

**SUNSHINE POLICY OF THE D J KIM ADMINISTRATION AND ITS
EFFECTS ON NORTH-SOUTH KOREAN ECONOMIC COOPERATION**

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Introduction

The historic summit meeting between South Korean President Kim Dae-Jung and North Korean leader Kim Jong-Il in June 2000 produced a five-point agreement, which made a specific reference to “promoting balanced development of the national economy through economic cooperation” among others. The North-South summit was a culmination of the Kim Dae-Jung administration’s “sunshine policy” of engagement, cooperation and exchanges aimed at inducing changes in North Korea toward opening up and reforming the country. The sunshine policy was especially well timed to accelerate certain recent positive moves in the North Korean attitudes towards the outside world.

In recent years there have been a number of encouraging signs and certain tentative developments indicating that North Korea may be seriously interested in broadening its relationship with the international community as part of the efforts to emerge out of its prolonged isolation. Many observers ascribe its motivation to the North Korean desire to develop its battered economy by emulating in part the Chinese model of adopting limited economic reforms while maintaining its Socialist political system. The desperate state of the North Korean economy has been well documented and widely reported.¹ In rebuilding its economy, the country faces perhaps one of the biggest challenges in securing a vast amount of needed investment capital, especially in the critical area of infrastructure development and modernization. For example, poor infrastructure accounts for the unusually high transport costs in North Korea, where the cost of transporting a 20-foot container from Inchon in South Korea to Nampo in North Korea is four times higher than the cost of shipping the same container to China. Any meaningful economic development of North Korea requires huge sums of investment capital, especially the external capital in convertible foreign currencies in order to procure essential capital equipment and modern technology.

This paper evaluates the effects of the June 2000 summit meeting on the economic

¹ For example, Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas*, Institute for International Economics, Washington, 2000.

cooperation between two countries and also discusses potential sources of foreign capital for North Korea that might be available for the country's economic development in the near and medium term into the future. There is a general agreement among experts that North Korea needs a large sum of investment capital to resurrect its battered economy. While the precise number is extremely difficult to project by its very nature, South Korean research institutes have come up with the estimates ranging anywhere from \$40 billion to \$2,240 billion as the potential total cost for the North-South unification, based upon the German unification experience where the new unified German government expended annually a sum equivalent to about 5-6 percent of the German GDP. Of course, the total unification cost is much higher than the amount needed for developing the economic infrastructure of North Korea to that comparable to South Korea's due to the extra costs involved in such areas as social and humanitarian assistance.

Economic Cooperation Since the 2000 Summit Meeting

Since the summit meeting, there have been an increased number of economic exchanges between the two countries. South Korea has increased its economic assistance to North Korea, including food and fertilizer aid. The South Korean government increased the size of its North Korean cooperation fund more than five fold in three years, from Won 172 billion in 1999 to Won 635 billion in 2001. Even though the progress has been very slow, various economic reform measures have been adopted in North Korea since the summit. Recently, North Korea changed several constitutional articles related to economic activities and has accommodated some of South Korean requests regarding changes in its economic policies, such as introduction of investment guarantees, adoption of international standards for resolving commercial disputes, protection of private and intellectual property rights, and prevention of double taxation.

Initial agreements have been reached to proceed with infrastructure projects, starting with construction of a rail link, a highway, and flood control on the Imjin River. Also, agreements were reached to move ahead with new projects in the north, the most significant being the agreement with Hyundai to proceed quickly with the development of an industrial zone in Kaesong. A vice ministerial-level inter-Korean committee has been established to work on economic cooperation on a continuous basis. In South Korea, a new inter-ministerial

coordinating committee, chaired by the Minister of Finance and Economy, has been formed to facilitate internal coordination and the vetting of issues needing decisions at the highest levels of the National Security Council and the President. The Federation of Korean Industries (FKI) has set up a North Korean coordination organization for the private sector to act as a sounding board for raising private sector perspectives and ideas on obstacles to investing and successfully operating business ventures in the north. The organization has already established working groups for several areas of investment and has invited participation from American, Japanese and European firms located in South Korea who are interested in business prospects in the north.

