

STUDIES SERIES

Studies Series 05-03

Evaluation of South-North Economic Cooperation and Task for Success

By Young-Yoon Kim

Evaluation of South-North Economic Cooperation
and Task for Success



Evaluation of South-North Economic Cooperation and Task for Success

By Young-Yoon Kim

Korea Institute for National Unification

Printed: May 2005

Published: May 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

(c) Korea Institute for National Unification 2005

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. 89-8479-289-6 93340

Evaluation of South-North Economic Cooperation and Task for
Success / By Young-Yoon Kim. -- Seoul: Korea Institute for
National Unification, 2005
p.; cm. - (Studies series ; 05-03)

ISBN 89-8479-289-6 93340 : 비매품

322.8311-KDC4

338.9519-DDC21

CIP2005000909

Evaluation of South-North Economic Cooperation and Task for Success

by Young-Yoon Kim

Korea Institute for National Unification

* * *

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

I. Purpose of the Study and Research Design	1
II. Quantitative Evaluation of South-North Korean Economic Cooperation	3
1. Trade Project	3
2. Investment Project	23
III. Qualitative Evaluation of South-North Korean Economic Cooperation	29
1. Current Status of South-North Korean Economic Cooperation	29
2. Problems in the Procedure of Economic Cooperation	35
3. Factors for Success and Failure of Economic Cooperation	46
IV. Plan for the Success of Economic Cooperation and Task	51
1. Task of the Enterprise	51
2. Cooperation Between Governments	63

• TABLES

<Table II-1>	North Korean Exports by Region	6
<Table II-2>	Change of Commercial and Non-commercial Trade	7
<Table II-3>	Contents of Non-commercial Trade	8
<Table II-4>	Materials Brought in from North Korea	10
<Table II-5>	Materials Exported to North Korea	12
<Table II-6>	Continuity of Trading Enterprises	13
<Table II-7>	Proportion Change of Processing Trade	14
<Table II-8>	Continuity of Processing Trade Enterprises	17
<Table II-9>	Comparison of the Production Cost of Processing Trade with North Korea and China	19
<Table II-10>	Approval of Entrepreneur and Enterprise	23
<Table II-11>	Present State of Cooperation Project with N. Korea	24
<Table II-12>	Type of Investment Project to N. Korea (As of 2003)	25

• DIAGRAMS

<Diagram II-1>	Progress of the Trade between two Koreas	4
<Diagram II-2>	Change of Balance of Trade toward North Korea	9

I . Purpose of the Study and Research Design

This research evaluates the difficulties of South Korean enterprises participating in economic cooperation with North Korea and examines the reasons for success and failure. The data was gathered empirically by a professional pollster from interviews with thirty businessmen who undertake South-North economic cooperation. For some enterprises, the author had successive interviews after the first overall interviews to obtain further detailed data.

The interviewees were part of enterprises that have taken part in the economic cooperation with North Korea for several years and have amassed a wealth of knowledge and experience on the issues.

II. Quantitative Evaluation of South-North Korean Economic Cooperation

1. Trade Project

A. Simple Trade

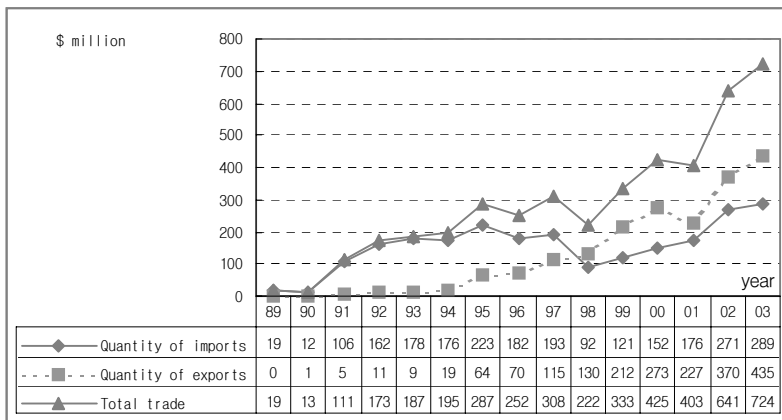
(1) Political Aspect of Trade

In 1989, the year two Koreas trade began, the amount of trade was less than \$20,000,000, but after the “Law of South-North Korean Interchange and Cooperation” was promulgated in August 1990, it exceeded \$100,000,000. The amount of trade has increased since 1991 when real trade began. By 2003, trade was 6.51 times greater than the 1991 level, representing a 16.8% growth rate.

Trade has not increased consistently. Trade between the two Koreas was depressed by the North Korean declaration of secession from the NPT in 1992. In 1994, the North Korean nuclear issue adversely influenced inter-Korean economic trade.

In addition, the incursion of a North Korean submarine into South Korean territory (9/18/1996) and the North Korean economic depression influenced a 12% decrease in trade in 1996 compared with the previous year. The South Korean economic crisis that led to the supervision of the IMF also decreased the volume of the trade with North Korea.

<Diagram II-1> Progress of the Trade between two Koreas



In general, South-North Korean trade is inclined to overcome external influences. After tensions with the US over North Korean nuclear issues declined in 1994, inter-Korean trade increased by 48% in 1995 with the help of “Law of Promoting South-North Korean Economic Cooperation.” The settlement of the North Korean nuclear problem led to the beginning of the Light-Water Reactor (LWR) project, increasing the export of materials, and ultimately exceeding \$300,000,000 of trade in 1997. However, following the foreign exchange crisis and

the submarine incursion that led to a standoff between two Koreas, trade reduced to \$221,940,000 in 1998; a 28% decrease compared to 1997. Conversely, in 1999 when the South Korean economy began to revive and in 2000 following the South-North Korean summit meeting, trade increased significantly to \$300,000,000 and \$400,000,000 respectively. The increasingly amicable relationship between the two Koreas after the summit meeting was particularly beneficial in increasing the export of materials for the Mt. Kumgang project and LWR construction.

Inter-Korean trade reached \$641,730,000 in 2002; a 60% increase over the previous year. In this amount, humanitarian support for North Korea and the export of materials for Mt. Kumgang project formed the major elements. Such increased trade continued until 2003 when it reached \$724,220,000; a 12.9% increase over the previous year. In this amount, the increase of non-commercial trade such as the support of food, fertilizer, and materials for connecting rail and road links to North Korea formed the major elements.¹ Inter-Korean trade is closely related to the two Korea's political relations.

(2) Interdependence of Trade

Following the increase in South-North Korean trade, S. Korea became the second largest trading country following China for N. Korea. N. Korean exports to S. Korea in 2003 represented 37.0% of total exports, demonstrating a high level of N. Korean dependence on the S. Korean economy.² This dependence includes

¹ non-commercial trade is bringing out to North Korea, that is, one-way support without the condition of give-and-take or payment, including humanitarian support of rice, fertilizer, and medical supplies, heavy oil supply by KEDO, and materials for cooperated project like Mt. Kumgang project.

the export of materials to S. Korea and the import of manufactured goods through processing trade.

<Table II-1> North Korean Exports by Region

(Unit: million dollars)

	1998	1999	2000	2001	2002	2003
Exports:	559.0	515.0	556.0	650.0	735.0	780.0
(China)	57.3	41.7	37.2	166.8	270.9	395.5
(Hong Kong)	52.5	63.3	46.4	38.0	21.9	-
(Japan)	219.5	202.6	256.9	225.6	234.4	173.9
Exports to S. Korea	92.3 (16.5)	121.6 (19.1)	152.3 (21.5)	176.2 (21.3)	271.6 (27.0)	289.3 (37.0)
Total Exports	651.3	636.6	708.3	826.2	1,006.6	-

* Number in parenthesis () is “Exports to S. Korea”/“Total Exports”

* For more details in 2003, refer to the data from the Bank of Korea

Despite such an increase in trade, the total nevertheless plays little part in the South Korean economy. The total inter-Korean trade in 2003 was 0.09% of South Korean GDP. By comparison, before the unification of Germany in 1989, West German exports to East Germany represented 2.85% of West German GNP, while in 2002, Taiwan’s direct export to China (excluding indirect exports through Hong Kong) formed 0.4% of Taiwan's GDP. Compared with these cases, South-North Korean economic interchange remains insignificant.

² Comparing South Korean export to the first export country China (including Hongkong) was 20.8% and to the U.S. was 20.2% of the total export in 2003, the portion of North Korean bringing out to South Korea was high.

(3) Commercial Aspect of Trade

The commercial element of South-North Korean trade is decreasing as the two Korea's trade is increasingly dominated by non-commercial support.

Between 1989 and 1997, inter-Korean trade was dominated by imports to South Korea. Since 1995, however, exports from South Korea have increased owing to heavy oil supply by KEDO and humanitarian support materials. Since 1998, South Korean exports exceeded imports from North Korea. Many South Korean exports were non-commercial support, such as materials for LWR construction, support for the Mt. Kumgang tourism project, grain and fertilizer donations, and materials for connecting the Seoul-Shinuiju and East Coast rail/road links.

<Table II-3> shows detailed data.

<Table II-2> Change of Commercial and Non-commercial Trade

(unit: thousand dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Trade	287,291	252,039	308,339	221,943	333,436	425,148	402,957	641,730	724,217
Commercial	230,291	163,382	174,020	72,701	89,416	110,529	111,389	171,782	223,707
Processing	45,892	74,402	79,069	70,988	99,619	129,190	124,924	171,177	185,009
Non-commercial	10,995	14,255	55,250	78,254	144,401	185,430	166,645	298,771	315,501

Source: *Inter-Korean Interchange and Cooperation, and Humanitarian Project*, (All books between 1995-2003)

While the amount of non-commercial trade in January 1995, was the supply of 50,000 ton alternative energy for the LWR,

approximately \$1,000,000, it increased a lot every year, exceeding \$100,000,000 in 1999. This increase has continued, reaching \$300,000,000 in 2003.

<Table II-3> Contents of Non-commercial Trade

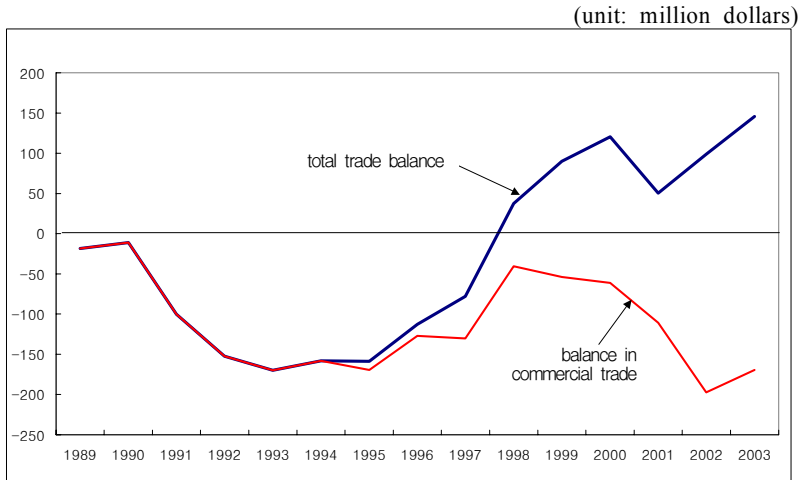
(unit: million dollars)

	Exports						Imports	Total Trade
	LWR	Support to North Korea	Heavy Oil (KEDO)	Mt. Kumgang Project	Other Cooperation Projects	Sub-total		
1995	-	0.2	10.8	-	-	11.0	-	11.0 (-)
1996	-	1.4	12.8	-	-	14.3	-	14.3 (30.0)
1997	17.8	8.4	29.0	-	-	55.3	2.8	61.1 (327.3)
1998	4.0	15.6	19.8	37.6	1.2	78.1	0.1	78.2 (30.0)
1999	14.4	43.4	39.5	40.6	6.3	144.3	0.1	144.4 (84.7)
2000	35.6	104.5	11.7	14.6	17.2	183.6	1.9	185.5 (28.5)
2001	33.7	110.6	3.5	5.8	10.4	164.0	2.7	166.7 (10.1)
2002	58.6	213.2	2.0	11.9	11.7	297.4	1.4	298.8 (79.2)
2003	23.7	270.7	0.0	16.1	4.8	315.5	0.2	315.5 (5.6)

* Number in parenthesis () is increase rate compared with the former year.
Source: The Ministry of Unification, www.unikorea.go.kr

The balance of trade with North Korea (total trade balance) has been in surplus since 1998 owing to the increase of non-commercial support to North Korea. However, if only commercial balance is considered, the balance shows a deficit. For example, in 2003, while the total trade balance showed a \$145,000,000 surplus, the balance in commercial trade recorded a \$170,000,000 deficit. As <Diagram II-2> shows, the gap between the total trade balance and the balance in commercial trade has been increasing, showing the increased export of supporting materials.

