


Strategies for development of  
a North Korean  
Special Economic Zone  
through Attracting Foreign Investment

*Kang-Taeg Lim & Sung-Hoon Lim*





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By Kang-Taeg Lim & Sung-Hoon Lim

Korea Institute for National Unification

The Impact of Personality Cult in North Korea

Printed: April 2005

Published: April 2005

Place of Publication: Korea Institute for National Unification

Publisher: President of Korea Institute for National Unification

Registration No.: 2-2361 (April 23, 1997)

Address: 535-353 Suyu-dong, Gangbuk-gu, Seoul, 142-887, Korea

Telephone: 82-2-900-4300; 82-2-901-2524

Fax: 82-2-901-2572

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Publications of Korea Institute for National Unification are available at major bookstores.

Also contact the Government Publication Sales Center:

Tel: 82-2-734-6818 or 82-2-394-0337

**ISBN No. 89-8479-287-X 93340**

Strategies for Development of a North Korean Special Economic  
Zone through Attracting Foreign Investment / By Kang-Taeg Lim  
and Sung-Hoon Lim. -- Seoul: Korea Institute for National  
Unification, 2005  
p.; cm. - (Studies series ; 05-01)

ISBN 89-8479-287-X 93340 : 비매품

332.11-KDC4  
338.95193-DDC21

CIP2005000756

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The analyses, comments and other opinions contained in this monograph are those of the authors and do not necessarily represent the views of Korea Institute for National Unification.

# TABLE OF CONTENTS

<b>I. Introduction</b> .....	1
<b>II. Developing a North Korean Special Economic Zone and the Economic Cooperation of the Two Koreas</b> .....	5
1. Concept and Function of the North Korean Special Economic Zone	5
2. The Expected Effects of the Development of North Korean Special Economic Zones	12
<b>III. Strategies for Developing a North Korean Special Economic Zone</b> .....	19
1. Developing Models of a North Korean Special Economic Zone	19
2. Development Scenarios of North Korean Special Economic Zones	28
3. Development Strategy for Kaesong SEZ and Mt. Kumgang SEZ	32
<b>IV. Attracting Foreign Direct Investment as an Alternative Financing Resource</b> .....	39
1. Spending from the Inter-Korean Cooperation Fund	39
2. Attracting Foreign Direct Investment	45
3. Structuring Project Finance	55
<b>V. Conclusion</b> .....	59

## • TABLES

<Table II-1> The Effect of the Development of North Korean Special Economic Zones ...	12
<Table III-1> Types of North Korean SEZs .....	22
<Table IV-1> Particulars of the Project Expenses .....	41
<Table IV-2> Contents and Characteristics of the Determinant of Foreign Investment .....	46
<Table IV-3> Related Laws for the Kaesong SEZ and the Mt. Kumgang SEZ .....	49
<Table IV-4> Incentive in Tax System for the Enterprises in SEZs .....	51
<Table IV-5> Recommended industrial sectors for inducing FDI for the Kaesong SEZ and the Mt. Kumgang SEZ .....	54

## • DIAGRAMS

<Diagram II-1> The Role of the Kaesong Industrial Complex as a Mediating Influence in Re-establishing the Homogeneity of the Two Koreas .....	17
<Diagram III-1> The North Korean SEZ Development Strategy: Specialization and the Procedure of Gradual Expansion .....	31



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## I . Introduction

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Since 1988, when economic exchanges officially began between the two Koreas, many experts on unification and North Korea, government officials, and businessmen interested in North Korea have paid attention to the two Korea's economic cooperation and examined the way to further develop such cooperation. They believe that the two Korea's economic cooperation has not only contributed to economic exchange between the two states but has also shown the possibility of advancing their political relations. In addition, they expect that South-North Korean economic cooperation would be helpful in promoting economic development, development of industrial infrastructure, building a harmonized industrial structure, as well as aiding the recovery of cultural and emotional homogeneity, eventually inducing national unification and reducing the costs of unification.

Although the two Korea's levels of economic cooperation,

varying in significance, has increased in quantity, it has not advanced in terms of quality. This economic cooperation has consisted of government-led large-scale projects and also small scale civil cooperation. Although this cooperation includes large scale projects such as the Mt. Kumgang tourism project, as a whole, it has not established itself as a stable, profitable system yet.

South-North Korean economic cooperation by private enterprises consists of imports and exports of limited items through third countries, processing trade and joint investment; this eventually led to the establishment of the Kaesong Industrial Complex on the basis of South Korea's capital and technology. The Kaesong Industrial Complex is helpful for South Korean business due to the short distance from Seoul and low waged labor force which may contribute to the competitiveness of small and medium enterprises which are experiencing difficulties these days. North Korea is going to develop two projects, the Kaesong Industrial Complex project and the Mt. Kumgang tourism project, out of four special economic zones (SEZs) in accordance with South Korea's investment program. These two projects, already showing good progress, may give the North Korean government good prospects about South-North Korean economic cooperation.

Both the South and North Korean governments look to the success of the Kaesong Industrial Complex SEZ (Kaesong SEZ) and the Mt. Kumgang tourism project (Mt. Kumgang SEZ), and hope that they benefit all participants. Participant includes the South and North Korean governments, development enterprises, private businesses and workers, and when we consider the broader picture, it includes all the citizens of South and North Korea and all neighboring countries who wish for peace in East-Asia.

This research focuses on establishing strategies and processes for the successful development of special economic zones in order to produce fruitful outcomes. Maximizing profits for all participants means that we need to move away from the zero-sum game and look towards cooperation which will maximize profits for each participant as well as the whole. From the above mentioned basis, this research covers the following issues.

Firstly, we analyze the complicated features of North Korean SEZs. Special Economic Zones are different from other North Korean industrial facilities in the sense that these are going to be developed on the basis of the importation of foreign capital. When the subject of construction is a South Korean enterprise, it adds greatly to the complications. The Kaesong SEZ could be, on the one hand, a part of a South Korean industrial complex, or, on the other hand, part of a North Korean industrial complex or it could be viewed as a joint industrial facility. Therefore, the Kaesong SEZ project and the Mt. Kumgang SEZ project can be the symbol of an increasingly open North Korean economic policy and the basis of a Korean national unification project.

Secondly, we will suggest a successful model and development strategy of these SEZs. We are going to present stable and consistent economic development strategies utilizing SEZs such as the Kaesong SEZ and the Mt. Kumgang SEZ, appropriate for North Korea, taking into account their current economic difficulties.

Thirdly, we consider the strategy for importing foreign capital including South Korean funds as a detailed development

project. Because this special economic zone project needs a lot of funding for establishing infra-structure, North Korea has to depend upon a suitable project finance system.

Finally, on the basis of the above argument, we are going to examine the appropriate way to activate South-North Korean economic cooperation and industrial development in South Korea.

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## II. Developing a North Korean Special Economic Zone and the Economic Cooperation of the Two Koreas

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### 1. Concept and Function of the North Korean Special Economic Zone

#### 1) Concept of the Special Economic Zone

According to the *Dictionary of Economics of North Korea*, “Special Economic Zone (Open Zone for Foreigners)” is defined as follows (*Dictionary of Economics*, p. 116):

The special economic area in China where flexible foreign economic policies are executed. China, in 1979, announced some parts of four cities as the special economic zone. The purpose of establishing special economic zones was inducing foreign capital, technology, and management skills as well as increasing foreign trade and foreign currency holdings, accelerating economic development. The Chinese special economic zone is different from the “industrial complex” in capitalist countries. While capitalist countries develop capitalist economies by inducing foreign capital in the “industrial complex,” in the Chinese special

economic zone, various economic systems coexist on condition that a socialist economy predominates. Foreign capitalists have the right to possess the means of production, a part of or whole rights of management, the right to employ and discharge workers, and particular privileges and special favors regulated by the Chinese government. However, foreign capitalists have to undertake economic activity in the special economic zone under the supervision and direction of the socialist country.

In the same Dictionary of Economics, the so-called “industrial complex” in capitalist countries is defined as follows (*Dictionary of Economics*, p. 176):

The Special area for industry separated in order to concentrate industries in particular sites for capitalists’ pursuit of profits. The origin of the “industrial complex” was the “Manchester Industrial Complex” in Britain in the late 19th century and this model has been diffused all around the world after World War II. In capitalist countries, an “industrial complex” is established under the name of urban and regional development for the pursuit of profits by the “monopolistic capitalist.” In colonized countries, the establishment of the “industrial complex” became a link to realize the new colonial industrial policies of the modern imperial monopolists. There are a lot of “industrial complexes” in South Korea these days. The imperialist countries, the U.S. and Japan, made South Korea into a military base and a colonized production base of export commodities. The multinational corporations of the U.S. and Japan working in South Korean “industrial complexes” are more invasive and rapacious than the imperialists of the “leased territories” in China in the late 19th century. Although the imperialists in the “leased territories” had the privilege of living in their own special area, they did not set barbed-wire entanglements around the “leased territory” in order to prohibit the passage of Chinese. The MNCs of the U.S. and Japan in South Korea set barbed-wire entanglements around the large “industrial complexes” and control the passage of the workers and visitors, exploiting South Korean workers in the complex. These MNCs’ privileges

of production, distribution, and trade reaches all around the nation and had the prerogative of “residence” by which they construct and live in palatial mansions. The MNCs of the U.S. and Japan obtained South Korean nationality and the rights equal to South Korean corporations as well as the extra privileges that even comprador capitalists cannot get. These MNCs have the right to invest 100% of the capital and reinvest double this amount of the original investment. In addition, they send their huge profits earned by the exploitation of South Korean workers to their home country without any restrictions. Thus the “industrial complexes” in South Korea operate for the imperialistic exploitation of the MNCs of the U.S. and Japan and submit to being used as a military base and as a colonized production base for export commodities.