Internationally, South Korea has openly supported the development of relations between North Korea and the international financial institutions (IFIs) and the South Korean government has floated the idea of creating an internationally supported fund to assist in the financing of infrastructure projects in the north. For the first time, North Korea was invited to attend annual meetings of the World Bank and IMF as a Special Guest in 2000. Similarly, Japan and North Korea accelerated their negotiations on normalization of relations and possible future Japanese financial assistance for economic development in North Korea as well as politically sensitive issues in their relations.

North Korea has also enlarged its economic cooperation with other countries in recent years. In order to link the Trans-Korean Railway (TKR) with Trans-Siberian Railway (TSR), railway ministers of North Korea and Russia met in March 2001 and subsequently the two countries exchanged railway delegations to discuss concrete measures to link the two railways. Also in 2001, North Korea and Germany established the Common Economic Community (CEC) to deepen economic cooperation in electricity, railway transportation, communication, etc. Also in 2001, the Netherlands entered into a cooperative agreement with North Korea in electricity generation, and Australia agreed to assist North Korea in exploration of mineral deposits, among others. A number of European delegations have visited North Korea in recent years to discuss various measures in order to promote economic cooperation with North Korea.

Despite these measures, however, no major breakthrough has been made in inter-Korean economic cooperation. Many of the initial high hopes raised by the summit meeting have not been followed by subsequent concrete actions, starting with the aborted return visit to the South

by North Korean leader Kim Jong-Il. Several planned meetings between North and South Korean economic officials have been abruptly cancelled by North Korea, and most South Korean chaebol firms such as Samsung, LG and SK have taken a wait and see attitude before taking new business ventures in North Korea, and only Hyundai has demonstrated a consistent enthusiasm for North Korean ventures but it has been undergoing tough financial difficulties, many blaming Hyundai's financial troubles on its failed North Korean ventures.

However, North Korea's international contacts have materially increased since the onset of the sunshine policy. The total number of North Korean delegations engaged in foreign training programs increased from only 3 in 1996 and 11 in 1997 to 25 in 1998 and 21 in 1999. With the assistance of the World Bank, the United Nations Development Program (UNDP), and the governments of Switzerland and the Netherlands, Shanghai University of Finance and Economics has designed in 1998 an Economics Management Training Program for 25 to 35 North Korean economic officials but at the last moment the North Korean government requested to postpone the training program. Many programs planned for 1999 were cancelled or delayed, perhaps due to a series of political defections by North Korean diplomats in 1998. After the former North Korean ambassador to Egypt defected to the United States in August 1997, three more diplomats followed suit in 1998. Another factor explaining North Korean reluctance to expand its foreign contacts appears to be the publicity surrounding these contacts. Apparently, North Korea seeks to avoid any publicity that might suggest that it is taking steps toward "economic reform" or system transformation.

One of the ongoing projects is the Tumen River Area Development Program (TRADP), launched in 1991 by the UNDP and four North East Asian countries of China, Russia, Mongolia, and South Korea. Japan has not formally joined the group, but has participated as an observer, along with the United States and several other countries from outside the subregion, which have taken an interest in the program. A UNDP-funded development initiative aimed at promoting regional economic cooperation, the project is to cost about \$30 billion over 20 years in order to turn the Tumen River area into the transportation and trading hub of Northeast Asia. As part of its plan for the project, North Korea declared both Chongjin and Rajin free economic development zones, and TRADP has provided a means to assist North Korea to develop policies

for the free economic zone and to demonstrate international support for this modest indicator of willingness to open up and consider new ways of relating to foreign business interests. But so far the project has not progressed as originally envisioned due to the fact that many issues related to TRADP are really national policy questions, not limited to an experimental economic zone alone and because the government focus seems to shift to overall nationwide reform measures and away from the TRADP framework.