<Diagram II-2> Change of Balance of Trade toward North Korea



* Balance in commercial trade = Total trade balance - Balance in non-commercial trade

Source: The Ministry of Unification, www.unikorea.go.kr

(4) Special Feature of South-North Korean Trade

South-North Korean trade is typical of trade between the advanced country and underdeveloped country; i.e. mainly the interchange of North Korean raw materials and South Korean industrial merchandise. The materials brought in from North Korea, in the beginning, were mainly minerals and metals such as gold, zinc, and pig iron. Until 1997, metals were the largest import from North Korea. After 1998, however, metal imports fell to under 10%, while agricultural and marine products and textiles increased to 44.2% of imports from North Korea in 2003.

<Table II-4> Materials Brought in from North Korea

(unit: %)

	Agricultural & Marine Product	Mineral	Chemical Industry Product	Plastic, Rubber and Leather	Textiles	Living Supplies	Metal Product	Machinery	Electric and Electronic Product	Others	Total
1989	12.5	5.9	0.6	0.0	0.0	0.0	80.8	0.1	0.0	0.1	100.0
1990	45.4	0.5	14.1	0.0	0.0	0.7	36.9	0.1	0.0	2.4	100.0
1991	9.4	20.8	5.4	0.0	0.0	0.2	63.7	0.0	0.0	0.6	100.0
1992	10.4	27.0	7.9	0.0	2.1	0.4	51.3	0.3	0.0	0.6	100.0
1993	6.6	48.9	0.7	0.0	4.7	0.4	35.4	0.0	0.0	3.2	100.0
1994	8.6	42.8	0.7	0.0	10.2	1.2	35.8	0.0	0.0	0.7	100.0
1995	9.5	38.8	0.2	0.0	12.9	1.2	36.6	0.0	0.0	0.9	100.0
1996	12.7	35.5	0.2	0.0	24.4	1.7	24.3	0.0	0.9	0.2	100.0
1997	14.2	32.5	0.1	0.3	24.4	1.4	24.8	0.5	1.6	0.2	100.0
1998	23.7	2.6	0.2	0.0	42.0	4.2	22	0.8	3.8	0.8	100.0
1999	39.5	1.8	0.4	0.0	37.6	3.2	13.3	1.3	2.3	0.5	100.0
2000	47.1	0.2	0.4	0.1	35.2	2.2	7.7	1.2	5.4	0.5	100.0
2001	51.1	2.1	0.0	0.3	31.2	3.1	5.6	1.3	5.0	0.3	100.0
2002	36.8	3.2	0.2	0.2	31.6	1.3	6.9	0.7	3.5	15.6	100.0
2003	44.2	5.9	0.3	0.2	33.4	1.3	11.3	0.3	3.0	0.1	100.0

Source: The Ministry of Unification, *White Paper of Unification 2004*, p. 176.

Textiles formed the second largest element of total imports from North Korea. The portion of textile has remained 30~40% of the total amount since 1998. Since 1998, when the Kim Dae Jung Government took office, agricultural product and textiles rose to 70~80% of the materials imported from North Korea. Most textiles are exported to North Korea as raw materials and then re-imported after processing. Consequently, inter-Korean trade is dominated by importing agricultural products from North Korea and exporting textiles to North Korea for processing. Most South Korean enterprises are attracted by the

13% tariff levied on North Korean agricultural products.

South Korean industrial products are the major commodities exported to North Korea. Initially, chemical products such as vinyl were the major items, but since 1993 textiles for processing have increased significantly. Since 1997, the proportion of textiles has been decreasing, as food support, non-metal products, and machinery increase. The percentage of machinery and machines for transportation had expanded to over 10% since 1997, and chemical industry products reached 36.8% in 2000 owing to the support of heavy oil for the LWR in 2000 and 30.8% in 2001. This has decreased since 2002 when the LWR project was suspended. In 2003, industrial products formed 71% of the total exports to North Korea, such as 21.0% chemical industry product, 20.5% textiles, 6.4% machinery, and 4.9% electric and electronic product, while agricultural products took 28.9%. The percentage of agricultural products increased because of the increase in food supply to North Korea.

<Table II-5> Materials Exported to North Korea

(Unit: %)

	Agricultural & Marine Product	Minerals	Chemical Industry Product	Plastic, Rubber and Leather	Textiles	Living Supplies	Metal Products	Machinery	Electric & Electronic Product	Others	Total
1989	0.0	0.0	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0	100.0
1990	0.8	0.0	0.0	0.0	7.0	0.0	0.0	92.2	0.0	0.0	100.0
1991	29.0	25.1	32.8	3.9	1.2	0.0	0.0	0.0	8.1	0.0	100.0
1992	0.6	0.0	50.6	22.2	7.0	0.8	18.5	0.2	0.0	0.0	100.0
1993	0.8	0.0	10.9	3.7	69.9	0.8	3.1	0.0	6.9	3.9	100.0
1994	18.1	0.0	8.7	0.4	64.9	1.9	1.5	0.4	0.8	3.4	100.0
1995	14.4	19.0	2.3	2.5	54.3	3.6	0.3	2.4	0.4	0.8	100.0
1996	9.6	18.4	4.9	2.5	54.1	4.4	0.4	1.3	3.2	1.2	100.0
1997	14.7	25.4	3.5	4.1	30.4	3.5	3.4	11.3	3.1	0.5	100.0
1998	15.1	15.8	4.9	2.7	22.9	3.3	7.3	22.3	4.4	1.2	100.0
1999	8.0	20.1	24.3	1.5	17.9	3.0	8.0	12.6	3.5	0.9	100.0
2000	9.6	5.9	36.8	1.5	15.9	2.3	5.1	11.8	10.2	0.8	100.0
2001	14.3	2.5	30.8	1.5	23.2	1.2	7.4	11.7	6.7	0.6	100.0
2002	29.8	1.4	24.2	1.1	18.2	1.5	7.1	10.2	6.0	0.5	100.0
2003	28.9	1.4	21.0	1.3	20.5	0.8	6.5	6.4	4.9	8.3	100.0

Source: The Ministry of Unification, *White Book of Unification 2004*, p. 178.

(5) Continuity of Trading Enterprises

Although many enterprises have participated in the South-North Korean trade project, few have continued for a long time. The percentage of enterprises continuing this project with North Korea for more than 6 years is 18.2%.³

³ This survey was executed in 2001 to the 64 enterprises which had experience of business with North Korea, 91 enterprises having business at that time, and 150 enterprises which took part in the promotion conference for Kaesong Industrial Complex. Among those enterprises 55 enterprises gave answers.

<Table II-6> Continuity of Trading Enterprises

	Valid Percentage	Cumulative Percentage
1 year	10.9	10.9
2 years	18.2	29.1
3 years	20.0	49.1
4 years	18.2	67.3
5 years	14.5	81.8
6 years	1.8	83.6
7 years	3.6	87.3
9 years	5.5	92.7
10 years	3.6	96.4
12 years	3.6	100.0
Total	100.0	

Source: Hyung-gon Chung, "Evaluation of Economic Interchange and Cooperation and the Implication for Improvement," p.5. (Unpublished, 2003)

B. Trade of Processing on Commission

Processing on commission is trade where South Korean enterprises supply materials and payment to North Korea for processing materials on the condition of re-importing the processed final merchandise to South Korea or exporting to the third countries. There are two types of processing trade: simple type is supplying raw materials; and equipment-supplying type is supplying equipment for production in addition to the raw materials.

(1) Importance of Processing Trade

Processing trade appeared in the South-North Korean economic cooperation project in 1994. Until 2003, the portion of processing

trade increased 7.2 times, recording an average 24.5% annual growth rate. The growth rate of processing trade is higher than total trade growth rate, revealing South Korean enterprises' preference.

<Table II-7> shows the development of the trade of processing on commission. In 1998, processing trade decreased to \$70,990,000 from \$79,070,000 in 1997, but has increased again since 1999. In 2002, processing trade was 26.7% of total trade and 49.9% of commercial trade; in 2003, it was 25.5% of total trade and 45.3% of commercial trade. Between 1996 and 2003, processing trade was 25~30% of total trade. Since 1998 it has formed 45~54% of commercial trade.

<Table II-7> Proportion Change of Processing Trade

(Unit: million dollars)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Amount of Processing on Commission	0.8	7.0	25.7	45.9	74.4	79.1	71.0	99.6	129.2	124.9	171.2	185.0
	(-)	(736.3)	(266.2)	(78.8)	(62.1)	(6.3)	(-10.2)	(40.3)	(29.7)	(-3.3)	(37.0)	(8.1)
Proportion to the Total Amount of Trade (%)	4.8	3.8	13.2	16.0	29.5	25.6	32.0	29.9	30.4	31.0	26.7	25.5
Proportion to the Commercial Trade (%)	4.8	3.8	13.2	16.6	31.3	32.0	49.4	52.7	53.9	52.9	49.9	45.3

* Number in parenthesis () is growth rate compared to the previous year (%)
Source: The Ministry of Unification, www.unikorea.go.kr

(2) Contents and Meaning of Processing Trade

Processing Trade, which began in 1992, has focused on one item - textiles. The proportion of textiles has exceeded 20% of the total amount of processing trade since 1996, reaching 68% in 2000, and 70% in 2001. In 2003, the textiles processing trade formed 86.2% of exports and 79.8% of imports. Textiles are the most important element of the processing trade in economic cooperation with South Korea, reflecting the suitability of the current North Korean labor force for this market.

Another area suitable for the processing trade is electric and electronic products such as color TVs, TV speakers, and electric wiring of automobiles. Many items such computer monitor components, stereos, electric components, railway carriages, cassette tape and recorders, and telephones have now been included in the processing trade. In the area of TVs, PCBs, monitors, and footwear, only one enterprise undertakes this trade. This illustrates how South Korean enterprises in the electric and electronic field are uncompetitive in the processing trade with North Korea.⁴

However, as the number of items for processing trade increases, the number of equipment-supplying type processing trade is also increasing. Between 1995 and 1999, 65 equipment-supplying type commodities were traded, valued at \$13,870,000, while in

⁴ Although there are some possible items such as animation and computer program which do not need the cost of physical distribution, the cooperation on these item needs lots of communication. However, there is no facilities for direct communication between two Koreas, and it takes lots of time and money for direct meeting, and there is no way to have communications on the basis of residence. Although it is possible to have the third country as a partner, it has limitations in terms of continuity. Therefore, there is no item as proper as textile for processing trade currently.