This Dictionary of Economics published in 1985 might not represent exactly the current official opinion of the North Korean authorities. However, it is helpful in understanding the changed opinion of the North Korean authorities after the government designated Sinuiju as a special administration district, Kaesong as a special industrial complex and Mt. Kumgang as special tourism district. In the mid 1980s, while North Korea expressed dislike for these “special economic zones” established by capitalists, it tried to understand the “special economic zone” model as followed by the Chinese government. This attitude of North Korea is indicative of a change from its earlier attitude in 1975. In the Dictionary of Economics published in 1975, there was no explanation regarding “special economic zones” or “industrial complexes” at all.

The first “special economic zone (hereafter SEZ)” project began in December, 1991 with the government's decision to establish a “Free Economy and Trade Zone” at Rajin-Sunbong in Hamkyungbukdo (in the northeastern part of North Korea).

The North Korean government began this project after it realized that the earlier “North Korean Joint Investment and Management Law” designed to induce foreign capital was not working well while the SEZ in China was successful. However, it seemed that the North Korean government was not fully ready to open up the Rajin-Sunbong area. The government expected that foreigners would invest, and it would be easy to induce foreign capital just by opening the area. The government's dream was broken amidst low foreign investment, and it had to console itself with the thought that this had been its very first trial opening.

These days, the North Korean government has designated Sinuiju as a special administration zone under the foreign minister with its own right of legislation, administration, and judiciary. This action has the following implications. First, the North Korean government regards the SEZ as the channel to obtain foreign capital, solving the current North Korean economic difficulties. Second, the North Korean government's concept of the SEZ has changed from the one in 1985. In the 1985 version, the concept could have been interpreted as follows: “Sinuiju is opened to foreign capitalists, and foreign MNCs will make this area a colonized production base of export commodities and strengthen their exploitation in this area.”

## **2) Functions of the Special Economic Zone**

The reason that the North Korean government changed its recognition of the SEZ and decided to open these zones is that North Korea needs foreign capital desperately.

Why then did the North Korean government designate Sinuiju,



Kaesong, and Mt. Kumgang as a special administration district, industrial complex, and special tourism district respectively in addition to Rajin-Sunbong? 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. We will now look into these purposes in detail.

First, the North Korean government wants to increase foreign investment by showing off its willingness to open itself up. It is important for the foreign investor to know whether the North Korean government has a strong desire to consistently reform and open itself up because the current North Korean economic system is very different from the international standard and many North Korean laws and regulations need to be reformed. Actually the North Korean government has shown their willingness to open up to foreign countries these days. The North Korean government announced the “7/1 Reformation of Economic Management System” in July, 2002, and the establishment of the “special administration district” in Sinuiju in September, 2002.<sup>1</sup> Then, in October, 2002, the North Korean government designated Kaesong and Mt. Kumgang as a special industrial complex and special tourism zone respectively.<sup>2</sup> These actions of reform and opening up

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<sup>1</sup> According to the “Law of Sinuiju special administration district,” this district has its own right of legislation, administration, and judicature; foreigner has the right to be a member of legislation committee; this special law will be kept on for 50 years from the initial enforcement; and this district shall be fully open to foreigners.

<sup>2</sup> Kaesong special industrial complex is designed to induce the investment of South Korean enterprises, and Mt. Kumgang special tourism zone is designed to develop this area as a international tourism course.

are intended to increase the level of economic support and cooperation of foreigners by showing off their image of pursuing peace and open-door policy.

Second, the North Korean government is planning to achieve economic growth by attracting capital from abroad and this is the major goal of its external economic policy. This policy has been changed through the years. While during the 1950s and 1960s, the North Korean government depended on socialist countries with priority given to the USSR, in the 1970s, it tried to induce the import of large scale capital and technology from western capitalist countries. However, after the accumulation of external debt owing to the inefficient economic system and the oil shock, the North Korean government changed its policy into inducing foreign investment instead of loans and export promotion during the 1980s and 1990s. This policy was not successful either because of the collapse of the international socialist market, and this was then followed by ten years economic recession. Consequently, in this new century, the North Korean government expects the role of SEZs to be a channel to induce international capital for economic growth.

Third, the North Korean government intends to propel economic growth by the nationwide expansion of the advanced technology and know-how introduced by the SEZs. The first step of the North Korean economic growth strategy is to open a particular area and induce state-of-the-art foreign technology, facilities, and management skill, and the second step is to expand such technology to the national industries, leading to an advanced national economic structure. In addition, the national industrial sector outside the SEZs will be protected from this opening up and will continue to develop to the point of being basic

level industries. Thus the North Korean government expects to import advanced industrial know-how, protect its currently weak national industry, and achieve economic growth through the effect of the correlation of industries.

Finally, the North Korean government expects the SEZs to play the role of a test ground of economic reform and as a vehicle for the learning of advanced industry. Many elements of the “7/1 Reformation” had already been executed in the Rajin-Sunbong economic and trade zone. The North Korean government executed several reform policies to develop the Rajin-Sunbong area in June, 1997, such as the harmonization of currency, readjustment of the exchange rate, granting permission of private management of restaurants and lodgings, enforcement of self-supporting accounting systems, and the establishment of a free market at Wonjungry. These were epoch-making reforms at the time, although they were minimized by the interference and control of the government later. In addition, the North Korean government plans to induce the import of advanced economic management systems to the SEZs, testing free market and competition systems.

## 2. The Expected Effects of the Development of North Korean Special Economic Zones

South Korean people are very concerned about North Korean special economic zones because South Korean enterprises are participating in the Kaesong Industrial Complex as developers and will move in there to undertake production. North Korea expects to induce foreign capital and technology through the SEZs and propel economic growth. Such change in the economic sector may lead to the political stability of North Korea which is expected to contribute to the political and military stability of the Korean peninsula. The following table explains these possible outcomes.

<Table II-1> The Effect of the Development of North Korean Special Economic Zones

	Economic Effect	Political and Military Effect
South Korea	Restoration of small and medium enterprises in difficulties, providing motivation for new growth	Alleviation of military tension, expansion of policy options toward North Korea
North Korea	Solving economic difficulties, acceleration of economic reform, enlargement of economic openness	Change from military-centered policy, increase in political stability
South and North Korea	Increase in South-North Korean cooperation, co-prosperity and balanced development, establishing the base of an economic commonwealth	Mitigation of military tension in the Korean Peninsula, establishment of confidence in the military situation
Northeast Asia	Enlargement of economic cooperation in Northeast Asia	Increase of peace and cooperation in Northeast Asia

## **1) Increase in South-North Korean Economic Cooperation and North Korean Special Economic Zones**

The two Koreas' economic cooperation has a positive relationship with the development of special economic zones. The development of SEZs in North Korea means the progress of reform and opening which would enlarge South-North Korean economic cooperation. We expect the improvement of the currently poor infrastructure, inefficient administration caused by the lack of market concepts of North Korean officials, and high risk associated with the obscurity of government policy.

The effect of the development of the SEZs on South-North Korean economic cooperation will be realized directly in the Kaesong Industrial Complex. Because South Korean enterprises are developing the complex as developers and have the responsibility for distribution and management, the activation of the Kaesong Industrial Complex has a direct effect on the enlargement of South-North Korean economic cooperation. Thus South Korea has to have a long-term and general plan for the development of North Korean SEZs including the Kaesong Industrial Complex. For this reason, we need to have a strategic understanding of the effect of and the development methods of North Korean SEZs.

First, North Korean SEZs can contribute to strengthening the competitiveness of the South Korean economy and improve the conditions for investment. These days, South Korean enterprises suffer from the aggravation of high-cost structures and try to find alternative production bases in China and Southeast Asia. North Korean SEZs can be an alternative. However, the conditions of production which are beneficial for South Korean enterprises might change in the future. In order to develop

North Korean SEZs beneficial for South Korean economic growth, various kinds of industries which can create international competitive power, including the newest technology industries, have to participate in the zones. Distribution of industries on the basis of division of labor is also important. In addition, South Korean enterprises' presence in North Korea for production purposes will improve the relationship between the two Koreas and mitigate tension on the Korean Peninsula, and upgrade the international credit standing of the South Korean economy.

Second, the development of North Korean SEZs can promote modernization of the North Korean economy and overcome long-term stagnation, and can contribute to co-prosperity and balanced development of both South and North Korea. During this process, the "cost for unification" which has created a negative image of unification would be reduced. In order to achieve these positive effects, South Korea needs to take part in the development of the SEZs and support economic restoration and modernization, setting the conditions for promoting reform and openness. In addition, we need to encourage international participation (including that of neighboring countries) in this project and help North Korea to be quickly integrated in the international network of economic cooperation.

Third, we can revive the role of the Korean Peninsula as a bridge between the continent and the ocean by improving South-North Korean cooperation. South Korea was not able to play the role of being the gateway to the continent because of the division with North Korea. With the progress of South-North Korean economic cooperation, the Korean Peninsula can emerge as the hub of commerce and transportation of Northeast Asia. Thus we need to establish an economic cooperation

network connecting North Korean SEZs and Northeast Asia in the fields of transportation and the IT industries.

Finally, the successful development of North Korean SEZs can serve as the motivating force for the reformation of the North Korean economy and its transformation into a market economy which may eventually lead to formation of a South and North Korean economic commonwealth. In accordance with the development of SEZs, the participation of South Korean enterprises will create the conditions for establishing a new physical and institutional base for future economic unification between the two Koreas.