North Korea and International Financial Institutions

Since the end of World War II, a number of IFIs have been established for the express purpose of providing external finance and technical assistance to developing countries. The oldest and the most well known among them is the World Bank Group, which is composed of three operational agencies of the International Bank for Reconstruction and Development (IBRD), International Development Association (IDA) and International Finance Corporation (IFC). Along with the World Bank, the other twin IFI born in the 1944 Bretton Woods Conference is the International Monetary Fund (IMF). IBRD loans have maturities of 15 to 20 years in general at an interest rate of 6 to 7 percent, calculated on the basis of annual weighted long-term borrowing costs of the World Bank's international bond issues plus a 0.5 percent margin. IDA credits have much longer maturities of 35 to 40 years and carry no interest except for annual service charges of 0.5 to 1 percent, and they are available to poorer developing countries whose per capita GNP as of 1996 was below \$925. According to an estimate by the Bank of Korea, per capita GNP of North Korea stood at \$573 in 1998, thus making the country eligible for IDA assistance. The IFC is the private sector assistance arm of the World Bank Group. While IBRD and IDA loans are extended to governments and government agencies of developing countries, the IFC makes loans as well as equity investments exclusively for the private sector firms in developing countries without any government guarantees. Since private firms in North Korea are almost non-existent at present, IFC might be less relevant at this stage but it can play a useful role later when foreign direct investments lead to establishments of private business entities either as stand-alone companies or as joint venture firms in partnership with North Korean host organizations. The IMF has many lending facilities ranging from five-year credit tranche loans to 10-year extended

fund facilities and others. The IMF equivalent to IDA credits is the Poverty Reduction and Growth Facility (PRGF) available only to poorest developing countries, with the same per capita GNP cap of \$925 as of 1996 as in the case of IDA credits.

The real problem, though, is that the normal financial assistance from the IMF and the World Bank Group is available only to their member countries. The same is true of other regional IFIs such as the Asian Development Bank, Inter-American Development Bank, African Development Bank, and the European Bank for Reconstruction and Development.

Unfortunately, North Korea is not a member of any IFI. In April 1967, the country made its first formal attempt to join an IFI by officially applying for a membership in the Asian Development Bank (ADB). The ADB, headquartered in Manila, the Philippines, has the IDA credit equivalents known as the Asian Development Fund (ADF) credits. ADF credits have a maturity of 35 to 40 years and carry no interest rates except for annual service charge of 1 percent. Despite strong support for the North Korean membership application from China, South Korea and several other Asian developing countries, the two largest ADB shareholders, the United States and Japan, have been against admitting North Korea into ADB and their vetoes effectively have stalled the North Korean application. North Korea has continued to show its interest in the ADB membership, by writing a formal letter in the summer of 2000 reminding the ADB board of its 1997 application.

Admission of North Korea into such IFIs as ADB, World Bank and IMF is contingent in practical terms upon the agreement of both Japan and the United States. The U.S. government withholds its agreement primarily due to the fact that since 1988 North Korea has been on the U.S. government's list as one of the seven countries supporting international terrorism. The other six countries on the list are Cuba, Iran, Iraq, Libya, Sudan and Syria. Furthermore, North Korea is considered a violator of the missile technology control regime. U.S. government officials have hinted on various occasions that North Korea has to satisfy the United States in the terrorism issue, ballistic missile-related matters, and transparency in its nuclear program before they can support the North Korean membership into IFIs. Japan on the other hand wants a satisfactory conclusion of the case of alleged North Korean kidnapping of Japanese citizens before it can consider supporting North Korean membership. Any membership into the World

Bank has to be preceded by North Korea being admitted into the IMF first. It is generally understood that a North Korean membership into the IMF would be similarly opposed by the United States and Japan, thus effectively precluding North Korea from becoming a member of both the IMF and the World Bank.

Since it will take some time for North Korea to be admitted into IFIs, North Korea might explore the avenue of international trust funds administered by IFIs even for their non-members. As mentioned previously, in 1993 the World Bank participated in establishing the Trust Fund for Gaza and West Bank for the express purpose of assisting Palestine that is still not a member of the World Bank. This trust fund raised over \$400 million through June 2000, including almost \$300 million from the World Bank out of its accumulated net profits and the rest from other donor countries, and these funds have been disbursed for various development projects in Palestine. In 1999, the World Bank and the Asian Development Bank collaborated to establish the Trust Fund for East Timor, which received funds from the World Bank Group as well as many individual donor countries such as Japan, Portugal and Australia. These funds have been used to finance many development projects in East Timor, which was not yet a member of the World Bank and the ADB. Similar trust funds were also established to assist Bosnia in 1996 and Kosovo in 1999, both of which were not members of any IFI at that time. North Korea should explore a similar approach until its formal membership into the ADB and the World Bank.