2000 alone, 31 items were traded at a value of \$5,570,000.⁵ This shows that as the volume of processing on commission increases, South Korean demand cannot be met with the equipment North Korea possesses currently. As the processing trade is expands to include technology-intensive industries, North Korean capacity will reach its limit.

(3) Number and Scale of Enterprises in Processing Trade

By the end of 2003, 109 enterprises were participating in the processing trade, representing 0.1% of the enterprises registered as trade businesses.⁶ This low proportion of the enterprises in processing trade reflects the difficulties faced in opening business with North Korea.

In 2003, the average amount of processing trade for an enterprise was \$1,020,000, but only 27 enterprises had actually exceeded \$1,000,000 per year.⁷ These two facts show that the processing trade has been led by a few very large-scale enterprises. \$1,000,000 is the minimum volume required for South Korean government approval for international trading business,⁸ which indicates most of the processing trade is executed on a very small scale. The enterprises trading less than \$1,000,000 annually represent 75.2% of the total enterprises in processing trade.

⁵ The Federation of Korean Industries, *Korean Economic Yearbook* (2001), p. 149.

⁶ The Ministry of Unification, *White Book of Unification* (2004), p. 180.

⁷ The Ministry of Unification, *Monthly South-North Korean Interchange and Cooperation, and Tendency of Humanitarian Project* (December, 2003).

⁸ Jong-geun Lee, "Research on the Structure of Processing Trade between two Koreas," M.A. Dissertation (Kyungnam University, December, 2002), p. 57.

The proportion of big business participating in processing of commission is reducing. Daewoo International Co. ceased processing trade on commission in 2001. The other three big businesses (LG Trading Co., Samsung Electronic Co., and LG Electronic Co.) only traded \$9,020,000 in 2003, representing 4.9% of the total amount of processing trade of South Korean enterprises.⁹ In 2004, these big businesses began to cease processing trade because of poor profits.

(4) Continuity of Processing Trade

The duration of enterprises in processing trade is not long enough. <Table II-8> shows that few enterprises have engaged in processing trade for several consecutive years.

<Table II-8> Continuity of Processing Trade Enterprises

	Number of Processing Trade Enterprises in that Period (%)	Cumulative Number (%)
1999	72(29.9)	72(29.9)
2000	77(32.0)	149(61.9)
For 2 years	43(17.9)	192(79.8)
For 3 years	10(4.1)	202(83.9)
For 4 years	17(7.0)	219(90.9)
For 5 years	22(9.1)	241(100)
Total	100.0	

Source: The Ministry of Unification, *Tendency of South-North Korean Interchange and Cooperation and Humanitarian Project*, (August 2004)

⁹ The Ministry of Unification, *Monthly Tendency of South-North Interchange and Cooperation* (August, 2004).

Most of the enterprises in processing trade have the tendency to abandon the business within a few years. Comparatively, the enterprises in textiles, clothes, leather, and footwear have continued their business for several years. Among the enterprises in textiles, 81% of enterprises were engaged for more than 3 years and 37.4% for more than 5 years, illustrating the longer duration compared with other items.¹⁰

(5) Profitability of Process Trade

(A) Present Condition of Profitability

In terms of the unit cost of processing trade, an enterprise entering the processing trade is more profitable than a long-established enterprise. Among the enterprises engaged in the processing trade with North Korea, 40.8% enterprises pay for 40~70% of the unit cost compared with the unit cost in South Korea, while 29.6% enterprises pay for 20~40% unit cost. The average unit cost of processing trade is 53.5% of South Korean unit cost, and the unit cost for textiles, clothes, leather, and footwear is 49.0% of the unit cost in South Korea. Enterprises with more than 5 years experience pay the lowest unit cost, while enterprises in the first year of operation pay the most unit cost.

However, most of the production cost including physical distribution in promotion trade with North Korea is more than 70% of the production cost in South Korea.¹¹

¹⁰ Small Business Corporation, *Report on the Status of Processing Trade with North Korea of Small and Medium Business* (December, 2001), p. 30.

¹¹ *Ibid.*.

<Table II-9> Comparison of the Production Cost of Processing Trade with North Korea and China

(unit: Korean Won/piece(A, B, C), Korean Won/set(D))

	Country	Raw and Subsidiary Materials	Processing Cost	Ocean Freight	Customs	Other Cost	Production Cost
Enterprise A	N. Korea	6,765(75.0)	1,950(21.6)	194(2.2)	0	114(1.2)	9,023(100.0)
	China	6,765(70.2)	1,560(16.2)	85(0.9)	1,108(11.5)	114(1.2)	9,632(100.0)
Enterprise B	N. Korea	4,068(69.3)	1,430(24.4)	260(4.4)	0	110(1.9)	5,868(100.0)
	China	3,324(58.1)	1,573(27.5)	60(1.0)	659(11.5)	110(1.9)	5,726(100.0)
Enterprise C	N. Korea	3,162(68.2)	1,170(25.2)	202(4.3)	0	105(2.3)	4,639(100.0)
	China	2,570(56.5)	1,287(28.3)	61(1.3)	523(11.5)	105(2.3)	4,546(100.0)
Enterprise D	N. Korea	-	9,750	15,200	0	6,500	31,450
	China	-	3,250	0	0	2,000	5,250

* Percentage in parenthesis () is the proportion to the production cost.

* Enterprise A: Production and sale of men's pants; Using 100% South Korean raw and subsidiary materials in both N. Korea and China

* Enterprise B: Production and sale of children's jumper; Using 100% South Korean materials in N. Korea, and using 100% Chinese materials in China

* Enterprise C: Production and sale of uniform; Using 100% South Korean materials in N. Korea, and using 70% Chinese materials and 30% South Korean materials in China

* Enterprise D: Production and sale of TV; Using 100% South Korean materials in both N. Korea and China

Source: Jong-geun Lee, "Research on the Structure of Processing Trade between two Koreas," M.A. Dissertation (Kyungnam University, December, 2002), pp. 66-69.

<Table II-9> shows that ocean freight for physical distribution cost is higher for the processing trade with N. Korea than with China. The only ocean-shipping route, Incheon-Nampo, is used by one shipping company with a limited schedule. In terms of Customs, however, North Korean products are exempt from duty (whereas Chinese products attract duty).¹² Nevertheless,

¹² Tariff exemption system gives important benefit to processing trade with North Korea. When S. Korea import N. Korean product or bring in processed

for most of the enterprises, the production cost in N. Korea is more expensive than that in China. This shows that although exemption from Customs duty reduces production cost, it is insufficient to give competitiveness compared to Chinese production.

(B) Factors Deteriorating Profitability

Despite low labor costs, it is not easy to improve profitability in North Korea because of many factors raising production cost.

Firstly, additional costs are commonly incurred for the inspection and modification of goods owing to generally inferior production. In the case of inferiority owing to the lack of detailed technology and finishing work, South Korean enterprises incur additional cost for modification after importing the goods.

Secondly, it is difficult and expensive for technicians to visit N. Korea for quality management compared with other countries. The additional cost caused missing deadlines or the claim for additional raw and subsidiary materials raises production cost.

Thirdly, shipping is often through Dandong in China because of irregular South-North Korean ocean freight. In most cases,

product, 13% tariff is exempted, which give 13% competitiveness to North Korean product. Considering South Korean enterprises' average margin rate is 10~15%, tariff exemption is great benefit. This tariff exemption system has been the most important factor promoting South-North Korean trade. At the beginning of processing trade with N. Korea, South Korean enterprises chose N. Korea because of the benefit of tariff exemption in spite of the poor conditions for production. Jong-geun Lee, "Research on the Structure of Processing Trade between two Koreas," M.A. Dissertation (Kyungnam University, December, 2002).

products are inspected in South Korea to find inferior goods before supplying to customers, adding additional cost.

Fourthly, when a Chinese intermediary company takes the role of remittance and payment, it charges commission fees.

Fifthly, South Korean enterprises pay 5% of invoice as the commission fee for certificating country-of-origin to North Korea, raising the production cost and decreasing competitiveness.

A significant element is that most enterprises do not regard ocean freight as an important factor for business because of low cost. However, the item costing the most for ocean freight fare, such as electric home appliances or bottled natural water, are inappropriate for the processing trade.

(6) Processing Trade's Contribution to North Korean Economy

In general, the trustee in processing trade has an inclination to obtain technology and capital and raise their ability to provide raw and subsidiary materials as well as to meet the order of the truster. The truster has a tendency to establish a local branch for efficient management and common benefit, paying regular shares to the trustee. Consequently, processing trade is inclined to transform into a local production business.

In South-North Korean processing trade, however, the trustee (N. Korea) has little capital or international information and lacks the flexibility to adapt to changes in the international market. There is no assured system for South Korean enterprise's participating in the management of a local branch, and it is difficult for the South Korean entrepreneur to reside in N.

Korea. Furthermore, there is no settlement system adopted by both Koreas. International settlement systems, such as a Letter of Credit, are not in common use in N. Korea, and only direct payment or wiring system is accepted. The assurance of a settlement system must precede a stable processing trade. The credit rating of North Korean banks has a poor international reputation. Those foreign banks that opened in N. Korea, such as ING Bank and Peregrine Bank, failed to establish an effective business network, and have already closed or operate only a communication office. International trade based on the credit of each part alone, without any assurance of settlement, cannot expand. The payment for processing trade is currently settled by wiring to the bank in the third country or by direct supply of materials in barter. These procedures may cause problems by creating time lags in movement of money and materials.

Another reason that processing trade cannot be substantial help for North Korean economy is that N. Korea takes only payment for processing. The processing trade has a generally close relationship with normal trade. For example, as the textile processing trade increases, the amount of textile trade increases too, with the increase of sewing factories and related industry. According to the classic theory of trade, the increase in commercial trade can develop the welfare facilities of the other party. The relations between the two Koreas are exceptional because there is no base to develop the processing trade in N. Korea. There is no raw and subsidiary materials provided within N. Korea, and almost all materials are supplied from S. Korea. If the truster directly supplies all materials for production, it has no linkage effect to local related industries. Even simple packing materials must be sent from S. Korea. Such a situation may also raise the cost for physical distribution to

some South Korean enterprises.

2. Investment Project

A. Project Approval and Present Condition of the Project

The investment to N. Korea was substantially activated in 1995 after the first “Promotion of South-North Korean Economic Cooperation” in 1994. By the end of 2003, there were 52 enterprises investing or intending to invest in N. Korea.¹³ 27 businesses were approved to do so. These number means there has been about 2 investments annually for the last 12 years.

<Table II-10> Approval of Entrepreneur and Enterprise
(unit: number of case)

	1992	...	1995	1996	1997	1998	1999	2000	2001	2002	2003	Total (A)	Canceled Approval (B)	Currently Effective Approval (A-B)
Entrepreneur	1	0	6	4	16	13	2	1	6	3	4	56	4	52
Enterprise	0	0	1	0	5	9	1	2	5	2	2	27	0	27

Source: The Ministry of Unification, www.unikorea.go.kr

¹³ Enterprises investing in N. Korea have to receive the “Approval of Economic Cooperation Enterprise” and “Approval of Economic Cooperation Entrepreneur” from the Ministry of Unification. In order to receive the latter approval, the enterpriser has to have more than 3 years experience in the same business, enough fund and technology; for the former approval, the project contents have to be realizable and the enterprise had already agreement with N. Korea about the distribution of benefit.

Among the 27 enterprises approved or the cooperation project with N. Korea until 2003, 16 enterprises has continued their project until September 2004. Active projects include the Mt. Kungang Tourism project and Kukyang Shipping Business. Most of the other approved enterprises have ceased trading or not even begun their projects, such as Gohap Trade Co., LG Electronics and LGICORP, Aja Communications, and Doorae Farming Association Corporation. <Table II-11> shows the current situation of these projects.