## **2) Realization of an Economic Commonwealth and North Korean Special Economic Zones: The case of the Kaesong Industrial Complex**

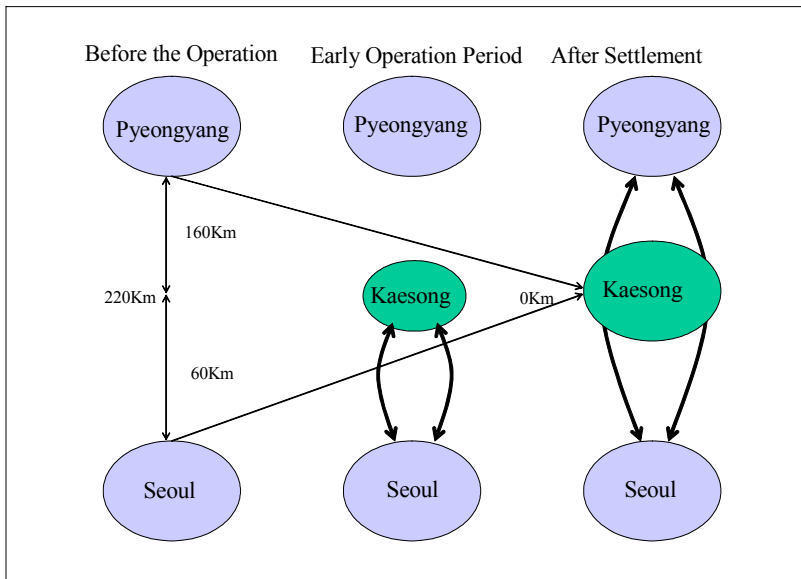
How can North Korean SEZs, especially the Kaesong Industrial Complex, contribute to establishing a South and North Korean economic commonwealth? The Kaesong Industrial Complex not only offers a location which is beneficial for South Korean manufacturing industries but also creates other effects. With South Korean enterprises' moving into the Kaesong Industrial Complex, South Korean business management and competition systems will be applied within the Complex, and a free market system will operate with the inflow of people, commodities, capital, and information from outside. In this South-North Korean joint venture, North Korean officials will be used in the decision making process of what is a free market system, and even in the South Korean enterprises, North Korean middle level officials and workers will have a chance to learn the business logic of competition and efficiency.

In addition, in the Kaesong area, an annex complex will be established with support facilities, tourism and amusement facilities, and residential facilities. These facilities will be used as a site for tourism for South Koreans and foreigners. Other public and cultural facilities and leisure sports facilities will be available for use by both South and North Koreans, helping each to understand the culture of the other.

The Kaesong Industrial Complex may contribute to the reduction of the physical and psychological distance between the two Koreas. Although the direct distance between Seoul and Pyongyang is only 220km, access has been only possible through China. After the road between South and North Korea is connected directly, the physical distance between the two Koreas will be reduced. If the Kaesong Industrial Complex is operated successfully, not only the physical but also the psychological distance will be reduced. In addition, the Kaesong Industrial Complex can play a mediating role between the two Koreas and will assist in re-establishing the homogeneity of the peninsula.



**<Diagram II-1> The Role of the Kaesong Industrial Complex as a Mediating Influence in Re-establishing the Homogeneity of the Two Koreas**





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## **III. Strategies for Developing a North Korean Special Economic Zone**

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### **1. Developing Models of a North Korean Special Economic Zone**

#### **1) Types of SEZ and North Korean SEZs**

The North Korean government executed the “Reformation of Economic Management System (hereafter, 7/1 reformation)” on July 1, 2002. This “7/1 reformation” was intended to change the operational system of the North Korean socialist economy to a more realistic model, reflecting the depressed economic activity and the expanded underground economy. This “7/1 reformation” is a trial for a total and systematic change, unlike the former partial changes in policy and regulations. With this reformation, the North Korean government announced a series of policies designating Kaesong, Mt. Kumgang, and Sinuiju as SEZs. North Korea had to increase its open door policy with the change of the economic management system.

Generally, SEZs are a place designated by the government, where foreign investors are granted preferential treatment in the form of alleviation of regulations, reduction of taxes and customs duties. These beneficial places for business are supposed to lead to economic growth and expand their effects through the rest of the country, achieving national economic growth. However, North Korean SEZs are established not only as places which are designed to be of benefit to business but also for overcoming economic difficulties which have been experienced since 1990 as well as constructing a base for future economic growth. It is envisaged that this SEZ is going to have a relationship with a capitalist system and play the role of being a test ground for the North Korean economy, which in turn will have an important influence on the national economic system.

We need to classify the characteristics and role of each North Korean SEZ in order to determine the direction of development. There are various methods of classification. According to the classification by function, the SEZ has been classified as a trade-centered SEZ, a production-centered SEZ, an offshore banking center, and a complex SEZ.<sup>3</sup> However, this classification cannot explain the direction of the future development of North Korean SEZs. Most of the SEZs in other countries were capitalist SEZs which already had infrastructure. Even the SEZs in China were different from North Korean SEZs in terms that the Chinese government played the central role as a developer. Therefore

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<sup>3</sup> There are other methods of classification. One method is to classify as production-centered, international-trade-centered, production and trade mixed, and knowledge creation (Samsung Economy Research Institute); other methods classify as trade and transportation, production and processing, complex, business (Korea Institute for National Unification).

classification by function is not the most appropriate method to apply to North Korea. In North Korea, because the infrastructure has not yet been established, first of all, foreign capital has to be invested for infrastructure, then appropriate enterprises can be induced to participate in the SEZs according to the purpose of each SEZ. Thus the North Korean government's strategy for developing SEZs should be sharpen its focus at the first stage in order to induce foreign capital for development.<sup>4</sup>

Each SEZ has to have a degree of competitive power in accordance with its own role in order to be developed successfully. Each SEZ has to have its own characteristics which will induce foreign enterprises on the basis of the arrangement of laws and regulations as well as social and regional infrastructure. For North Korea, it is not possible to establish infrastructure purely through government initiatives. That is why the North Korean government has to introduce appropriate policies in order to induce foreign investment.

North Korean SEZs can be classified by function as trade-centered SEZs, production-centered SEZs, and tourism-centered SEZs, although tourism-centered SEZs were not included in the classification by the function. The main function of the trade-center SEZ is active trading with other countries. Therefore, the North Korean government is going to develop the cities located near the border and coast, Sinuiju and Rajin-Sunbong, as trade-centered SEZs. Kaesong is designated as a production-

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<sup>4</sup> In the case of the Rajin-Sunbong SEZ, the North Korean government took the role of initial investment. However, its ability in terms of investment was insufficient and the investment of foreign enterprises was not successful either. Thus foreign investment should be pressed ahead for Rajin-Sunbong also.

centered SEZ with the support of cost reductions and privileges in taxation, and which will serve as the production base of further enterprises. The Mt. Kumgang area will be developed as an international tourism course with accommodation and other conveniences. North Korea SEZ types can be explained in terms of the following table.

<Table III-1> Types of North Korean SEZs

Classification	Contents	Location
Trade-centered	<ul style="list-style-type: none"> <li>Free trade zone with locational advantage, international trading function utilizing transportation and infrastructure</li> </ul>	<ul style="list-style-type: none"> <li>Rajin-Sunbong</li> <li>Sinuiju<sup>5</sup></li> </ul>
Production-centered	<ul style="list-style-type: none"> <li>General SEZ designed to be the production base of enterprises with privileges in both costs and taxation</li> <li>Classified in detail according to the type of industry and scale</li> </ul>	<ul style="list-style-type: none"> <li>Kaesong</li> </ul>
Tourism-centered	<ul style="list-style-type: none"> <li>Currently a tourist resort to be developed as a site for international tourism with necessary conveniences and facilities</li> </ul>	<ul style="list-style-type: none"> <li>Mt. Kumgang</li> </ul>

Each SEZ has to be developed according to its own function. The production-centered SEZ is the most common SEZ with industrial facilities intended to induce foreign investment for production. Normally this production-centered SEZ is established with the privilege of charging no tariff and no limit in quantities of raw material for export, and reduction or exemption of the

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<sup>5</sup> The North Korean government originally planned to develop Sinuiju SEZ as a complex SEZ with the functions of international banking, trade, industry, commerce, most recent technologies, amusements and tourism.

corporation tax and income tax for three to ten years in order to achieve maximum production. In addition, other benefits are offered such as being a 'one-stop-service' in administration, simplification of the process of import and export, permission of sending profits back to the home country for foreign enterprises, reducing the limitations of hiring foreign workers and importing capital, and offering good social overhead capital and low rents.

The production-centered SEZ can be classified by its spatial size and purpose as an export processing complex, an unfenced export-processing zone, a complex for importing advanced technology, as well as a state-of-the-art industrial complex. The export processing complex is the most common production-centered SEZ established to promote the growth of industry and exports through direct foreign investment and learning about foreign technology. This export processing complex is often established by the countries propelling industrialization at the early stage of economic development, giving special privileges to the commodities for export as opposed to those for domestic use. The usefulness of the export processing complex often decreases in line with to the growth of the economic activity of a country because most industries in this zone are labor intensive.

The purpose of the unfenced export-processing zone is the same as that of the export processing complex, and each has a different location and different governing regulations. Usually unfenced export-processing zones are located at or near borders and ports, giving foreign investors benefits such as exemptions from tariffs and the simplification of procedures, and basic facilities. However, reductions in the level of restrictions and

special business conditions are not given to enterprises in the zone.

Complexes for importing advanced technology are established to induce technology intensive industries by foreign direct investment. This type of complex is different from the export processing complex in terms of not having restrictions in terms of export and entry into the domestic market, and in that they offer various means for the development of technology and the production of up-to-date commodities.

State-of-the-art industrial complexes are established in industry intensive areas to connect academic, research, and industrial organizations for the purpose of attracting high value added industry and knowledge intensiveness. With this goal in mind, this type of area is arranged for competitive high technology industries, eventually utilizing such industries for the development of the area and accomplishing organic coordination of industrial policy and regional development policy.