Some prominent experts in South Korea have recently proposed establishment of a new Northeast Asian Development Bank (NEADB) as a separate IFI with the implicit purpose of assisting North Korea. NEADB would be engaged in development financing in northeast China, Siberia and Mongolia along with North Korea. However, potential donor countries such as the United States and Japan are not likely to participate in such a bank since it would overlap similar functions already being performed by the World Bank and ADB, except for assistance to North Korea. Without the active support of these two major donor countries, the new bank is not likely to collect enough capital to become a viable IFI. Furthermore, all IFIs fund their operations mainly by issuing bonds in international capital markets and thus high credit ratings are essential for successful bond issues. Both ADB and the World Bank carry the highest credit ratings of triple-A's due to the strong financial backing from major industrialized member countries such

as the United States, Japan, the United Kingdom and Germany. Without their active support, the new NEADB is not likely to receive a high credit rating and thus its ability to issue bonds successfully at reasonable interest rates in international capital markets would be severely handicapped.

Promoting Private Foreign Direct Investments in North Korea

If North Korea provides a favorable environment for foreign direct investments (FDIs) by enacting the necessary laws and regulations regarding the property rights, profit remittances, accounting and taxes, labor standards, etc., it could attract FDIs as in the cases of China and Vietnam. The country possesses potential attractions for certain projects with labor-intensive assembly and manufacturing components, given the low cost but highly adaptable labor forces there. North Korea has developed a special economic zone (SEZ) in the Rajin-Sonbong area, which has suffered so far from its remoteness to potential market places and poor infrastructure there. Fortunately, there are plans to develop other SEZs in places such as the Haeju District on the western coast just north of Inchon which is a major South Korean port and next to the main airport for the Seoul metropolitan area as well as in the Kaesong City just north of the demilitarized zone with an easy access from South Korea. It is reported that the Hyundai Group would develop the necessary infrastructure and then lease the sites to Korean and other foreign investors. Most initial FDIs would be export oriented, given the negligible local market in North Korea. Furthermore, most FDIs might employ modern project finance methods that are not dependent upon the host entity's credit standing or balance sheet but rather upon the potential cash flows of the project itself. In such cases, some of the modern innovative project financing techniques such as build-operate-and-transfer (BOT) can be very useful in order to minimize the project risk on the part of foreign investors.

Conclusion

Since the historic North-South Korea summit meeting in 2000, there have been some palpable signs of North Korean outreach to the world in the economic field, along with diplomatic

initiatives. The sunshine policy of the Kim Dae-Jung Administration has been somewhat successful in drawing out North Korea toward more dialogues and exchanges with the international community. However, the success so far has not been as notable as originally expected in the immediate aftermath of the summit meeting. Due to complex internal political problems and inherent systemic weaknesses of the country, North Korea has been hesitant in opening up its economy and initiating needed economic reforms. By nature, any economic reforms and more open contacts with the outside world appear to be piecemeal rather than to follow a big-bang approach. This strategy of gradualism implies only a very slow progress in economic cooperation even after the summit, with each progress carefully reviewed and calibrated by the North Korean regime before proceeding further. The gradualism strategy seems suitable in securing the support of existing elites of the regime and in learning how to introduce market mechanisms into the country. It is interesting that North Korea has expanded its diplomatic relations with Western countries following the North-South summit, recently establishing diplomatic relations with 13 European Union (EU) member countries and the EU itself. The EU also announced a support strategy for North Korea over the next few years, including the energy sector and an education and training project to teach officials and businessmen the basic principles of a market economy and international trade. Economic cooperation between North Korea and individual European countries is increasing, too.

Among the most urgent economic cooperation issues is how to channel the needed massive international capital to finance modernization of infrastructure in the north. There are a number of potential international financing sources for North Korea's economic development. They range from various lending instruments available from IFIs to international trust funds, innovative project financing techniques for promising FDIs, a number of fixed income securities that can be issued in international capital markets, and international bank loans. Access to all these financing sources requires a careful strategy on the part of North Korea in terms of proper sequencing and preparation. Such international financing skills are woefully inadequate or almost non-existent in the country. Perhaps one of the first technical assistance programs that the IMF and the World Bank can embark upon could be to provide such expertise to the relevant North Korean authorities so that they can develop a systemic approach to accessing international

funding sources for their infrastructure projects.

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