<Table II-11> Present State of Cooperation Project with N. Korea

	Total Cases	Discontinued	Not Began	Proceeding	Unknown
Entrepreneur	52	30	2	19	1
Enterprise	27	10	0	16	1

Source: Examination by the author

B. Type and Scale of Investment and Cooperation Project

Among the approved projects, 39.6% are collaborative (19 cases), 27.1% are joint (13 cases), and 22.9% are independent investments (11 cases).

<Table II-12> Type of Investment Project to N. Korea (As of 2003)

Investment Type	Approved Enterprises (case)	Amount of Planned Investment (A, million dollars)	Amount Invested (B, million dollars)	Rate of Processing (B/A, %)
Collaboration	19	11,012	3,779	34.3
Joint	13	3,485	571	16.4
Collaboration and Joint	3	2,016	0	0.0
Independent Investment	11	41,033	14,741	35.9
Research	2	2,030	546	26.9
Subtotal	48	59,576	19,637	33.0
Light-Water Reactor Project	4	408,014	103,981	25.5
Total	52	467,590	123,618	26.4

* At the exchange rate of 1197 Korean Won to the US\$ (December 31, 2003)
Source: The Ministry of Unification, www.unikorea.go.kr

By the end of 2003, investment of \$596,000,000 was planned, excluding the LWR project. Only 33% of the planned investment (\$196,000,000) took place. The Mt. Kumgang project was the largest element, accounting for \$144,810,000 (73.9%) of the total, excluding the LWR project.¹⁴ Excluding the Mt. Kumgang project, only \$51,190,000, 13.1% of the planned investments took place.

¹⁴ The amount of investment for Mt. Kumgang project if \$250,000,000, 34% of total planned investment.

C. Qualitative Feature of Investment Project

(1) Supporting Investment

The institutional base to facilitate investment in N. Korea is in place. In accordance with South Korean government's announcement of "Promotion of South-North Korean Economic Cooperation (1994, 1998)," most of the obstacles to the investment have been removed. Nevertheless, inter-Korean economic cooperation is inclined to proceed on the basis of non-economic logic. For example, most of the economic cooperation of small and medium enterprises has not been profitable because of the exclusion of market economy principle.

Currently three large cooperative investment projects are proceeding, i.e. Kaesong Industrial Complex, Mt. Kumgang Tourism Zone, and the connection of the Seoul-Shinuiju and East Coast Rail/Road links. These are inter-governmental (quasi governmental) projects representing the image of cooperation of two Koreas.

Hyundai Asan, the developer of Mt. Kumgang project, has shown cumulative deficit, and is not expecting profit for the future large-scale investment plan. Considering the large scale of investment, the expensive tourism payment is burdensome, while the number of tourist has been less than expected.

These investment projects are characterized as support for the North Korean economy. For example, as of July, 2003, Hyundai had spent 753 billion Won on Mt. Kumgang tourism-related projects such as gaining the exclusive rights for 7 important projects (600 billion Won),¹⁵ Jung Ju-young Gym (57 billion Won), color TV (8 billion Won), Pyongyang Art Group's

performance in Seoul (6 billion Won), automobiles (40 billion Won), and other support (76 billion Won).¹⁶ The LWR project and the connection of Seoul-Shinuiju and East Coast rail/road links also support the North Korean economy, while South Korea has offered to meet the expenses of constructing the Kaesong Industrial Complex.

(2) Initiative of Project

Another special feature of the investment project to North Korea is that the marketability has not been assured and the North Korean government takes an active hand in the project. North Korean government regards South-North economic cooperation as a means to obtain foreign currency and advanced technology without the reformation of internal economy system. If the North Korean government believes economic cooperation with South Korea threatens its socialist system, it may take measures to protect the system. Investment projects and processing trade therefore proceed in an environment of mutual tension.

¹⁵ Seven important projects are railroad, communication, electricity, Imjin River Dam, Tongchun airport, development of Mt. Kumgang water resources, and general sightseeing.

¹⁶ Subsidy from the Korea Tourism Corporation, 84 billion won, is included. *Jungangilbo* (August 7, 2003).

III. Qualitative Evaluation of South-North Korean Economic Cooperation

1. Current Status of South-North Korean Economic Cooperation

A. Motive of Participating in the Project with North Korea

The motive and will of an enterprise participating in the project with North Korea greatly influences the business outcome. When questioned about their motive for participation, most of the enterprises responded as follows:

- ① “There will be merit in economic cooperation with North Korea escaping the fulfilled South Korean Market.” This means many enterprises expect future profitability from the cooperative project. However, most of the enterprises are ignorant of the real conditions of South-North Korean economic cooperation. The subsequent responses below also illustrate their vague expectations;
- ② “To contribute South-North economic cooperation;”
- ③ “To produce good quality goods using pollution-free

- North Korean materials;”
- ④ “To utilize the Custom-free privilege and good quality North Korean needlework;”
 - ⑤ “To move factories in China to North Korea because the management in China became difficult;”
 - ⑥ “Because the business with North Korea has good prospects;”
 - ⑦ “As a part of helping one's homeland;”
 - ⑧ “To preserve the right to conduct business with North Korea;” and
 - ⑨ “To establish model business trusted by both Koreas on the basis of appropriate investment and advanced management.”

Some enterprises participated at the request of North Korea despite recognizing the difficulties faced by the business:

“After visiting Pyongyang and Rajin-Sunbong to determine the prospective business market, I realized the North Korean economic conditions are very inferior for establishing plants and industrial facilities. Nevertheless, because of the request of North Korean government and for the purpose of knowing about North Korea, I tried to find business item not closed related with infrastructure.”

(Company L)

The responses above seem to indicate many enterprises do not have a full understanding of North Korea's different political and economic system and environment.

B. Evaluation of the Project with North Korea

(1) Evaluation of Current Status of the Business with North Korea

More than half of the enterprises (65%) considered that their business with North Korea was not going well. Reasons for the difficulties included:

- ① Disputes among South Korean enterprises conducting business with North Korea, for which there is no mediation institution;
- ② Although each enterprise insists that its product is better than its competitors, there is no independent confirmation;
- ③ Insufficient support from the South Korean government for projects, and the limits on importing North Korean agricultural and marine products;
- ④ North Korean people's insufficient understanding of the market economy, and the difficulty in delivering goods by the appointed date owing to the irregular ocean shipping;
- ⑤ Difficulty in delivery because of the inferior physical distribution;
- ⑥ High cost of ocean shipping;
- ⑦ The demand of North Korea for payment in goods not cash;
- ⑧ Treatment of financial loss for the invested facilities in North Korea; and
- ⑨ Difficulties in free access and communication.

The main reasons for abandoning projects with North Korea were:

- ① North Korean one-sided suspension of the project;
- ② Dispute during development of the project; and
- ③ The deterioration of profitability.

(2) Evaluation of the Profitability of the Project with North Korea
Among the enterprises having business with North Korea, 63.3% is in a deficit, and 36.7% is in the break-even point or in surplus.

73.7% of enterprises did not consider the deficit scale a major burden for the business management. The result shows that most enterprises having business with N. Korea also run business in S. Korea, and the deficit in the business with N. Korea has little influence.

Most of the causes of are N. Korean in origin, such as:

- ① Delay in delivering date;
- ② Low competitiveness in price and quality compared with the Chinese goods;
- ③ Dishonored debts;
- ④ Buyer's claim to the delayed delivery;
- ⑤ Higher cost compared to international standard; and
- ⑥ Unrealistic North Korean demands without reference to the international market price.

In some cases, however, the South Korean enterprises bears some responsibility for causing the deficit, such as:

- ① Failure to establish a market for the imported goods;
- ② Customer doubts over the genuineness of North Korean manufacture;
- ③ Over-competition between enterprises, and
- ④ Critical South Korean public opinion reducing demand.

For the deficit caused by North Korean factors, most South Korean enterprises (84.2%) tend not to claim about it, despite the opportunity for compensation.

(3) Evaluating Success and Failure and the Reasons

Many enterprises tend not to regard their business with North Korea as a failure.

Among the enterprises that considered themselves successful, 42.8% claimed to be making profit, 28.6% anticipated future profits, and 28.6% claimed they gained valuable experience by conducting business with North Korea.

Many enterprises considered their success due primarily to a reasonable business plan and connections with powerful North Korean officers.

The enterprises that considered themselves unsuccessful, 63.6% claimed no profit, 27.3% stated future profitability has uncertain, and 9.1% claimed to have ceased business with North Korea.

Factors affecting failure can be categorized by origin: North Korea and South Korea. The important factors originating from North Korea are lack of understanding about economic cooperation and a general closed policy.

North Korea regards the economic cooperation as national support and does not consider the profit motive of South Korean enterprises. South Korean enterprises judge N. Korea does not make effort to understand the business and has a poor understanding. In addition, North Korean enterprises have a weak sense of economy, find it difficult to adapt to international change, and there is little change in policy for the development of project.

The North Korean government has no intention to permit free

business activity by South Korean enterprises. The closed policies toward the special economic zone are not consistent, applying different rules and regulations to each enterprise. N. Korean authorities often do not permit S. Korean engineers to stay for quality management. If the S. Korean engineer cannot directly verify the N. Korean production, it is impossible to correct any flawed processes, leading to the failure of quality control and difficulties in business.

The factors of failure from S. Korea are reckless and over propelling of the project, ignorance of N. Korean conditions, misjudgment of S. Korean market, an unprepared sales network, failure in fund raising, and S. Korean economic depression.

C. Future Plan of the Project

Future plans reflect the intention of enterprises based on current status. More than 80% of enterprises included in the survey intended to expand or maintain the current scale of business.

The positive outlook reflects the possibility of improving South-North Korean economic cooperation. Many conditions necessary for the cooperation have matured, and many agreements between the two parties have been finalized. Where S. Korea enterprises are losing competitiveness because of expensive labor costs, the fulfillment of the two parties' agreement will improve the profitability of cooperative business.

Furthermore, existing enterprises will have improved prospects deriving from their superior knowledge of the N. Korea environment. This illustrates the importance of market and experience of cooperation business in project success. Some enterprises

believe “the improvement of relations of two parties will lead to resolution of the N. Korean nuclear problem, eventually leading to good conditions for business.”

In general, “although there are lots of difficulties in the cooperation project with N. Korea, it is possible to succeed on the condition of choosing appropriate items and reasonable business plan.”

Conversely, the enterprises planning to maintain or reduce current scale, or terminate the business perceived few prospects for the project, believing investment conditions immature and unlikely to improve in the near future. They point out some important factors such as long-term solution of N. Korean nuclear problem, and impossibility of reformation of Kim Jong-il regime during the nuclear crisis makes the improvement of economic cooperation conditions improbable.

2. Problems in the Procedure of Economic Cooperation

A. Connection and Communication with North Korea

Most of S. Korean enterprises engaging in cooperative business in N. Korea make communications with N. Korea through foreign branches or visiting a third country. Many have established a liaison office in Beijing for the communication by telephone and fax. Some have direct connections with the Beijing mission of the N. Korean “Committee of National Economic Cooperation” (formerly the “Association of National Economic Cooperation”).¹⁷ A quarter of enterprises have communication by telephone and fax through a third country or

by e-mail. The N. Korean partner of communication is, in most cases (56.6%), the mission of the “Association of National Economic Cooperation,” N. Korean institution for foreign economy.¹⁸ A few enterprises contact partners in N. Korea directly (26.7%), while a small proportion communicate through an agent in a third country (6.7%).