## **2) The Design of North Korean Special Economic Zones**

There are four SEZs in North Korea: Sinuiju SEZ, Rajin-Sunbong SEZ, Kaesong Industrial Complex, and Mt. Kumgang Tourism Zone. Rajin-Sunbong SEZ was established in 1991 with the goal of inducing foreign investment up to as much as four thousand seven hundred million dollars until 2001. However, because it has accumulated less than one hundred million dollars up until the present, Rajin-Sunbong SEZ is said to have been a failure. The law of the Sinuiju special administration district was passed on September 12, 2002 to establish Sinuiju as the center of an international physical



distribution network. After Yang Bin, who was nominated as the Minister of Sinuiju SEZ, was arrested in China, the North Korean government has not been able to find a suitable replacement for some time, slowing down the progress of the SEZ project.

On the contrary, Mt. Kumgang and Kaesong SEZs, where investment and development are being led by South Korea, is making steady progress. The Mt. Kumgang project guarantees the inflow of 7 hundred million dollars to North Korea, and the infrastructure of Kaesong SEZ has been developed successfully with a high level of interest and participation by South Korea enterprises (136 enterprises applied for the selection of 15 enterprises). These two SEZ projects are different from the other two SEZ projects in terms of having reliable investors and high levels of demand. The developers of each SEZ project have to keep this in mind. What following is an outline of the special development strategy of each SEZ.

The short-term strategy of Kaesong SEZ is for it to develop in a way that it centers on the manufacturing industry as a production base for the South Korean market. Until Kaesong SEZ is able to produce a few success stories, it will probably be unsuccessful in inducing the inflow of large-scale international capital into the facilities for cultural, tourism, and leisure oriented or joint-venture enterprises. It is better to push ahead with the first-step of development utilizing South Korean enterprises and exploiting the merit of the short distance to the South Korean market. The attractiveness of Kaesong SEZ is less than Chinese SEZs for multinational corporations because MNCs usually invest in a country which has a large internal market. The MNCs will invest directly into China itself,

not Kaesong SEZ, if they intend to access the Chinese market. The medium and long-term strategy of Kaesong SEZ is the formation of its own cluster and to then form connections to the South Korean industrial clusters. It is desirable, in the beginning, to develop partial processing plants or engage in the manufacturing of parts or simple commodities, then move on to large scale manufacturing factories and assembly plants. Kaesong SEZ has the greatest potential to induce foreign investment among all the North Korean SEZs. It is expected to begin inducing foreign enterprises which have already invested in South Korean enterprises.

Mt. Kumgang SEZ provides a good vision for future profit making with the establishment of the tourism through land route. Mt. Kumgang SEZ needs to extend its business operations in primary industries (agriculture and fisheries). Currently, small scale farming sites and fisheries are being operated, and with these cooperative operations, North Korean workers are learning quickly.<sup>6</sup> Mt. Kumgang SEZ may develop faster than Kaesong SEZ in terms of software development because of its emphasis on the creativity of middle-level managers in Mt. Kumgang SEZ while the focus is on the supply of manpower in Kaesong SEZ. Inorganic agriculture and fisheries in Mt. Kumgang SEZ will compete in the South Korean market. Establishment of a fishery-processing plant, only two-hours distance Wonsan, can be considered.

The characteristic of Sinuiju SEZ is that of internationalization. While Kaesong SEZ and Mt. Kumgang SEZ are designed to

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<sup>6</sup> 7/1 Reformation was helpful for making such conditions because every unit in North Korea has engaged in economic activity more competitively after that reformation.

achieve North Korean industrial capability by joint ownership of an industrial base with South Korean industry, Sinuiju SEZ can be utilized as the channel for entering the international market. Physical distribution, high value added processing, and trade all need to be focused upon. A Shanghai style synthetic SEZ can be considered for Sinuiju although it is not desirable to apply a synthetic SEZ model from the beginning. It is desirable to achieve the competitive power of North Korean industry first, then Sinuiju SEZ can play the role of being a channel to the international market. It is 1km from Sinuiju to Dandong in China. However, the features of these two cities are totally different. While Dandong is developing very fast, the development of Sinuiju is very slow. The reason is that the direction of physical distribution is one way from Dandong to Sinuiju. If the direction of physical distribution is changed, Sinuiju can be developed. That may lead to the competitiveness of North Korean industry, something which has not yet been achieved. North Korea may begin to acquire competitiveness by the Kaesong SEZ. When the competitiveness of South Korean industry moves to Sinuiju, through Kaesong and Pyeongyang, the mutual direction of physical distribution between the two cities, Sinuiju and Dandong, will be realized. Dandong can be developed owing to the presence of the North Korean market, and Sinuiju can be developed with the help of the competitiveness of South Korea.

It is very difficult to induce foreign investment into the Rajin-Sunbong SEZ because the development of this SEZ is very slow and has had a negative image. These days, however, Russia and China have expressed their interest in this area. If Russia and China increase their investment into the Rajin-Sunbong SEZ, its role as a base of physical distribution will

be considered again. After the establishment of a connecting railroad, this SEZ can be the base for entering into the Maritime Provinces of Siberia and East-North Provinces of China. In addition, it is desirable to develop industry in the fields of steel, chemistry, and cement which meet the characteristics of that region. In order to induce foreign investment, first of all, it is important to gather people and expand physical distribution network. The next step will be the establishment of a policy to develop trade, processing and manufacturing commodities for trade, and setting up industries appropriate to regional characteristics. The most important thing to improve the competitiveness of Rajin-Sunbong SEZ is the connection of a railroad (Seoul to Wonsan), linking with the South Korean physical distribution network.

## **2. Development Scenarios of North Korean Special Economic Zones**

### **1) Development Directions of North Korean SEZs**

The success of North Korean SEZs will have positive effects upon the South Korean economy. The policy of North Korean SEZ will play an important role in reviving and developing the future North Korean economy. It is very important to make a concrete and successful development strategy for the four SEZs. It is important to focus on the development of Kaesong SEZ and Mt. Kumgang SEZ at the early stage of development, followed by the economic development of Pyeongyang, Nampo, and Wonsan, eventually leading to the success of Sinuiju as the complex SEZ.

The substantial task of initiating this project is the connection

of a railroad between the two Koreas. This railroad connection has more meaning than just the linking of South Korea to China and Russia, and decreasing the cost of physical distribution. In addition, this railroad connection can be the channel of South Korean competitive power to North Korea, serve as the main route for the development of SEZs, eventually becoming the base of South-North Korean economic unification, thereby reducing the cost of national unification.

While the east-side railroad is supposed to connect the South Korean railroad to Mt. Kungang, Tongcheon/Wonsan(Hamheung), and Rajin-Sunbong(Cheongjin) to TRS, the west-side railroad will connect the South Korean railroad to Kaesong, Nampo (Pyeongyang), and Sinuiju to TCR. Along these two main railroads, electric and communication network and social overhead capital will be established, which will be expanded to other areas of North Korea. These two railroads and roads connecting Seoul to North Korean SEZs will be the axis of the North Korean economic development plan.

The above arguments emphasize the step-by-step development of North Korean SEZs, not a simultaneous process. It will not have much chance of success to develop Sinuiju like the Shanghai complex SEZ model on the basis of short-term foreign investment. Basically, international investment funds chase after large markets. Because there is no such market with high purchasing power in North Korea, the North Korean SEZ policy has to be set up on the basis of the South Korean market which has purchasing power. The competitive power of North Korea should be constructed based on South Korean competitiveness. From this premise, the following development strategy can be recommended.

## **2) Development Strategy Linking SEZs**

Mt. Kumgang SEZ and Kaesong SEZ, where the investment from South Korea is possible, will be the first target for development. Mt. Kumgang SEZ will be developed focusing on tourism and the primary industry. This industrial capacity will be extended to Wonsan, and industrial competitiveness developed in Wonsan shall be managed at Pyeongyang, the central city of North Korea. At the same time, the linkage development to Rajin-Sunbong will be propelled forward.

The development of manufacturing industry should begin at Kaesong SEZ. The cluster linking Kaesong and Haeju and Seoul is supposed to be the base for the manufacturing industry which will be eventually extended to Pyeongyang and Sinuiju SEZ. The commodities manufactured in Kaesong SEZ by the support of South Korean competitive power can be provided to Sinuiju SEZ for trade items.

The North Korean government has to establish a step-by-step concrete development strategy for each SEZ utilizing South Korean market power. Each SEZ should be specialized as manufacturing industry in Kaesong SEZ, tourism and primary industry in Mt. Kumgang SEZ, physical distribution and trade industry for Rajin-Sunbong SEZ, and international complex SEZ for Sinuiju. South Korean competitive power will be linked in Kaesong SEZ and Kumgang SEZ and extended to Pyeongyang, Sinuiju SEZ, Wonsan, and Rajin-Sunbong SEZ.

<Diagram III-1> The North Korean SEZ Development Strategy: Specialization and the Procedure of Gradual Expansion



### **3. Development Strategy for Kaesong SEZ and Mt. Kumgang SEZ**

#### **1) Kaesong Industrial Complex**

##### **A) Importance of Kaesong Industrial Complex**

The Standing Committee of the Supreme Council of the People of North Korea, in November 20, 2002, promulgated the “Law of Kaesong Industrial Complex” and announced the plan of developing Kaesong SEZ. Kaesong SEZ is a model of the two Korea’s economic cooperation in pursuing common economic profit and prosperity. This project will revive the depressed North Korean economy and will be the base for national economic growth. For South Korea, this project will help it’s international competitiveness, based on the use of cheap labor costs, creating a new growth engine.

The detailed benefits that Kaesong Industrial Complex can provide to South and North Korea are as follows. First, the mix of comparative advantages of the two Koreas gives a degree of common interest and prosperity. The fusion of plentiful North Korean labor and South Korean capital and technology can give South Korean enterprises the momentum to overcome current difficulties, at the same time, reviving the North Korea economy.

