic reforms, conditional assessments to the international system will be effective to change North Korea's opaque and unstable economic system. (Reed, 2005)

#### **4. Social Economic System in North Korea**

The economic landscape in North Korea has been described as a collapse of planned economic policy, dominance of heavy industry, change after reforms in 2002, but few considerations into market oriented policies (EUI, 2007). Though North Korean regime remains proud of its ideology *Juche*, self-sufficiency turns out to be ineffective, and imminent release for aid seems to be necessary. That's why North Korea is interested in the international financial system and the foreign investment.

Since the foreign investment has been mostly conditioned by the market situation, stable social market economy rules for successful transition period are necessary in North Korea. This view is also relevant to the plan in the Gaeseong Industrial Com-

plex Project<sup>4</sup>. But technology transfer and aid should be compatible with the interim process to market system in North Korea. It gives more leverage to the government for the intervention in the market.

Therefore the successful orientation to market economy should be enacted either through control or through the cooperation with the donor countries. Some previous experiences in the eastern European countries also give implications for economic transformation in North Korea. And the experience of German reunification showed that people and their awareness to political decisions influenced transformation process. For instance, we know that the rent-seeking activities of politicians in the former German Democratic Republic (GDR) invoked the revolt against the regime. It is therefore recommended for South Korea to check the scope of the aid to North Korea through annual based evaluation. Because the possibility that the politicians raise money from aid and do not distribute it for its own purpose is not to be excluded, the transparent flow of money will be a precondition for the effectiveness of aid.<sup>5</sup>

	Open economy	Stabilization	Infrastructure
Role of North Korea	Promotion of commercial activities	Control on Marco-economics	Linkage to the domestic industry
Role of South Korea	Promotion of commercial activities	Conditional aid/ Capacity building	Project cooperation like special economic zones

*<Table 4.1 Social market perspective in North Korea’s Transformation Process>*

In fact, the following questions should be asked to concretize the role of governance in a transitional phase: could commercial activities be complemented with governmental control? In initial phase, the control on economy should be more dominant than the liberalization strategy. With the combination of the open economic system, a successful path will be the gradual transition to social market economy. Then gov-

<sup>4</sup> For the recent report about Gaeseong Industrial Complex, see the website of Ministry of Unification.  
<sup>5</sup> I am grateful to Prof. Dr. Jürgen Backhaus for his comment on the German experiences. Since the transformation process in North Korea is unusual compared to other previous transition economies, a careful assessment dealing with the people’s awareness will be more important.

ernment should play a role in creating breakthrough in the stagnating economic situation. The analysis is based on social market perspective.<sup>6</sup>

In <Table 4.1>, the role of government is classified by the application to market economic system in North Korea. Since the foundation to the market economy is linked to provide stable institution rules and proper application of politics, South Korea may restrict itself to play a role in promoting commercial activities and leading some projects, which will have spill-over effects on other economic sectors in North Korea. Especially the success in North Korea's economic transformation will depend on the political factors rather than economic theory on the development. Furthermore the unique political situation under the dictatorship should be considered.

## **5. Conclusion and Outlooks**

We try to describe South Korea's aid to North Korea during the last decade. Though the aid takes aim at improving cooperation and prosperity between two Koreas, the way to implementation is deviated from the international trend in development aid. Since political and security reasons held the advantage over commercial interest in North Korea, the effectiveness of aid still remains a controversial issue for economic cooperation. Facing with losing control over people and external challenges, North Korea tries to increase economic cooperation with neighborhood countries. In this point, some lessons can be drawn from the social market economic perspectives.

Economic orientation toward social market will have substantial effects on the transition process in North Korea. While market system for open economy, stabilization, and infrastructure provide economic foundations for a successful transition process, the government side of two Koreas should cooperate to give the political assistance to the related economic activities. In so doing, the institutions will provide good environments to attract private investment and to make North Korea's economy competitive, which at least supports sustainable economic growth.

From the perspectives of social market economy, the conditional aid for effectiveness and policy rules in commercial activities should be designed in advance and evaluated to avoid rent-seeking under the dictatorship in North Korea. Although experi-

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<sup>6</sup> Participation in the conference for Social Market Economy in Zwickau led me up to this point. I would like to express gratitude to the participations for the useful comments and the discussion.

ences in the other transition economies could not be applied to the case of North Korea, some lessons from social market economy will give two Koreas some insight for economic cooperation. It may enable us to avoid trial and error in the last decade.

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