Almost all the enterprises have a communication channel for continuing business (96.6%). It takes long time to establish such communication channel. It is difficult to induce North Korean partner's understanding about the business and trust in the enterprise in the early stages. In many cases, the connection with counterpart is through the third country agent, and in a few cases, directly with the making an agreement of business. The average time to establish a connection with a counterpart

¹⁷ The “Committee of National Economic Cooperation” expanded from the “Association of National Economic Cooperation” has the departments in charge of Kaesong Industrial Complex, Mt. Kungang Tourism Zone, normal south-north economic cooperation business, and supporting project. The “Committee of Chosun Asia Taepyeongyang Peace” which had taken the project of Kaesong SEZ and Mt. Kungang SEZ does not participate in South-North Economic Cooperation Project any more, making a single channel of cooperation project. *Joongangilbo* (October 31, 2004).

¹⁸ N. Korean government established the “Association of National Economic Cooperation” in 1994 for having business with S. Korean enterprises. All South-North Korean talks about economic cooperation should be done through the “Association of National Economic Cooperation.” There are five general companies under the “Association of National Economic Cooperation,” that is, Gwangmyungsung General Company, Samchunry General Company, Kaesun General Company, Mt. Kungang General Company, and Korea Commercial Bank. Each general company deals with South Korean enterprises dealing similar type items. South Korean enterprises do not have the right to choose their counterpart, but only the “Association of National Economic Cooperation” choose the counterpart. Jong-geun Lee, “Research on the Structure of Processing Trade between two Koreas,” M.A. Dissertation (Kyungnam University, December, 2002), p. 59.

is 1 year, although it can take 2~3 years for some enterprises.¹⁹ Early selection of an appropriate business counterpart has proved important for success.

However, most South Korean enterprises face the following difficulties in establishing communications with a counterpart. Firstly, it is not easy to know the person in charge and there are no criteria to make such judgment.

Secondly, the North Korean partner is usually hostile and ignorant of international commercial business, and it is difficult to meet the partner and visit the business site.

Thirdly, because of indirect communication through the mission of the “Association of National Economic Cooperation” in Beijing, there are many cases of misunderstanding and miscommunication. When the channel to the mission in Beijing and “Dandung” is blocked, there is no other way to communicate. Furthermore, communication is expensive.

These problems reflect the need to establish a direct communication channel with North Korea to promote successful business and future economic cooperation. Such a channel can be established by contact between the S. Korean government and the N. Korean authorities.

Some enterprises communicate with N. Korea 1-2 times a week

¹⁹ It is also important whether the counterpart has real power. After choosing counterpart, it takes another 1 year in average to produce goods really. For some items such as textile, clothes, leather, and footwear, it takes less than 1 year. The reasons of taking long time to begin cooperation business are inefficient system of communication and decision-making in N. Korea and N. Korean effort to test the trustworthiness of S. Korean enterprises.

(33.3%), and some daily (10%). Although frequent communication is helpful for leading the business in the planned direction, it is expensive. In addition, in the talks with N. Korean partners, S. Korean enterprises must explain the capitalist market economic system.

S. Korean enterprises usually send and receive samples through a third country: some use delivery companies via a third country (23.4%), some use a third person (26.6%), and some deliver directly in a third country (23.4%).

B. Visiting North Korea

There are few chances to visit N. Korea for S. Korean enterprises. It cost 10,000,000 Won per visit per person, and there are no arrangements for free access. Some enterprises visit N. Korea once a year, while some have not visited at all since the beginning of their business.

It takes 2 weeks (29.6%) to four weeks or more (59.2%) to process the letter of invitation to visit N. Korea. In real term, a visit to N. Korea can vary between 2 weeks (23%) to 4 weeks or more (77.0%) after deciding to go.

Most enterprises (80%) did not consider North Korea demands for visit as unjust. Unreasonable North Korean demands included insurance for fulfilling the agreement, unfair economic support, compact size automobiles and computers. These unreasonable N. Korean demands are burdens on S. Korean enterprises in commencing their business.

C. Initiation of Business and Negotiation with N. Korea

To avoid trial-and-error, it is important to understand the difficulties in opening business with N. Korea.

South Korean enterprises have experienced many difficulties. There are cases of demanding cash investment or prepayment. In many cases it is difficult to talk about technical problems with North Korean counterpart because the counterparts as they are often not a professional in the field. In addition, there are difficulties in transportation, the payment system, and communication system, causing problems in the quality of the product.

The lack of ordinary communication channels makes it difficult to know the progress of the project. N. Korea often demands investment before S. Korean businessmen even visit N. Korea. It seems that N. Korean authorities think such invested facilities will remain although S. Korean enterprises leave without fulfilling their promises.

When market conditions change, planned technical procedures may also require adaptation. In this case, it is not possible to change the North Korean labor force. The N. Korean people lack a sense of international affairs, lack an understanding of the importance of investment, and rigidly resist any change of plan unless ordered by higher-ranking officials.

D. Physical Distribution, Production, Wage, Delivery, Customs, and Payment

(1) Physical Distribution

In general, the cost of physical distribution is a large proportion of promoting a project. Sometimes physical distribution is the most important factor of the trade, influencing cost competitiveness and profitability.

The failure to meet delivery date is a larger problem than the cost of physical distribution. The major cause is North Korea's inferior ocean-going physical distribution infrastructure.²⁰ Shipping schedules are often changed because so few goods are transported. When there are significant quantities of cargo to be moved, however, unloading is often delayed. The condition of unloading facilities and roads to the plants are inadequate, which may damage materials. It takes an average of 4~5 days for goods from Nampo to reach factories in Pyeongyang.²¹ In addition, North Korean Customs often delay clearance to conduct inspections.

²⁰ As of 2000, the capacity of loading and unloading of N. Korea is 35,010 thousand ton, which is 10% of the capacity of S. Korea, 416,250 thousand ton. It is not possible to use the latest model container vessel because N. Korean harbors lack container unloading facilities, and N. Korean maximum berthing capacity is only 10,000~20,000 ton. In general, N. Korean harbor facilities are old and make trouble. Because there is not enough facilities for unloading big merchandise in N. Korean harbor, in many cases, such work is executed by person.

²¹ It took average 36~48 hours from Incheon to Nampo for shipping materials. The long interval of shipping decided by N. Korea was also a big problem. Indirect transportation often caused damage of materials. For the processing trade of "Seojun Apparel," the cost for physical distribution took 20%, and there were much loss caused by the delay in transportation. The claim by the party placing an order was 5~10% of the delivery price withing 7 days, and the party placing an order often refused acceptance after 7 days.

Consequently, sometimes South Korean enterprises send materials to China and transport them to N. Korea by rail, despite the higher cost.

The inefficiency of physical distribution raises the cost and causes loss. The unit cost of shipping between the two Koreas is three times more expensive than that with other country, becoming an obstacle to open trade with N. Korea.²² Irregular freight shipments to N. Korea must use a container yard far from the harbor, and the enterprise must purchase its own container, generating additional transportation costs. When adding the cost of S. Korean physical distribution, the total physical distribution cost can exceed the unit price of competitive products in S. Korea. The cost of physical distribution transferred to the production cost. In the textile processing trade, the cost of physical distribution represents 40% of the production cost, or 10~15% of sales price. This offsets the benefit of no Customs duty.

Unloading at the North Korean harbor is undertaken manually, because of the lack of facilities and frequent mechanical trouble. Separation of large cargos may take 12 hours. Nampo, the largest harbor in N. Korea, has poor unloading facilities and vessels after often delayed in the lock. Poor weather conditions cause further delays. North Korean authorities may also refuse permission to load or suspend shipping following criticism of Kim Jong-il by South Korean politician's or skirmishes between Korean warships.

²² The container shipping cost from Incheon to Cheonjin, competing line with Incheon-Nampo line, is \$400~600.

(2) Fixing Price

Many enterprises conducting business in N. Korea are in difficulties for determining price. The majority of enterprises consider that, in most cases, price is established mainly by discussions with N. Korean counterparts, although they also consult the international price. It means N. Korean productivity or worker's wage level is not the criteria of pricing. On occasion, the N. Korean counterpart will fix price unilaterally to simplify the process.

Difficulties in pricing are widespread. Firstly, there are many cases of unreasonable price demands owing to N. Korean's vague perception about pricing. Because of no precedent and vague criteria, N. Korean price demands are inconsistent, and sometimes they insist on high prices regardless of the quality of goods. Although N. Korean counterparts agreed in accordance with international price at the beginning, as the project progresses, they often ask improper price.

Secondly, N. Korean counterparts do not consider brand value or quality level. They often set prices by simplistic comparison with goods made in a third country or simply seek an excessive price without reference to pricing norms.

Thirdly, it is difficult to reflect changing conditions in pricing. It is almost impossible to reflect the loss according to the delayed delivery and the change in international price. It is also difficult to change price according to the decreased competitiveness of goods.

Fourthly, while the pricing system in N. Korea is one channel, in S. Korea, several enterprises compete for one item, limiting

the influence on fixing price.

(3) Quality Control and Guiding Technology

It is almost impossible to control the quality of goods or inspect merchandise. According to a survey by “Small Business Corporation,” there are more cases of quality control by the third country technician such as Korean-Chinese (46.7%) than the quality control by S. Korean technician (13.3%).²³ In some cases, the N. Korean counterparts take the role of quality control, and the S. Korean enterprise does not participate in at all (36.7%).²⁴ North Korean authorities restrict visits by South Korean engineers. Such visits are only allowed during the establishment of facilities and before the production of goods.

It is difficult to send a quality control manager to North Korea. South Korean enterprises can send materials and provide guidance instructions that anticipate production process problems. Such restrictions cause high defect rates.²⁵ These defects in the processing trade are offset by payment in 54.9% of S. Korean enterprises. Because there are no appropriate measures to resolve the defective production issues, 38.7% of enterprises accept the loss in order to continue the business with N. Korea. The inspection of goods is not undertaken on site, but after import to S. Korea. South Korean enterprises’ satisfaction rate for the product is about 70%, which is a very low level.²⁶ North

²³ Small Business Corporation, *Report on the Status of Processing Trade with North Korea of Small and Medium Business* (December, 2001), p. 16.

²⁴ *Ibid.*.

²⁵ According to the survey by the Small Business Corporation, only 51.9% of the enterprises are satisfied with the quality at the level of 70~100%. *Ibid.*, p. 47.

Korean restriction on inspections at the site is unreasonable behavior toward S. Korea. The North permits on-site inspection for Japan and EU enterprises engaged in the processing trade.²⁷

(4) Delivery Deadline

Among South Korean enterprises engaged in processing trade with N. Korea, 60% considered the appointed date of delivery well observed. The factors described below can all influence the delay of delivery.

Firstly, there is a latent lack of responsibility and credibility in the socialist economic system. Secondly, there is a combination of the inferior physical distribution system, a lack of professionalism, poor materials, production delays, and problems in shipping and Customs clearance. Thirdly, N. Korean high-ranking officials may occasionally order production priority transferred to other goods, preventing appointed deadline being kept. Fourthly, the N. Korean work force cannot respond to sudden changes in order. South Korean enterprises must therefore give allow sufficient flexibility in terms for delivery, and react quickly when expecting delays. The establishment of an agreement to settle claims is important an important step.

²⁶ The average satisfaction rate of the quality is 83.3%. The satisfaction rate of textile, clothes, leather, and footwear is 86.7%. The enterprise with longer business experience with N. Korea has higher rate of satisfaction. Small Business Corporation, *Report on the Status of Processing Trade with North Korea of Small and Medium Business* (December, 2001), p. 18.