Second, because the success of Kaesong Industrial Complex will have positive effects on both Korean economies, it can bring about balanced development of the two Koreas, establish an economic commonwealth, and reduce the costs of unification.

Third, Kaesong Industrial Complex is expected to be the first



successful case of South-North Korean economic cooperation. The success of Kaesong Industrial Complex will encourage South Korean enterprises to invest in North Korea and activate economic cooperation.

Finally, the success of Kaesong Industrial Complex derives additional meaning in its role as a test ground of economic reform and the open policy for North Korea. After the failure of Rajin-Sunbong SEZ, the open policy of the North Korean government had acquired a negative image. Thus the success of Kaesong SEZ can show the North Korean government the potential of opening and accelerate the expansion of opening.

## B) Development Strategy

For the successful and stable development of Kaesong Industrial Complex, in the short-term, it needs to be developed as a manufacturing-centered SEZ, and for the long-term, as a complex SEZ. In detail, it is desirable to develop Kaesong SEZ on the basis of a division of labor with Seoul utilizing their short spatial distances in the initial development stage, then it needs to induce the MNCs interested in the Northeast Asia market, thereby developing cooperative business with the Northeast Asian area.

The short-term strategy includes the following: Kaesong SEZ has to provide a chance to strengthen their internal competitiveness for South Korean enterprises which are faced with structural regulation by the South Korean government's economic policies. It is especially important to offer low-cost labor for South Korean small and medium enterprises which plan to move their manufacturing base to foreign countries because of the high

cost of labor in South Korea. The settlement of Kaesong SEZ can provide the chance for South Korean enterprises to get competitiveness again, leading to recovery in business conditions. Even enterprises with high added value will begin to invest in Kaesong SEZ. In the case that many South Korean enterprises lose competitiveness and experience failure in exploiting the market, Kaesong SEZ can help the South Korean economy to find an alternative and serve as an economic take-off point as envisaged by the short-term strategy.

The mid-term strategy will be the linking of Kaesong SEZ with the Metropolitan (Seoul) area. Kaesong SEZ has the benefit of conditions convenient for physical distribution because it is located near Seoul. Thus, utilizing this merit, Kaesong SEZ can be developed as an industrial complex linked with the division of labor of the Metropolitan area. It is important to find the development strategy which makes the best use of the close distance, while avoiding the problems caused by the overcrowding of the Metropolitan area. It is desirable to develop the service and the high-technology industries as well as the manufacturing industry. In addition, it is important to make Kaesong SEZ part of the growth triangle with Seoul and Incheon. In this triangle, Seoul takes the role of banking and information, Incheon takes on physical distribution and trade, and Kaesong may take the role of manufacturing commodities.

The long-term development strategy of Kaesong SEZ is to be a complex SEZ which will play an important role in Northeast Asia as well as on the Korean Peninsula. The Kaesong SEZ can play an important role of linking the economic cooperation belt of the Yellow Sea rim. At first, Kaesong SEZ should be developed to link the Metropolitan area including Incheon to

Pyeongyang and Nampo, then link the east coast of China and the west coast of the Korean Peninsula. In addition, Kaesong SEZ has to induce the MNCs of the U.S. and EU which plan to penetrate Northeast Asia, playing the role of the Asian base of these MNCs.

According to each development stage, the strategically targeted industry will be changed. For the short-term goal, the industry which can maximize North Korean low-cost labor and which can show off the result of fast growth have to be chosen. Such success in a short period can give Kaesong SEZ continuous development and make it a base for North Korean economic reform and further opening up. Industries appropriate for the short-term strategy are labor intensive light industry, which does not need skilled labor, such as the textile, clothing, footwear, bag, toy, and personal ornaments industries. Industries which can be chosen for the next step would be small and medium size labor intensive industries, which need low-level skilled workers, such as electricity, machinery, automobile, electronic accessory and assembling industries.

After the success of the short-term development strategy, the mid-term and long-term strategies have to choose industries having enough spin-offs beneficial to the modernization process of the North Korean economy such as the high technology industry. The high value added industries which can contribute to the growth of production and the North Korean economy are desirable for this stage.

Eventually, it is important to induce industries conducive to the competitiveness of both Koreas, establishing South-North Korean cooperation. In addition, we have to induce industries

which have relationships with the Northeast Asian region and attractive to foreign capital.

## **2) Mt. Kumgang Tourism Zone**

### **A) Importance of Mt. Kumgang SEZ**

Mt. Kumgang tourism has been the symbol of the improvement of South-North Korean relations since 1998. In spite of several difficulties, this project has been driven forward, and the North Korean government promulgated the law of Mt. Kumgang SEZ in 2002, beginning development in earnest for it to become an international tourism zone.

While Kaesong SEZ expected to induce the inflow of capitalist systems and technology, improvement of productive power, and earning foreign capital, Mt. Kumgang SEZ has different effects upon North Korea because it has already been equipped with the necessary infrastructure in the stable operation stage. In Mt. Kumgang area, Hyundai Asan and the North Korean people have had various economic relations such as the agreement of cultivating agricultural products, supplying live-fish, and participation in hotel management. The pragmatic “7/1 reformation” of the North Korean government helped to accomplish such South-North Korean cooperation. After all, Mt. Kumgang became the area where North Korean people experienced a capitalist market economy naturally.

In addition, the development of Mt. Kumgang SEZ derives meaning for other important reasons. First, Mt. Kumgang is the starting point of the east economic development axis which connects South and North Korea and is the basis of economic

cooperation. This east axis of economic cooperation can be extended to Wonsan, Rajin-Sunbong, and the northeast area of China and the Maritime Provinces of Siberia. The development of Mt. Kumgang SEZ will give North Korea greater balance compared with the west axis centered around Kaesong SEZ. For South Korea, this east axis can be helpful for the development of Kangwon province.

Second, the development of Mt. Kumgang SEZ will establish unification infrastructure in tourism through the South-North Korean tourism interchange and enhance the tourism value of the Korean Peninsula. A tourism network is needed to establish connections between Mt. Kumgang to Mt. Myohyang, Mt. Chilbo, and Mt. Baekdu in North Korea, and to Mt. Sorak and Mt. Odae in South Korea. It is important, in this project, to establish an environment-friendly and nature-friendly development plan.

Finally, in addition to economic utility, Mt. Kumgang SEZ can be used as a meeting space for separated families and various events as it has been used for South-North Korean officials' negotiations. Thus the expansion of South-North Korean interchange through the development of Mt. Kumgang SEZ will play an important role during the national unification process. For the student, Mt. Kumgang SEZ can be utilized as a space for experiencing unification.<sup>7</sup>

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<sup>7</sup> According to a poll in late 2003 by the Korea National Tourism Organization, among 800 Mt. Kumgang tourists, 48.6% answered that their negative perceptions on unification changed after visiting Mt. Kumgang. It seems that this result came out after the land based tourism passing through the Military Demarcation Line began.

## B) Direction of Development

The hopes and expectations placed upon Mt. Kumgang SEZ's success are increasing. Mt. Kumgang SEZ shows an enhanced profit making structure, inducing internal and foreign investors' interest. Hyundai Asan announced it will create a master plan to make Mt. Kumgang SEZ as an international tourism complex on the basis of the consultations between the WTO and Kumho Engineering Company. This plan includes the construction of a skiing ground, golf course, cable car, theme park, cinema studio, marine museum, and airport. There are a few matters to be solved before the execution of this project. First, large scale funding is needed for the project. The plan to induce internal and foreign capital is also needed. Second, current regulations regarding Mt. Kumgang SEZ need to be supplemented to create more convenient fund-raising conditions and to ensure long-term development, permitting more free activity to individual tourists.

In addition to its development as a complex tourism zone, Mt. Kumgang SEZ needs to build up primary industry (agriculture and fishery). Currently, a partial market economy of agriculture and fishery and hotel service by North Korean people at Mt. Kumgang Hotel have been formed. The adaptive and learning abilities of North Korean people in this process is evaluated as excellent. This result shows the possibility that Mt. Kumgang SEZ will develop faster than Kaesong SEZ in the management sector. While they emphasize the supply of labor in Kaesong SEZ, the creativity of mid-level managers is emphasized in Mt. Kumgang SEZ. Mt. Kumgang is evaluated as having competitive potential vis-vis the South Korean Market in the sector of inorganic vegetable cultivation and marine products. Thus the cooperation in this area needs to be enlarged.

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## **IV. Attracting Foreign Direct Investment as an Alternative Financing Resource**

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### **1. Spending from the Inter-Korean Cooperation Fund**

#### **1) Promotion and Expenditure of the Inter-Korean Cooperation Fund**

According to the record of the promotion and expenditure of the Inter-Korean Cooperation Fund (hereafter, Cooperation Fund), most of the Cooperation Fund is composed of the government subscription and the deposits of public fund. A small portion of the Cooperation Fund is composed of the proceeds earned by fund management and private subscription. The Cooperation Fund has been used through the “Inter-Korean Cooperation Account” and “Light-Water Reactor Account” since 1999 when the first deposits were made in the public capital management fund. The “Inter-Korean Cooperation Account,” supplied by government subscription, is used for humanitarian support to North Korea in the form of aid such

as supplying fertilizer, connection of the South-North Korean traffic network, and loans for the cooperation fund. The “Light-Water Reactor Account,” supplied by the deposits of the public funds, is used for the expenditure of building light-water reactors and the replenishment of the public fund.

These days, the expenditure of the Cooperation Fund increased to over one trillion won. In particular, the “project expenses” items of the “Inter-Korean Cooperation Account” is continuously increasing. This fund for “project expenses” is used for “humanitarian support” to North Korea like supplying fertilizer, “loans for recovering the national commonwealth” such as loans for food and materials/equipment, “establishment of a cooperation base” such as the connection of roads and railroads, “loans for the cooperating business fund,” “supporting the meetings of separated families,” and “aiding in human visits and interconnectedness.” The increases in the “project expenses” item fund is owing to the enlargement of cooperating business activity after the summit meeting in 2000.

The Cooperation Fund is classified as “supporting project expenses” and “investment project expenses” with the exception for the “Light-Water Reactor Account.” The criterion of distinguishing “support” and “investment” is not compensation or absence of compensation for the support, but whether the expense is for one time consumption like food and fertilizer or expense for SOC and cooperation projects intended to promote the development of the North Korean economy and increase in levels of cooperation.

The “supporting project expenses” include supporting funds for humanitarian and non-economic interchange/cooperation projects, such as supporting food and fertilizers, meetings of



<Table IV-1> Particulars of the Project Expenses

(unit: hundred million won)

Classification		'00	'01	'02	'03	'04 Plan
Supporting Project Expenses	o Humanitarian support for North Korea (fertilizer, other support by NGO and private organizations)	977 (47.7%)	976 (38.4%)	1,226 (35.2%)	1,501 (33.9%)	1,600 (26.9%)
	o Support for the meeting of separated families	28 (1.4%)	13 (0.5%)	20 (5.7%)	29 (6.5%)	347 (5.8%)
	o Support for interchange, cooperation, and human visits	11 (0.5%)	4 (0.1%)	237 (6.8%)	20 (4.5%)	175 (2.9%)
	o Loan for recovering national commonwealth (Loan for food)	867 (42.3%)	190 (7.5%)	967 (27.7%)	1,560 (35.3%)	1,320 (22.2%)
	Subtotal	1,883 (92.0%)	1,183 (46.6%)	2,450 (70.2%)	3,110 (80.4%)	3,442 (58.0%)
Investment Project Expenses	o Loan for recovering national commonwealth (Connection of road and railroad, loan for materials and equipment in North Korea)	- (0.0%)	- (0.0%)	306 (8.8%)	360 (8.1%)	526 (8.9%)
	o Establishment of cooperation conditions (Connection of road and railroad in South Korea, establishment of basic facilities in Kaesong SEZ)	160 (7.8%)	898 (35.3%)	368 (10.6%)	763 (17.3%)	1,520 (25.6%)
	o Loan for interchange and economic cooperation	5 (0.2%)	460 (18.1%)	361 (10.4%)	187 (4.2%)	450 (7.6%)
	Subtotal	165 (8.0%)	1,358 (53.4%)	1,035 (29.8%)	1,310 (19.6%)	2,496 (42.0%)
Total		2,048	2,541	3,485	4,420	5,938

Source: Ministry of Unification, *Major Statistics of South-North Korea Cooperation Fund (For the Latest 5 Years)*, (May, 2004)

separated families, and interchange within the cultural and social sector. The “investment project expenses” include investment

funds for economic interchange and cooperation, investment for infrastructure, and support for materials and equipment. Those are funds for the “establishment of interchange/ cooperation conditions,” “loans for interchange/cooperation project fund,” “supplements for interchange/cooperation losses,” and loans for materials and equipment out of the “loan for recovering the national commonwealth.”

## **2) Particulars of Investment Project Expenses**

### **A) Mt. Kumgang Tourism Project**

Hyundai Asan asked the Korea National Tourism Organization (KNTO) to participate in the Mt. Kumgang project to help it continue. With this request, the KNTO and Hyundai Asan made an agreement to propel the Mt. Kumgang project forward as joint participants on June 20, 2001. The Korean government approved, on June 29, 2001, the application of the KNTO regarding the loan of the Inter-Korean Cooperation Fund in order to promote the Mt. Kumgang tourism project to the tune of 900 hundred million won. Beginning with the loan of 450 hundred million won on September 5, 2001, the Korean government loaned out 334 hundred million won in 2002, 60 hundred million won in 2003, and finally loaned out 56 hundred million won in 2004 as a ninth loan.

### **B) Road/Railroad Connection Project**

The South and North Korean governments agreed on the connection of the Seoul-Sinuiju railroad and the Munsan- Kaesong road at the first and second South-North Korean Ministers'

Talks (July 31 and September 1, 2002), and made agreements on the connection of the East Coast Road/Railroad as well as the Seoul-Sinuiju Road/Railroad at the meeting with the South Korean special envoy in April, 2002. The South Korean government decided to provide support of 1,804 hundred million won needed for the connection of the south part of Seoul-Sinuiju Railroad and Tongil Bridge-Jangdan road from the South-North Korea Cooperation Fund (at the Conference for Driving South-North Korean Interchange and Cooperation on February 8, 2001). At the first Practical Meeting for Connecting the South-North Korean Road/Railroad on September 17, 2002, the South Korean government reached agreement on supplying materials and equipment to North Korea.<sup>8</sup> At the same conference, the South Korean government agreed on providing 1,668 hundred million won for the construction of the south part of East Coast Road/Railroad<sup>9</sup>, and providing loans to North Korea to the amount of 459 hundred million won for the construction of the north part of the East Coast Road/Railroad and the Seoul-Sinuiju Road/Railroad from the South-North Korea Cooperation Fund.<sup>10</sup> At the Conference for Driving South-North Korean Interchange and Cooperation in October, 2003 (the

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<sup>8</sup> The major contents of the agreement are as follows. First, South Korea supplies materials and equipment needed for the connection of the East Coast Road/Railroad and the Seoul-Sinuiju Road/Railroad in the name of loans. Second, the repayment period of the loan is 30 years with a 10-year grace period, with the interest rate of 1% annually.

<sup>9</sup> This project cost has increased with the additional expense for the construction of approaching road according to the establishment of CIQ after the completion of the design. At the 125th Conference for Driving South-North Korean Interchange and Cooperation in April, 2004, they raised the fund up to 2,186 hundred million won.

<sup>10</sup> The amount of the first loan to North Korea was 597 hundred million won including 138 hundred million won for transportation, equipment management, and other expenses.

119th Conference), the two Koreas reached agreement on supplying additional loans to North Korea to the amount of 620 hundred million for the construction of the north part of the same lines.<sup>11</sup>

### C) Kaesong SEZ Development Project

The expenditure of the South-North Korea Cooperation Fund for the development of Kaesong SEZ consists of “expenses for basic facilities construction,” “expenses for operating management office of Kaesong SEZ,” and “supplements for the participating enterprises' investment.” The support for basic facilities are classified as the support for internal facilities without compensation such as water facilities, drain facilities, waste reclamation facilities, and buildings and the credit support for external facilities such as electricity and communication facilities. Among internal facilities, building construction began in August, 2004 and the construction of other internal facilities will begin in 2005 after the schedule is mutually agreed. The schedule for constructing external facilities is not set up yet because both parties have not reached agreement on the communication operating system. In the first place, the commercial support of 15,000kW electricity and 100 communication lines for the participating enterprises have been agreed upon.

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<sup>11</sup> The amount of the second loan to North Korea was 899 hundred million won including 179 hundred million won for transportation, equipment management, and other expenses.

## **2. Attracting Foreign Direct Investment**

### **1) Conditions of North Korean SEZs for Foreign Direct Investment**

For MNCs, the motives behind direct foreign investment are market-seeking, resource-seeking, efficiency-seeking, and strategic asset or capability-seeking (Behrman, 1972). “Market-seeking” is establishing manufacturing facilities in particular regions in order to utilize the purchasing power of the region and escape export barriers such as tariff and quarter. “Efficiency-seeking” refers to the regional production in order to develop international competitiveness by reducing the production costs using the low cost production factors of the region. “Resource-seeking” pursues regional manufacturing in order to establish efficient and stable production systems on the basis of cheap regional raw materials and resources. “Strategic asset or capability-seeking” is intended to obtain the advanced technology and know-how of developed countries, usually taking the form of joint ventures or acquisition to realize long-term strategic goals.

In the UNCTAD Report (1998), the motive of direct foreign investment included policy frameworks and business facilitation in addition to the above four economic determinants. “Policy framework” refers to socio-political stability, equal opportunities for internal and foreign enterprises, the policy of private management, and joining international agreements for foreign direct investment. “Business facilities” are the facilities and services which are part of the investment process such as the foreign investment inducing efforts of the regional government, investment incentives and administrative support, consistent management of foreign investments, and establishment of schools for foreigners.

<Table IV-2> Contents and Characteristics of the Determinant of Foreign Investment

Characteristic	Classification	Detailed Contents
Substantial Factors	Economic Factors	<ul style="list-style-type: none"> <li>• Market demand (market scale, national income per capita, market growth, import barriers, accessibility to regional markets, and consumers' preferences)</li> <li>• Productivity (productivity of expert and non-expert, cost of parts and raw materials, charges for traffic/communication/public facilities, and financial costs)</li> <li>• Availability of materials (petroleum, gas, mineral, raw materials, farmland, and tourism resource)</li> <li>• Strategic acquisition of assets (market for M&amp;A and availability, technology level)</li> </ul>
Accompanying Factors	Socio-political Factors	<ul style="list-style-type: none"> <li>• Socio-political stability (country-risk, social climate)</li> <li>• Union-management relations (organization of unions, characteristics of unions)</li> <li>• Policies for private management (privatization of government-invested institutions)</li> <li>• Legal system (intellectual property, law of competition and labor, tax administration, regulation for establishing enterprise)</li> <li>• International pacts (taxation pact, investment pact, and FTA)</li> </ul>
	Facilities and Services	<ul style="list-style-type: none"> <li>• Investment promotion activities (image raising and public relations)</li> <li>• Facilities for living (foreigner's schools, living and cultural facilities)</li> <li>• Management conditions (transparency in accounting, bureaucracy, and corruption)</li> <li>• Consistent management services for investment (ombudsman)</li> </ul>

Source: Sung-Hoon Lim, *Strategic Foreign Direct Investment Marketing*, (Hakhyunsa, 2004), p. 8.