²⁷ Jong-geun Lee, "Research on the Structure of Processing Trade between two Koreas," M. A. Dissertation (Kyungnam University, December, 2002), p. 23.

(5) Payment and Collection

Although there are many payment systems including cash payment in the business with North Korea, the payment through a third country is most popular. When importing, S. Korean enterprises pay through the Office of N. Korean Association of National Economic Cooperation in China using T/T. When exporting, South Korean enterprises collect cash at Dandong or Beijing, or use an account in a third country, paying expensive commission. N. Korean counterparts occasionally offer payment in goods when they face cash flow difficulties.

The difficulties in payment and collection are described below.

Firstly, there is no direct settlement system between the two Koreas. South Korean payment is simple, but the cash collection procedures can cause problems. It is dangerous to collect large amounts of cash in a third country.

Secondly, sometimes N. Korean counterpart's unilateral claim makes the collection difficult.

Thirdly, settlement cannot be confirmed quickly because of communication difficulties.

The government should designate a bank in charge of settlement between the two Koreas. The establishment of a bank for settlement can be developed to the settlement by a Letter of Credit and liquidation settlement.

3. Factors for Success and Failure of Economic Cooperation

This research is focusing on finding the factors influencing the success and failure of South Korean enterprises participating in business with North Korea. The subject of this research is the enterprises in the processing trade and investment cooperation projects. For the enterprises with simple trade, it is not easy to evaluate success and failure because they trade only once. These enterprises may continue to trade if they expect positive profitability, but may quit at any time. Conversely, the processing trade and investment project must be continued for the agreed project period.

There are many cases of success and failure due to the general conditions or a reason unique to the enterprise. The following factors are important influences in the success and failure of South-North Korean economic cooperative projects.

A. Factors for Failure

(1) Factors in North Korea

<General Conditions>

- General closed door policy and difficulties in opening business with North Korea
- Lack of perception of market economy and lack of professionalism
- Ignorance of the international market, global change, and international commerce
- Lack of understanding about price
- Lack of understanding about general business cooperation.

<Conditions for Business>

- Lack of loading and unloading facilities, and inferior condition of physical distribution including roads
- Frequent refusal and suspension of transport
- No participation in the management of joint company
- Lack of purchasing power of internal market

<North Korean Attitude to Economic Cooperation>

- Unilateral suspension of the project
- Delay in decision-making
- Unreasonable demand for additional payment (expensive wages, processing fee, and raw materials)
- Lack of credibility and responsibility
- Unilateral claiming

<Conditions for Production and Promoting Project>

- Difficulties in communication
- Difficulties in quality control and technical guide
- No permission for technician visits, and general difficulties in accessing the site
- Poor quality materials
- Delay of production and non-observation of appointed date
- Difficulties in supplying raw and subsidiary materials

(2) Factors in South Korea

<Regarding North Korea>

- Unclear motive for conducting business with North Korea
- Unplanned or excessive promotion of the project
- Ignorance of business conditions in North Korea

<Regarding South Korea>

- Over competition between enterprises
- Lack of sales network and misjudgment of internal market
- Difficulties in financing the cost before the initiation of business
- Lack of regular shipping services and expensive physical distribution owing to non-observance of schedule
- Large scale investment required
- Deterioration of profitability owing to excessive support to North Korea during the process of the project
- Unreasonable expansion of business
- Excessive burden for importing goods
- Lack of support from the government
- Lack of motive to continue the project

(3) Factors in both Koreas

- Deterioration of political relations between two Koreas (battle of warships, incursion of submarines)
- Non-establishment of an institution for mediating disputes
- Non-establishment of a settlement system and difficulties in collection
- Difficulties in communication
- Low level credibility

B. Factors for Success (in South Korea)

- Obtainment of powerful and appropriate business partner
- Utilization of human power
- Establishment of reasonable plan, and passion of execution
- Funding

- Appropriate item
- Timely business
- Technical training; thorough quality control
- Efficient leadership and managing counterpart (Driving project, Denial of unfair demand or additional charge)
- Establishing credit through presenting vision and technology
- Establishment of communication channel
- Exact explanation and understanding of current problem
- Firm agreements (preparation for the delay and suspension of production)
- Appropriate wage levels
- Using North Korean labor power in a third country
- Accumulation of various experience of the business with North Korea

IV. Plan for the Success of Economic Cooperation and Task

1. Task of the Enterprise

For an enterprise, it is important to secure stability of the cooperative business. The plans for securing stability by stages of the project procedure are as follows.

A. Project Preparation Stage

(1) Collecting Information about the Project and North Korea

Most of the businessmen may consider themselves well-informed about N. Korea after just a single visit. Such an attitude is not conducive to the success of the project. Before commencing business with N. Korea, a S. Korean enterprise must collect sufficient information about the business and examine the site by visiting N. Korea if possible. It is important to gather information on the area of business and understand any North

Korean government restrictions, the capability of counterparts, conditions of the factory site, and the development measures to minimize risk. Consultations with other enterprises already running business in N. Korea are invaluable to share the experience of others.

In addition, it is important to keep in mind following things. Firstly, the North Korean government's will to open a business is not enough. Because of their lack of business acumen, there will be many difficulties during initial contact and negotiation.

Secondly, the inferior condition of (SOC) may cause difficulties with electricity, transportation, and site selection, leading to production problems. Other difficulties include gaining timely access to N. Korea, inability to provide quality control and technical guidance, the high cost of visiting, and supply security of raw and subsidiary materials. The absence of direct communication, expensive physical distribution, and irregular shipping services may cause delay of delivery. Settlement through China also causes difficulties by delaying confirmation of remittance. Many problems are not resolved equitably.

Thirdly, business conditions may change abruptly or deteriorate, reflecting political relations between the two Koreas. Political factors can adversely affect production in North Korea.

(2) Establishment of Business Plan and Examination of Business Prospect

Most South Korean enterprises began cooperative business with North Korea to make profit by reducing cost. Such enterprises planned to utilize North Korean low processing costs, cheap

labor, securing raw materials at the site, exploit the duty free system, and use North Korea as a base for exporting to the third countries. However, the real conditions in North Korea are far worse than expected. The cooperative business with N. Korea cannot make profit in a short time, where condition may change abruptly compared with business in other countries. South Korean enterprises must examine the prosperity based on a long-term plan, examining both defects and merits. Some South Korean big businesses have ceased cooperative business with N. Korea because profit is less than business with other countries. Big businesses are not investing because they cannot make profit.

South Korean enterprises must examine the factors listed below to promote project. Firstly, the project should begin on a small scale and then expand gradually as credibility grows.

Secondly, it is important to make appropriate scale investment plan considering the relations with the enterprise's current business. Facilities, a supply of materials, and management must all be secured.

Thirdly, conditions affecting the prosperity of the project must be examined. The enterprise has to understand the risks involved with the agreement, during importing and exporting, in sales, approval of visiting, approval to export materials and facilities, and the restrictions in South Korean law. For example, the enterprise must examine the category of strategic goods, and the requirement for special approvals on certain foods, liquors, and drugs. Before beginning the project, it needs to check sales network, market, and physical distribution system, and needs to consider over competitiveness among the enterprises dealing

with similar item. This analysis can aid assess the profitability of the project.

(3) Cooperation Style and Deciding Business Item

The joint management system that is the connection of South Korean capital and North Korean site, building, and labor, includes difficulties in quality control and labor disputes. In this system, the legal rights of South Korean enterprises are limited. One option for smaller enterprises is to open a business with N. Korea in cooperation with a larger enterprise.

Choosing appropriate commodity for the cooperative project with N. Korea is vital. It is desirable to choose items whose raw materials are available in N. Korea and for which the cost of physical distribution is low. E-commerce could prove successful as although it requires high technology, no transfer to N. Korea takes place during the investment and business development phase.

(4) Importance of Funding

Funding is important for projects with N. Korea, which usually demand continuous capital supply. South Korean small business should not enter cooperative projects because of the bad South Korean economic conditions, the low cost, or shared language of N. Korea. It is not usually possible to make profit within 4~5 years, and it is impossible to make large profits with only small investment in a cooperative project.

B. Securing Cooperation and Choosing a Counterpart

(1) Guide for Contacting North Korea

North Korean government designated the “Association of National Economic Cooperation” as the sole channel for the economic cooperation with S. Korea.

The enterprise trying to engage in business with N. Korea for the first time will usually select an agent in Hong Kong, Japan, China, a professional agency for investment in N. Korea, or a South Korean enterprises already operating in N. Korea. Persons in political or social organizations are not suitable as agents.

North Korean officials or counterparts should be met in a humble, friendly manner, showing neither economic superiority nor ignorance. N. Korean counterparts may demand more than expected. The N. Korean system should be approached with an open mind, discussing business but not politics. The North Korean party concerned will have much experience of interviewing South Korean enterprises and will have their own criteria for assessment. Their principle criterion is whether the South Korean enterprise is sincere. They prefer sincere small-scale enterprises with a strong will to continue the project, rather than an enterprise with abundant funds and glossy business plans. The “sincerity” can be demonstrated by a feasible plan and effective negotiations with N. Korea.

(2) Securing a Credible North Korean Counterpart

It is important to secure a credible North Korean counterpart, preferably in a high-ranking position of authority. The successful

development of the project, in some sense, depends on the counterpart.

The North Korean counterpart also poses a risk to the South Korean enterprise. North Korean apprehension derives from the loss and damage experienced during the previous cooperative projects with South Korea. It is important to build up mutual trust by developing the cooperative business sincerely. It is reasonable to expect the North Korean counterpart will honor the agreement. If the project is not profitable for North Korea, the organization or the representative of the project will be reprimanded by the North Korean authorities. North Korean party concerned think they have not established a single good plant yet in spite of long-term cooperation project with South Korea as well as their experience of failure in Rajin-Sunbong SEZ project.²⁸ This experience inclines North Korean against beginning cooperative business.²⁹ Furthermore, it is important to ensure changes in South Korean conditions do not adversely influence the cooperative project schedule.

New cooperative businesses must confirm the credibility of the North Korean counterpart even through an agent of a third country. It is also important, however, to build up the relations of humanity with North Korean people in the cooperation

²⁸ In these days, North Korean authorities complain to the related persons that “During the 10 years economic cooperation, they have not build up a good plants, and the processing trade has not yield profit to N. Korea, and other trade also suffer difficulties owing to uncollected amount, giving bad image to N. Korean people.” *Joongangilbo* (September 17, 2004).

²⁹ It is same in the case of claiming from South Korea. Because the North Korean person in charge will be reprimanded, it is not easy to make a claim. Interview with Sung-soo Kim, former director of Seojeon Apparel (May 10, 2004).

business, although demanding the right on the basis of the agreement. North Korean counterparts are best selected with the assistance of an experienced and successful cooperative enterprise.

C. Negotiation and Agreement

(1) Principles of Negotiation and View

Both parties involved in the cooperative project typically meet in Beijing or Dandong or by telephone. There are two important factors in negotiation.

Firstly, the business principle of give-and-take must be remembered. Accurate information must be collected through thorough investigation and analysis, and in negotiation, explain with statistics and logic. N. Korean counterpart will only cooperate on this basis. Compare the project with the cases of other countries and persuade N. Korean counterpart it will make profit to N. Korea.³⁰

Secondly, consider the possibility of project success. Unrealistic promises or agreements reduce trust and will an obstacle to future business. The North Korean counterpart will often request letters of investment intent during the negotiations.

³⁰ North Korean counterpart try to accept reasonable offer on the basis of objective and concrete evidence. For example, Taekwang Techo Co. presented exact data comparing the processing cost in Chinese plants and N. Korean plants, then made agreement of processing cost in 2003. Interview with Sang-kwon Ahn, director of Taekwang Techno Co. (May 10, 2004).