Regarding the investment conditions for North Korean SEZs, in this book, the author will examine market conditions, legal/

institutional conditions, and facilities and services about Kaesong SEZ and Mt. Kumgang SEZ which is linked with the South Korean economy as follows.

#### A) Market Conditions

According to *Regulations of Labor in Kaesong SEZ(2003.9)*, it is prescribed that “the salary of workers should be \$50 at the lowest. The lowest salary cannot be raised more than 5% of the salary of the previous year.” They prescribed the same wage level in the *Regulations of Labor in Mt. Kumgang SEZ*. The wage level of North Korea is 30% lower than that of China and similar to that of Vietnam and other East-South Asian countries. North Korean wage levels are competitive.

When we evaluate North Korean labor quality, we must consider education levels, working regulations, and labor productivities, etc. The evaluation by MNCs of those who operated or who are operating in North Korea is the only way to examine these factors because official data on labor forces is not published by the North Korean government. MNCs usually evaluate the level of North Korean workers' education, and learning ability as excellent when they are considering comparatively cheap labor costs. In contrast they did not give good evaluations in regards to the North Korean government's labor policy, labor regulations, and work culture.

However, in the case of Kaesong SEZ, exclusive labor management rules can be established. The reason for this is that not only is the Kaesong SEZ organization composed of South Korean businessmen in Kaesong SEZ who are in charge of employment and management of Kaesong SEZ, but also

because an enterprise is able to make its own rules through negotiation with the representatives of Kaesong SEZ workers. The South Korean enterprise maintains greater authority and flexibility in employing workers compared with past cases. Although, at present, there may be minor confusion and it is still undergoing trial and error, the employment system will settle down in the near future, giving North Korean SEZs a higher degree of labor competitiveness.

In spite of these advantageous labor conditions, North Korean SEZs have weak points in terms of their marketing channels and infrastructure. Considering North Korean economic power, popularity, and potential energy for growth, it seems that North Korean purchasing power will be unable to increase rapidly. However, the fact that Kaesong SEZ has a cosmopolitan South Korean market a short distance away can make Kaesong SEZ an attractive investment location. Mt. Kumgang SEZ also can be a more profitable place when we consider that Mt. Sorak tourism is linked with Mt. Kumgang tourism. If ten percent out of an annual ten million Mt. Sorak tourists visit Mt. Kumgang, the Mt. Kumgang tourism project will be successful.

## B) Legal/Institutional Conditions

The North Korean government announced its intention to develop Mt. Kumgang SEZ as an international tourism site and Kaesong SEZ as an international SEZ of industry, trade, commercial business, and banking with its promulgation of the “Law of Mt. Kumgang SEZ” and the “Law of Kaesong SEZ” in November, 2002.



**<Table IV-3> Related Laws for the Kaesong SEZ and the Mt. Kumgang SEZ**

Laws Related with Kaesong Industrial Complex	Laws Related with Mt. Kumgang Tourism Zone
Law of Kaesong Industrial Complex (11/20/2002)	Law of Mt. Kumgang Tourism Zone (11/13/2002)
Regulations for Kaesong Industrial Complex Development (4/24/2003)	Regulations for Mt. Kumgang Tourism Zone Development (5/12/2003)
Regulations for Establishing Enterprises in Kaesong Industrial Complex (4/24/2003)	Regulations for Establishing Enterprises in Mt. Kumgang Tourism Zone (5/12/2003)
Regulations on Taxation in Kaesong Industrial Complex (9/8/2003)	Regulations on Taxation in Mt. Kumgang Tourism Zone (4/29/2004)
Regulations on Work in Kaesong Industrial Complex (9/18/2003)	Regulations for Trespassing, Staying and Residence in Mt. Kumgang Tourism Zone (4/29/2004)
Regulations on Customs in Kaesong Industrial Complex (12/11/2003)	Regulations for Establishing Management Organization in Mt. Kumgang Tourism Zone (4/29/2004)
Regulations for Trespassing, Staying, and Residence in Kaesong Industrial Complex (12/11/2003)	Regulations of Advertizement for Mt. Kumgang Tourism Zone (5/6/2004)
Regulations for Establishing Management Organization in Kaesong Industrial Complex (12/11/2003)	Regulations on Work in Mt. Kumgang Tourism Zone (5/6/2004)
Regulations of Advertizement for Kaesong Industrial Complex (2/25/2004)	Regulations on the Management of Foreign Currency Holdings in Mt. Kumgang Tourism Zone (5/6/2004)
Regulations on the Management of Foreign Currency Holdings in Kaesong Industrial Complex (2/25/2004)	Regulations on the Real Estate in Mt. Kumgang Tourism Zone (9/21/2004)
Regulations on the Real Estate in Kaesong Industrial Complex (7/29/2004)	
Regulations on Insurance in Kaesong Industrial Complex (9/21/2004)	

The Law of Kaesong Industrial Complex and the Law of Mt. Kumgang Tourism Zone are similar in terms of both laws' assurance of free business activity, their strong intention to induce foreign investment through providing business facilitation procedures. The only difference between the two is in terms of the development concept. Mt. Kumgang is a tourism SEZ while Kaesong is an industrial SEZ related with South Korean industries.

### C) Facilities and Services

The major business facilitation processes for investors in North Korean SEZs are providing investment incentives and utilizing social overhead capital. The incentives in the tax system offered to enterprises in Kaesong SEZ are no better than those in other SEZs. Table VI-4 shows the preferable tax system of North Korea for foreign investors in SEZs.

**<Table IV-4> Incentive in Tax System for the Enterprises in SEZs**

General Preferential Provisions Applied to SEZs	Preferential Provisions Applied to Kaesong SEZ
<p>Income tax rate on foreign enterprises in SEZ is 14%, and income tax rate on high technology industry, high level research and technical development is 10%. Tax rate on foreign enterprise out of SEZ is 25% of the settled profit and 20% of other profits. (Taxation Law for Foreigners, Article 12; Enforcement Ordinance, Article 12)</p>	<p>Income tax rate in Kaesong SEZ is 14% of the settled profit. Tax rate on infrastructure construction, light industry, and newest technology is 10% of the settled profit. (Regulations of Taxation in Kaesong SEZ, Article 19)</p>
<p>For an enterprise which invested in the establishment of manufacturing sector in the SEZ and operates more than 10 years, income tax shall be exempted for three years after making profit and reduced by 50% for the following two years. (Enforcement Ordinance, Article 28)</p>	<p>For an enterprise which invested in manufacturing or recommended sector and operates more than 15 years, income tax shall be exempted for five years after making profit and reduced by 50% for the following three years. (Regulations of Taxation in Kaesong SEZ, Article 29)</p>
<p>For an enterprise which invested in the service sector in the SEZ and operates more than 10 years, income tax shall be exempted for one year after making profit and reduced by 50% for the following two years. (Enforcement Ordinance, Article 29)</p>	<p>For an enterprise which invested in service sector and operates more than 10 years, income tax shall be exempted for two years after making profit and reduced by 50% for the following one year. (Regulations of Taxation in Kaesong SEZ, Article 29)</p>
<p>For an enterprise which invested more than sixty million won on railroad, road, communication, airport, and harbor infrastructure in the SEZ, income tax shall be exempted for four years after making profit and reduced by 50% for the following three years. (Enforcement Ordinance, Article 30)</p>	<p>For an enterprise which reinvested profit and operates more than three years, 70% of the income tax for the re-investment shall be reduced at the following year. (Regulations of Taxation in Kaesong SEZ, Article 29)</p>

The important infrastructure supported by South Korea are the Seoul-Sinuiju Railroad/Road, the East Coast Railroad/Road, and the establishment of the site for the Kaesong SEZ. At the first and second South-North Korean Ministers' Conference in Sept. and Oct., 2000, the two Koreas agreed on the connection of the Seoul-Sinuiju Railroad and the Munsan-Kaesong Road, and at the Meeting with the South Korean special envoy in April, 2002, they reached agreement on the East Coast Railroad/Road. Accordingly, on September 18, 2002, the railroad/road construction work between Seoul-Sinuiju and East Coast began in the two Koreas. On December 31, 2002, the South Korean part of the East Coast Railroad/Road was completed, and on October 31, the South Korean part of the Seoul-Sinuiju Railroad/Road was finished.

The support for infrastructure construction in Kaesong is progressing well. The South Korean Land Corporation has finished 19% of one million “*pyeong*” (about 3.3 square meter) of the site as of at the end of September, 2004, and is well on the way of constructing road and water facilities, and is designing the facilities for waste water and waste matter.

## **2) Industries for Foreign Investment in North Korean SEZs**

The recommendable industries for foreigners to invest in North Korea are clothing, furs, leather goods, bags and shoes, furniture, electric devices, machinery, electric converters, the wood and lumber industry, medical instruments, optical instruments, precision manufacturing, and watchmaking. However, these items are not to be recommended in Kaesong SEZ and Mt. Kumgang SEZ. The reason for this is that they need to be considered in related to South Korean industry competitiveness

and market conditions. The primary strategy concept of establishing Kaesong SEZ and Mt. Kumgang SEZ, as mentioned earlier in this paper, is to focus on the industries which can supplement South Korean industrial competitiveness and expand such industries to other parts of North Korea. The key point of selecting target industries in Kaesong SEZ and Mt. Kumgang SEZ is the need to utilize South Korean markets and competitiveness such as accumulated capital, high-technology, and the consumer demand of neighboring districts (e.g. the Seoul metropolitan area).