(2) Check Points in Making Agreement

Prior to making an official agreement, the two parties will typically exchange the letter of investment intent and the Memorandum of Understanding (MOU) for the cooperative project. The letter of investment intent includes the list of business items, outline of the project, contents of the project, scale, location, management, and procedure and schedule. The letter of investment intent is not legally binding and remains negotiable.

The MOU is the final negotiation between the two parties, which will form the official contract. The MOU will be signed by the project manager, but is not legally binding. The MOU includes the title of the cooperative company, location, term and concerned law, name and address of the manager, total amount of investment, proportion of investment, registered fund, funding style, board of directors, business item and scale, sales of the product, and employment and payment.

The contract must include all details as it is legally binding. The contract must define general rules, establishment of company, goal of business, scope and scale, total amount of investment and registered person, borrowing money and liquidation, duty of each party, transfer of technology and use of brand, raw materials, supplying parts, product sales, board of directors, management organization, labor management, tax, financing, accounting and auditing, distribution of profit, dissolution and liquidation of company, insurance, change of contract, revision and cancellation of contract, responsibility of default, irresistible force, related law, solution of dispute, and supplementary provisions. Additional contracts regarding production must include name of goods, size, available period,

packing, loss rate of raw material, unit cost and increase rate of raw material and processing, conditions for supplying facilities and redemption, quality and delivery, technical training, compensation for damage, and solution of dispute.³¹

The contract should be with the business manager. When arranging a contract through a trading channel of N. Korea, it needs to have written guarantee that approves the effect of the contract or promising of making another contract in the future. In case of contract through an agent, it needs to have the contract the agent had made with the person in charge. North Koreans most commonly break contracts by failing to meet delivery date, product quality or quantity, or payment schedule. A means to resolve settlement dispute should be included in the MOU.

D. Stage of Driving Project

(1) Securing Leadership of Driving Project

Establishing strong leadership for the North Korean counterpart is an important factor in driving the project to make profit. The success of the project depends on management of the N. Korean counterpart. While recognizing the N. Korean counterpart's opinion may lead to failure, only the S. Korean enterprise can create success.

The first step in managing the N. Korean partner is to prepare a contract that includes the S. Korean enterprise's requirements

³¹ T enterprise, dealing natural water, had to quit the cooperation business because its contract did not include the extent of price raising. It needs to make concrete contract including all details to prevent unreasonable demand of N. Korean counterpart.

and outlines the benefits the N. Korean can expect, which will ensure the N. Korean honors the contract. The S. Korean enterprise must then demonstrate the will to terminate the project if the N. Korean party does not honor the contract, demanding compensation for damage caused by the N. Korean party. Specific data must be presented to the N. Korean counterpart, illustrating that the contract is reasonable. To avoid difficult negotiations, sufficient statistical data should be prepared to persuade the N. Korean counterpart. The N. Korean party's participation in resolving any problems is an important guarantee. For example, it is needed to get the promise that S. Korean persons will stay in N. Korea and N. Korean counterpart will accept it if needed to settle down the dispute. In addition, both parties have to make it sure such agreement is not fulfilled, the cooperation project will be stopped and N. Korean party is responsible for the loss caused by such trouble.

The S. Korean enterprise must demonstrate that the project will generate sufficient economic profit and technology transfer to ensure the N. Korean party will not give up or terminate the project. Guarantees must be honored by both parties. The S. Korean enterprise must persuade the N. Korean counterpart with clear and objective data, and should not change words according to the N. Korean counterpart's attitude change.

(2) Technical Guidance and Management of Labor

The quality of the product is vital to the success of the cooperative project. Experienced personnel and proven technology will ensure a good quality product. However, it is not easy to train experts in the cooperative project with N. Korea. Newly

established plants that have no expert staff will especially likely to produce defective goods. Many N. Korean workers tend to move companies, often following training.³² The S. Korean enterprise is not permitted to recruit workers directly. Only the N. Korean government organization of labor can distribute workers. Although the technology training is important, conditions for the provision of such training are not good in N. Korea.

It is difficult to ensure the quality of goods without addressing such problems. The S. Korean enterprise must therefore develop a solution using available labor supply and technical training. These issues must be addressed in the contract negotiation stage, with clear penalties.

The S. Korean enterprise must make an agreement with the N. Korean counterpart to provide technical training at a certain place and time the S. Korean party designates. N. Korean workers are good at working to order but lack a problem-solving capability. The S. Korean enterprise must provide thorough education in diagnosis of mechanical failures and repair. The N. Korea party will consider this training as capitalist interference. The S. Korean enterprise must insist on the training and persuade the N. Korean party of the mutual benefits, using clear data and a long-term vision.

In general, the N. Korean counterpart will not like being directed

³² T enterprise had N. Korean workers who had worked in the factory of making drinks and cans. Such workers could learn about production facilities quickly, and the high ranking workers were good at technology and operating machinery. Although T enterprise tried to make them work 8 hours a day and 6 days a week, N. Korean manager changed their working time as he needed.

by the S. Korean enterprise. However, the N. Korean party will be very interested in high technology industries.³³ Using such attitudes, the S. Korean enterprise must promote the merits of S. Korean technology to induce N. Korean interest in the project and eventually securing the training schedule as the S. Korean enterprise requires. In some cases, N. Korean technicians may be trained in Vietnam, China, or South Korea. For example, Pyonghwa Motors has factory in Vietnam. Technicians from Japan and Vietnam visit N. Korea to provide technical training, usually staying for 6 months. The South Korean technicians, however, may only stay for about 2 months when providing training.

(3) Production and Others

The production process must be explained in detail to the N. Korean counterpart. The S. Korean enterprise must prepare a written contract for agreement, and include additional delivery time to anticipate delays by the N. Korean counterpart. In the clothes processing trade, sample or model clothes should be sent as well as instructions to ensure the correct product is manufactured.

S. Korean enterprises must make clear they will claim for losses suffered from faulty production procedures. Many S. Korean enterprises are unwilling to make claims.

In addition, communication channels with the N. Korean coun-

³³ In case S. Korean subcontracted small enterprise order N. Korean party, it is desirable for small enterprise to visit N. Korea with big enterprise to make PR about the technology for producing goods to induce interest of N. Korean party.

terpart must be kept open for the management of production. In the absence of a direct trade office between the two Koreas, a liaison office in the third country should be established.

2. Cooperation Between Governments

A. Priority Solution of Obstacles against the Economic Cooperation

The S. Korean government has to solve the problems restricting economic cooperation as soon as possible. Major problems include communication problems during negotiations, securing free entrance, inferior and expensive physical distribution systems, and the absence of an inter-Korean banking system.

The S. Korean government, through negotiation with N. Korea, must establish institutional measures that ensure the market system in the economic cooperation between the two Koreas. As the priority task, the government must create a contract of communication and entrance as a subsidiary contract of “Big Four Agreement on Economic Cooperation.”

70% of the businessmen surveyed considered the priority task for the North Korean government to be guaranteed free access for S. Korean enterprises. If such an agreement cannot be reached quickly, a channel for negotiating economic activity is an immediate necessity. An economic cooperation office should be established in the Kaesong Industrial Complex, which could be used as the channel for economic negotiations. These institutional measures are the first steps towards a South-North Korean agreement on direct trade.

A direct trade system should recognize official trading partners. Although the N. Korean government has not recognized S. Korea as an official trading partner, the expansion of direct trading with S. Korea demonstrates a change of attitude. Changing from indirect trade through third country agents to direct trade will reduce inefficiencies, such as the communication difficulties, claiming, settlement, and time and cost. In addition, it will reduce the inefficiency of indirect payments and document duplication by revealing origin of the product, and preventing disguised imports from third countries. The expansion of direct trade will increase profitability and legal protections.

In order to create a direct trading system, an institutional and physical supply system must be established. The physical supply system includes a negotiation channel for agreements, connection of communication and mail services, and establishment of a physical distribution through land and ocean. An institutional supply system includes decision of trading items, confirmation of origin, establishing direct settlement system, coordination of dispute resolution, and preparation for future petition to the World Trade Organization (WTO) on direct trading.

B. Supporting the Activation of Economic Cooperation

(1) Cause for Government's Support

South-North Korean economic cooperation projects face political risks as well as inherent business risks. In contrast to simple one-time trade, processing trade or investment projects require repeated relocation of facilities, shipment of raw and subsidiary materials, production, import of production equipment. These

elements are all affected by political relations of the two Koreas. Because S. Korean enterprises supply facilities and materials first, the S. Korean party bears the risk until the finished products are returned.³⁴ The N. Korean counterpart offers no insurance on the S. Korean materials, and deliveries of finished product can be delayed or cancelled. In the worst case, the project itself can be closed. Although there is the “Agreement on the Investment Insurance” between the two Koreas, it is difficult to apply this contract to real situations. Disputes are difficult to solve on-site because it the South Korean party cannot visit freely. Until now, South-North Korean cooperative projects have been characterized by the S. Korean party minimizing losses while the N. Korean party maximizes profit.

South-North Korean cooperative projects are different from business within S. Korea in pattern and content. As cooperative projects are beyond the control of S. Korean enterprises, the S. Korean government should support the project. Government support can reduce the political risk of the project.

(2) Stance of the Enterprise regarding Government’s Support

S. Korean enterprises participating in cooperative projects with N. Korea require the support of the government on funding, opening a land route, establishment of an economic cooperation office, and an increase of shipping companies and regular shipping services.

³⁴ The cost of raw and subsidiary materials is 70~90% of finished product for the item of clothes, electric and electronic industries, high proportion compared with other items.

The enterprises contributing to the research, chose the connection of rail and road links, improvement of harbor facilities and SOC in North Korea, and the support by the South-North Cooperation Fund as the most important tasks for the S. Korean government to encourage cooperative projects.

The improvement of SOC such as the connection of road links and establishing harbor facilities cannot be achieved quickly. South Korean enterprises therefore seek the immediate expansion of financial support. The S. Korean enterprises believe that the process for obtaining funding is excessively complicated and difficult, and the amount of financial support is inadequate. Enterprises complain that the S. Korean government is ungenerous with support for private enterprises while actively supporting the reunion of separated families and cultural projects. Although the government encourages the cooperative project by highlighting the low cost of labor and sites, the real cost of the projects are high when including the subsidiary cost, risk, and other difficulties faced in the procedure. Although the S. Korean government has supported Kaesong Industrial Complex with ample funding and personnel, it has not provided substantial support for cooperative enterprises or the processing trade with North Korea.

South Korean enterprises also have other negative observations on the projects. Firstly, although it is widely considered that S. Korean enterprises participating in cooperative projects with N. Korea obtain generous support from the government, this is not the case. Many consider the private enterprise business in the same category as humanitarian aid, the establishment of Kaesong SEZ and Mt. Kumgang SEZ, and the connection of Seoul-Shinuiju and East Coast rail and road links.

Secondly, the frequent change of senior personnel at the Ministry of Unification contributes to the inefficiency of this project. Each time personnel change abruptly, the individual projects must be explained once again from first principal and government support requested. This leads to inconsistent support for the projects.

Thirdly, many S. Korean enterprises seek to participate in the Kaesong Industrial Complex project but not in other areas because the government promotes the Kaesong project as a national task. Many enterprises regard this as discrimination against other regions. Government support must be distributed equally.

Fourthly, the current law of the “Supplement for Loss System” is inadequate for the real world.³⁵ Enterprises seek a revision of this instrument.³⁶ For example, if the Mt. Kumgang project has historical significance in contributing to the reconciliation of the divided Koreas, any loss suffered by the business proprietor due to the political situation and tension should be compensated by the S. Korean government. Many S. Korean

³⁵ According to the “Supplement for Loss System,” for the loss caused by emergent accident or by the fault of N. Korean counterpart, S. Korean government supplement a part of the loss from the South-North Korean Cooperation Fund.

³⁶ There are two supplement systems, the “Supplement for Loss System (May, 2004)” for the trade with N. Korea and the “Supplement for Loss System for South-North Korean Economic Cooperation Project.” According to the former system, South Korean enterprises participated in this agreement shall be supplemented by the government for 50% of the loss caused by N. Korean counterpart of emergency accident. According to the latter system, South Korean enterprises participated in this agreement shall be supplemented by the government for 70% of the loss caused by N. Korean counterpart of emergency accident, and 90% of the loss in the Kaesong SEZ.

enterprises began business dealings with N. Korea as a matter of national pride and perceiving an important role in the improvement of South-North Korean relations. Private enterprises with business in N. Korea, as a part of important national project, emphasize need for government support.

Fifthly, the status of the Ministry of Unification must be enhanced. The government must promote the authority of the Ministry of Unification to manage the cooperative projects. The main support for the cooperative projects is financial, such as from the South-North Korean Economic Cooperation Fund. The government must therefore support the project at the national level.

Finally, South Korean enterprises seek government support in consistent planning and approval of projects. The government should encourage and support the cooperative projects as the enterprises by minimizing supervision and regulations.

(3) Items and Contents of the Government Support

(A) Financial Level

Firstly, S. Korean enterprises seek government support at the production stage. Sending raw materials to N. Korea, delivery of the product, sales of the product, and settlement takes more than 2 months longer than the same activity in normal domestic business. Many enterprises suffer financial problems during the period and therefore seek financial support from the Export-Import Bank of Korea to smooth business operations. Because N. Korean counterparts do not deliver the product until payment is made, many S. Korean enterprises have been dishonored.

Secondly, where the S. Korean government cannot provide financial support to the cooperative projects with special loans, many enterprises seek government insurance for the materials exported to and investments in facilities in N. Korea. This should be accepted as a mortgage for loans from S. Korean banks. The mortgage list should be expanded to include machinery exports, SOC, and other buildings constructed in N. Korea.

Thirdly, the S. Korean government should offer compensation for the financial shortfalls of N. Korea. Because there is no internal market in N. Korea, it is impossible to export goods targeting the N. Korean market or sell products produced by cooperative projects in N. Korea. Some N. Korean counterparts suggest compensation trade, by which N. Korea imports materials or purchases the product from the cooperative project and pays S. Korea with substitute materials.³⁷ However, it is difficult for S. Korean small enterprises to import and market substitute materials unrelated to their principal business. S. Korean enterprises therefore hope the government will establish a network of enterprises to sell substitute materials or give assurance of mortgage to the substitute by making an open account.³⁸ The regulated quotas on imports of some North Korean materials should be revised to enable smoother trading.

Fourthly, the government's support for physical distribution is

³⁷ For settlement measures, there are letter of credit, remittance bill, and others. Letter of credit is opening credit to the agent of a third country, and remittance bill (or T/T) is making remittance to the N. Korean account in a third country bank. In remittance, first send 30~50% of the total amount against the risk of N. Korean non-fulfillment and send the remainder after delivery of the product. In some cases, compensation trade is adopted.

³⁸ Small Business Corporation, *Cases and Procedure of South-North Korean Economic Cooperation of Small and Medium Business* (2003), p. 49.

important. Currently, shipping between the two Koreas passes through Incheon-Nampo and Busan-Rajin ocean routes where third country ships operate, and another route through Dandong (China). These shipping routes are limited and expensive because of low volumes of freight. South Korean enterprises seek government subsidy of the shipping fare to reduce the physical distribution cost.

In addition, S. Korean enterprises want the government to offer substantial institutional support such as banking and insurance system rather than free support.

(B) Institutional Level

The main institutional difficulties South Korean enterprises face in the cooperative projects with N. Korea are transportation (26.8%), gaining approval to visit and contact N. Koreans (17.5%), gaining approval to trade (16.1%), and Customs clearances (12.9%).³⁹

Procedure for approval to visit and contact North Koreans must be simplified. South Koreans, including those resident in foreign countries, who want to contact N. Koreans for cooperative projects or other trade must gain permission from the Ministry of Unification in advance and report the result after contact. The documents needed for gain approval to contact North Koreans, usually through internet, are:

- ① Application for contacting North Koreans;
- ② Identity paper;

³⁹ The Korea Traders Association & the Ministry of Unification, *Report on the Improvement System of South-North Korean Trade and the Improvement of the Procedure* (August, 2004), p. 4.

- ③ Company introduction letter;
- ④ Plan of the project with N. Korea;
- ⑤ Letter of Introduction (LOI) from N. Korean counterpart;
- ⑥ LOI from intermediary company;
- ⑦ Copy of identity number of trading permission; and
- ⑧ Copy of registration of businessman.

The documents required for approval to visit North Korea are:

- ① Application for permission to visit N. Korea;
- ② Identity paper;
- ③ Letter of Invitation;
- ④ Photograph;
- ⑤ Visit plan;
- ⑥ Letter of company introduction/letter of attorney, and permission according to the Article 70, the Military Service Law (related person). In addition, the visitor has to report the result within 10 days after visit.

61.8% of the enterprises conducting business with N. Korea were dissatisfied with these procedures, complaining of lengthy approval time (30.9%) and complicated paperwork (30.9%). Many requested simplification of the application papers, improvement of the result reporting system, and a reduction in the approval period, claiming that the letter of introduction from the N. Korean counterpart and intermediary company serve no purpose. A company beginning new business in N. Korea would find it impossible to get the data for such documents.⁴⁰

In light of these concerns, S. Korean enterprises seek a reduction in the period of application approval from the current 7~20 days to 7 days for contacting North Koreans, reporting contact with N. Koreans post factum, permission to visit N. Korea,

⁴⁰ *Ibid.*, p. 14.

and permission to visit N. Korea for residents of foreign countries. The current 10 days period for the submission of the report of contacting a N. Korean and submission of a report of the result should be retained.

Documents should be simplified, with enterprises exempted from providing a copy of businessman registration (application to contract a N. Korean), identity paper (application to visit a N. Korea), and introduction paper of company (application to visit N. Korea). Identity papers should only include immediate family and not friends. Papers of introduction from N. Korean counterparts, introduction of intermediary company, and project plans for N. Korea, should only include title, person in charge, and contact address in the contents section. North Korean visa and invitation letter should only require submission of documents once, for the first visit, and not annually. Furthermore, the application to visit N. Korea should be automatically include an application to contact N. Koreans.

To gain the approval to visit N. Korea, the applicant must submit a “safety assurance” issued by N. Korea, even though the safety of the visitor is the responsibility of both authorities. Demanding a “safety assurance” from the N. Korean authorities reveals the South's distrust of them, which may cause difficulties to S. Korean enterprises engaging in talks with N. Koreans.

Secondly, the range of general approval commodities should be expanded. Trading commodities are classified as either “general approval item” (approved by the Minister of Unification in advance) or “special approval item” (which requires specific approval). “General approval items” can be cleared in Customs without an approval letter. Facilities exported to N. Korea are

usually “special approval items” and raw and subsidiary materials are “general approval items.” Facilities should be included in the “general approval item” category to improve trading conditions with N. Korea.

Thirdly, the S. Korean government imposes value-added tax (VAT) on the processing fee while the product itself is exempt from tax. Importing through a third country attracts tax. Internal taxes such as the special consumption tax, liquor tax, education tax, and transportation tax are paid at Customs. Exporting items whose raw material was imported, the tax paid on the raw material is refunded. For the materials of South-North Korean trade, the Customs clearance procedure for normal trading materials is applied, and normal report form of trade is used. The S. Korean government does not regard business with N. Korea as domestic trade. Regulations for internal trade between the two Koreas must be established, with an agreement to simplify the Customs clearance process.

Fourthly, it is difficult to confirm the country-of-origin. While there is no agreement about Customs clearance between the two Koreas, for clearance without tax, a document must be submitted to certify the North Korean origin. However, such documents lack credibility.⁴¹ Many Chinese agricultural and marine products are disguised as North Korean and imported to S. Korea. This exploits flawed regulation and an agreement

⁴¹ Certification of origin is issued by related government organization in order to certify that certain material or product is produced or processed in this country. In North Korea, it is called certification of producing district, and is issued by “Inspection Office for Exporting Product” under the “North Korean Inspection Committee for Exporting Product.” Certification of origin is needed to be exempted from tax, and all products from N. Korea is inspected to confirm the certification.

is therefore required between S. Korea, N. Korea, and China, about the procedure of Customs clearance and certification of products from N. Korea.

C. Establishment of Internal and External Conditions

The improvement of inter-Korean economic cooperation reflects the improvement of the two Korea's relations, North Korean reform and open policy, and changes in North Korea towards cooperative projects.

By reform and open policy, North Korea will begin to understand the capitalist economic system, accept international practice, and permit the economic activity of South Korean enterprises. South Korean businessmen will then be able to visit N. Korea freely, quality control engineers will be able to stay for longer periods and independent private company will be able to open businesses in N. Korea. Without such developments, economic cooperation between the two Korean cannot be realized. Only North Korean reformation can expand the investment opportunities.

South Korean enterprises hope S. Korean government makes efforts in key areas to improve conditions for economic cooperation. Firstly, N. Koreans need to experience the S. Korean capitalist economic system. Through such experience, N. Koreans will understand the consequences of their unilateral demands for increased processing fees, which cause difficulties and ultimately losses to both parties; the difficulties in communication and physical distribution that cause delays in production and delivery, decreasing profitability; and their conditional negotiation and unilateral demands for support are in conflict with the basic sense of responsibility in economic cooperation.

By improving North Korean understanding of the capitalist system, the S. Korean government must invite N. Korean economic officials, managers, and engineers to S. Korea, and demonstrate economic facilities to educate them about the principle of a market economy. This can be achieved by inviting N. Korean technocrats to experience the market economy and international capitalist system. In addition, economic cooperation should be encouraged within S. Korean territory, such as permitting a famous N. Korean restaurant to open in S. Korea.

Secondly, N. Korean authorities should acknowledge S. Korean enterprises' business with N. Korea as official trade. Although N. Korea has law system including the Law of Joint Management, Law of Foreign Economy, Law of Foreigner's Investment, Law of Management of Foreign Currency, and Law of Customs, there is no law regulating and promoting the South-North Korean economic trade. It is not clear whether N. Korea regards S. Korean enterprise as a foreigner.⁴² North Korea does not institutionalize the trade with S. Korea by law, but instead controls and manages according to whim. S. Korean enterprises therefore have no trust in North Korean law. There is no North Korean law defining or regulating South Korean enterprise, and the only channel to contact South Korea is through the "Organization in Charge of South Korea." This forces S. Korean enterprises seeking cooperative business with N. Korea to engage a powerful counterpart related to the N. Korean authorities. In

⁴² According to the Law of Foreigner's Investment, "expanding and improving the economic cooperation with other countries is the DPRK's consistent policy. The DPRK encourage the investment of foreigners insuring the principle of equality and reciprocity. (Article 1)" In accordance with this provision, S. Korean enterprise is supposed to be regarded as a foreigner. However, N. Korean authorities does not regard S. Korean enterprise as a foreigner or executing reciprocal measures.

order to generate smooth and consistent economic cooperation between the two Koreas, the counterparts must be recognized as official partners.