According to previous research on location selection, this book suggests two criteria in selecting recommendable industries for foreign investors.<sup>12</sup> One is industries which have already a degree of foreign investment already and the other is industries which have competitiveness on the basis of their regional advantages. The former refers to the present competitiveness in attracting FDIs while the latter refers to the local governments' desire to develop future competitiveness in their area. The latter is also closely associated with local specialized industries recommended by central government to accomplish balanced development on the national level.

The MNCs prefer metropolitan areas since they are the center of politics and business, the region which has already induced foreign investment, and border areas. The industry where foreign investment is concentrated is a competitive one. The industry specialized on the basis of regional merits or regional industrial clusters is also a competitive factor which can induce foreign investment.

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<sup>12</sup> Mariotti, S. and Piscitello, L., "Information Cost and Location of FDIs Within the Host Country: Empirical Evidence From Italy." *Journal of International Business Studies*, Fourth Quarter, 1995.

**<Table IV-5> Recommended industrial sectors for inducing FDI for the Kaesong SEZ and the Mt. Kumgang SEZ**

	FDI sectors the most attracted by region <sup>1</sup>	FDI sectors the most attracted by region <sup>1</sup>	Core strategic industry by regions <sup>2</sup>	Favorable/general business for each regions <sup>2</sup>	Recommendable FDI inducement sectors for the Kaesong SEZ	Recommendable FDI inducement sectors for the Mt. Kumgang SEZ
Seoul	mining, financial business, other services, other manufacturing industries, agriculture and forestry, retail/wholesale, trading, insurance, real estate, textiles/clothing, foodstuffs	construction, marine products, warehousing/transportation, medicines, electricity/gas	textiles/clothing, ICT, precision machinery/machine tools, business services	footwear, electronic information devices	textiles/clothing, footwear, machinery and tools, electronic information devices, automobile parts, new materials, mechatronics	tourism, culture, lodging, mining, agricultural/marine products processing, foodstuffs
Incheon	-	real estate	semiconductors, electric/information devices, precision chemistry, biochemical industry	automobiles, mechatronics, precision machinery, environment, information services, culture, logistics/distribution		
Kyonggi	other services, vehicles, warehousing/transportation, medicines, electricity and gas	other services, agriculture/forest, insurance, foodstuffs, electricity/gas, footwear	environment, distribution, instruments, automobiles, mechatronics	automobiles, electronic information devices, biochemical, new material, information services		
Kangwon	-	mining, other manufacturing industries	precision machinery, tourism, culture, biochemical	information services		

Note: 1. Industrial sectors held the 1st and 2nd rank as a result of analyzing foreign investment between 1962-2003 by 16 regions.

2. Sectors designated by Ministry of Commerce, Industry and Energy as core or favorable businesses by region, Ministry of Commerce, Industry and Energy, *Basic Plan for Promoting Industrial Agglomeration*, 2003.

Accordingly, industrial sectors can be recommended for attracting foreign investment into the Kaesong SEZ and the Mt. Kumgang SEZ as follows. The Kaesong SEZ is characterized as a manufacturing oriented zone, in which textiles/clothing, footwear, machinery and tools, electronic information devices, automobile parts, new materials, and mechatronics are selected. In contrast, considering the locational advantage of Mt. Kumgang SEZ, tourism, leisure, organic elements, lodging, mining, agricultural and marine products processing, and foodstuffs are recommendable (see Table IV-5).

### **3. Structuring Project Finance**

#### **1) Target Industries of Project Finance in North Korean SEZs**

Even if there are numerous infrastructure related projects in Kaesong SEZ such as construction of electricity, communication, and road construction, this hardly represents prosperous project finance in the real world. This is because each business size can not be satisfied with minimum economic scales.

On the contrary, there are more attractive projects which can be available in Mt. Kumgang SEZ, although it is a smaller scale project than Kaesong's. Hyundai Asan plans to expand this tourism project into the eight neighboring areas such as the three coastal areas between Haekeumgang and Myungsasimri in Wonsan, the three areas near lakes (Samilpo, Sijungho, and Dongjungho), and the two areas near mountains. The first step in the projects is the building of rest facilities, performance building, entrance management offices, harbor facilities, hot spring facilities, residential facilities, hotels by the sea, family hotels, golf courses, complex facilities in Gosung harbor, rest

areas on the sightseeing road; second step projects include the construction of hotels, family hotels, golf courses, skiing grounds, an airport, and a light industry complex; and the third step of the projects are the enlargement of hotels, constructing a marine museum, theme park, golf courses, and sports facilities. These businesses can be adjusted as project finance projects as a tool for financing of the SEZ. In addition to these tourism and resort facilities, large scale agricultural areas can be the target of project finance.

## **2) Successful Project Finance Plan in the North Korean SEZs**

It is important to consider the following three factors which can help to make project finance a success. First, developing project targets which meet the regional characteristics of the SEZ is important. Regional characteristics include the national risk level, geographical position, access to the market, and the type of industry. Among these features, market and the type of industry are more important factors. Kaesong SEZ project is an industrial complex development. Usually the structuring of project finance of industrial complex development is relatively difficult to achieve profitability when compared to resource development project finance such as the development of energy, wood, and minerals or large scale tourism zone development. The construction of SOC such as roads, electricity, and communications are not appropriate targets of project finance because they cannot yield profit quickly.<sup>13</sup> In order to achieve profitability, the project scale has to be large and general in

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<sup>13</sup> In many cases of project finance investment, from the initiation stage, government subsidies for operational costs and operational losses are factored in.



nature. Therefore, it would be better to create the complex package by combining residential amusement facilities for obtaining project finance. Until now it seems that the investment method of Kaesong SEZ would be direct investment instead of project finance because it probably will not be possible to substitute project finance for the Inter-Korean Cooperation Fund which is supposed to support the infrastructure of Kaesong SEZ. However, if Kaesong Industrial Complex is extended to neighboring areas, the possibility of obtaining project finance will increase for constructing connecting roads such as the Incheon-Kanghwa Island bridge and other infrastructure.

On the contrary, it is possible to structure project finance to each sector of the Mt. Kumgang SEZ. It is possible to design this project as a large one supported by project finance or divided up according to the sector for project finance and direct investment.<sup>14</sup> However, if the sector for direct investment takes on a greater portion of the profitable projects available, the profitability of project finance will be reduced. Therefore, first, we need to design large scale general projects and encourage project finance for this project, eventually creating a win-win situation to all involved.

Second, the formation of an organization to propel the project finance efficiently, composed of experts, is something else which is needed. This organization will take on the task of promoting the project rapidly and in a precise manner, such as project merchandise development, making a master plan

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<sup>14</sup> Hyundai Asan may invest directly and operate the project or transfer the project after construction. As an alternative, Hyundai Asan can take part in project finance and take some portion as a developer, still making profits from the project and increasing added value of the project.

for each project, examination of feasibility, collecting investors (foreign sponsors), and evaluation of credit levels. In project finance, many investors and developers with different interests are entangled and a high level of financial skill is needed, and there are a number of economic goals in addition to the establishment of conditions for unification and the recognition of a commonwealth for the two Koreas. In order to coordinate several goals and various investors and related sections, a professional promotion organization has to be set up from the beginning.

Third, adopting objective and international levels of promotional procedures are required; which requires precise examination of the feasibility and getting a credit level inspection from an international credit evaluation institute. For the success of project finance, the project sponsor has to use a minimum of memorandums, payment assurances, and limited payment assurances to the lending bank but structure a security package which satisfies credit risk. Usually there is a significant gap between the lending bank and the project sponsor in regards to the evaluation of project finance profitability. While the project company tries to diffuse risk using project finance, the lending bank requires the assurance of the project company in case the repayment of the fund cannot be fulfilled. Therefore, it is important to create a precise feasibility study of the project in order to get a clear and accurate picture of exact cash flow and business profit. The feasibility study includes the analysis of demand, economic efficiency, profitability, and risk. In addition, more than one susceptibility analysis is needed to cover weak points and other areas of insufficiency, leading to a more exact expectation of cash flow. Such a feasibility analysis can be the basis for designing fund raising and will contribute to easier fund raising.

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## V. Conclusion

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In summary, this book suggests that the sequential approach for successfully establishing North Korean SEZ rather than the simultaneous approach. Furthermore, each SEZ should have differential strategies, with regard to function and targeting of industry: manufacturing industry in the Kaesong SEZ, tourism and primary industry in the Mt. Kumgang SEZ, physical distribution and trade for the Rajin-Sunbong SEZ, and international business complex for the Sinuiju SEZ. South Korean competitive power will be linked in the Kaesong SEZ and extended to Pyeongyang, the Sinuiju SEZ.

Considering a way to attract a FDI into SEZ, we should not only fully utilize North Korean cheap labour forces but also South Korean's effective market demand. Competitiveness in labor forces appeals to MNCs seeking for production efficiency. In contrast, the South Korean metropolitan area adjacent to the Kaesong SEZ can be an attractive FDI climate to the MNCs

seeking for potential market.

Also South Korean government has to consider the policy goal of attracting foreign investment for the Kaesong SEZ not from the perspective of employment creation, regional development, foreign exchange inducement like the typical foreign investment policy, but from the standpoint of relaxing of South-North Korean tension and the formation of a community for constituting the basic condition of unification. It has to raise the real investment attraction possibility through inducing joint ventures rather than wholly-owned subsidiary. Furthermore, additional investment of foreign firms invested in South Korea rather than new investment.

Project finance is expected to be a main fund-raising of the Kaesong SEZ and the Mt. Kumgang SEZ, too.

The Mt. Kumgang SEZ is apt to apply much more project finance compared with the Kaesong SEZ. In order to attract international capital for the Kaesong SEZ easily, it is advisable that both sides lay out the project finance through “one package structure”. Especially as for the Kaesong SEZ, It seems to difficult to organize a profitable project individually due to a lack of the existing facilities and physical infra structure. Therefore, it is desirable that a comprehensive package including living facilities and physical infrastructure is organized.







